

BEFORE THE
PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of)
Rocky Mountain Power to Increase)
Rates by \$29.3 Million or 1.7 Percent)
Through the Energy Balancing)
Account)

Docket No. 12-035-67

REDACTED

Rebuttal Testimony of

J. Robert Malko

On behalf of

Utah Industrial Energy Consumers

January 8, 2013

1 **Q Please state your name and business address.**

2 A J. Robert Malko. My business consulting address is 245 North Alta Street, Salt
3 Lake City, Utah 84103.

4 **Q Are you the same J. Robert Malko who filed direct testimony on behalf of**
5 **Utah Industrial Energy Consumers (“UIEC”) in this proceeding?**

6 A Yes.

7 **Q What is the purpose of your rebuttal testimony in this proceeding?**

8 A The purpose of my rebuttal testimony is to respond to the supplemental
9 testimony of Richard S. Hahn and Matthew Croft for the Division of Public Utilities
10 (“Division” or “DPU”), and the supplemental direct testimony of Brian S. Dickman
11 filed on behalf of Rocky Mountain Power (“Company”).

12 **Q Would you summarize the framework or criteria that should be used to**
13 **determine what costs incurred in the EBA period should be reasonably**
14 **assigned to the ratepayers as opposed to the shareholders?**

15 A As with all costs, “good utility practice” requires that three regulatory principles
16 should be used as a framework to analyze whether it is just and reasonable to
17 assign costs to ratepayers: (1) prudence and prudent management; (2) used
18 and useful; and (3) known and measurable. I agree with the following quotation
19 made by Dr. Jonathan A. Lesser and Dr. Leonardo R. Giacchino in their text
20 Fundamentals of Energy Regulation, 2007, p. 41:

21 Ideally, *Good Utility Practice* incorporates three regulatory
22 principles that determine whether utilities will be allowed to
23 recover their costs and earn a return on their capital
24 investments. These principles combine regulatory “carrots and
25 sticks” to encourage utilities to make disciplined economic
26 operating and investment decisions. In determining the
27 revenue requirement, costs and investments are examined as
28 to whether they are (1) “prudent,” (2) “used and useful,” and (3)
29 “known and measurable.”

30 Allowed expenses, whether capital or operating, must satisfy
31 these principles to be part of a firm’s revenue requirement.
32 Those that do are called above-the-line expenses, and they can
33 be included in the firm’s revenue requirement. Those that fail
34 to satisfy any of the three principles are called below-the-line
35 expenses, and they cannot be included in the revenue
36 requirement. In essence, below-the-line expenses cannot be
37 charged to ratepayers. Of course, the regulated firm that
38 wishes to lard its executives with luxurious cars and lavish
39 offices is still free to do so. However, the associated expenses
40 should be borne by the company’s shareholders alone.

41 **Q How should that proposed framework be applied in a cost recovery**
42 **proceeding like the current EBA case?**

43 A A reasonable application of the proposed framework addresses issues
44 concerning (1) reasonable risk sharing between utility ratepayers and utility
45 investors, and (2) efficient behavior by utility managers to produce results of a
46 workably competitive market associated with costs, prices, and earnings.
47 Regulatory ratemaking, even when it is through an energy balancing account, is
48 certainly not simply a cost reimbursement scheme. Part of ensuring reasonable
49 risk sharing and efficient behavior is to require that there be a determination of
50 whether the costs a utility seeks to recover were prudently incurred. An energy
51 balancing account is not a guarantee of cost recovery and should not be used to

52 protect utility managers from findings of unreasonable and imprudent behavior in
53 order to achieve an end-result of a target financial return for the utility.

54 **Q Does the Division's Audit Report recognize the need for a prudence**
55 **determination?**

56 A The Utah Division of Public Utilities' Audit Report ("Division Report") (Nov. 13,
57 2012) states:

58 The intent of this audit was to review the prudence and
59 accuracy of the Company's Energy Balancing Account Costs
60 (EBAC) as well as resolve issues identified by the Division in its
61 EBA Initial Comments filed April 27, 2012 (Initial Comments).

62 Division Report at 3. To that end, the Report states that "La Capra was assigned
63 to ascertain whether the actual costs included in the EBA filing were based on
64 the Company following its stated policies and procedures, were prudent, and
65 were in the public interest." *Id.* at 28. This echoes the Division's Report of the
66 Hedging Collaborative established in Docket No. 10-035-124, in which it stated
67 that the principles and guidelines articulated in the report "do not relieve
68 PacifiCorp's burden to demonstrate the prudence of all energy Planning and
69 Procurement activities."

70 **Q Did Mr. Hahn conduct a prudence review of the losses from short-term**
71 **power purchases and sales and from natural gas swaps?**

72 A No. In his initial direct testimony, Mr. Hahn stated that the documentation of
73 power and natural gas transactions provided by the Company "did not appear to

74 describe or explain why each transaction was entered into,” and that the
75 “underlying analysis and explanation for the transactions” was “extremely
76 sparse.” Hahn Direct at ll. 476-78. He concluded: “I was unable to conduct a
77 complete review of the appropriateness or prudence of transactions in the
78 sample.” *Id.* at ll 496-97. Specifically, with respect to short-term power
79 transactions, he stated that the Company did not explain why it entered into the
80 transactions, and that the Company should give an explanation “to ensure that
81 only appropriate costs are included in the EBA deferral.” *Id.* at ll. 536-40.
82 Likewise, Mr. Hahn testified that “the Company has not explained the specific
83 reasons why [the natural gas swap transactions he reviewed] were entered into.”
84 *Id.* at ll. 625-26. He concluded that “until such information is provided, it is not
85 possible to completely assess these transactions.” *Id.* at 628-29.

86 **Q Did the Division accept Mr. Hahn’s conclusions?**

87 **A** Yes. The Division’s Report states:

88 The primary conclusion reached by La Capra is that PacifiCorp
89 has not provided sufficient supporting documentation and
90 explanation regarding the purposes of the NPC transactions ...
91 Therefore La Capra states that it could not determine the
92 prudence of the transactions from the documentation provided.

93 Division Report at 29. The Division also accepted Hahn’s statement: “Based
94 upon my review to date, I cannot agree that these costs underlying the variance
95 were prudently incurred.” Division Report at 29.

96 **Q What was the recommendation you made in your direct testimony based on**
97 **the inability to determine the prudence of the transactions?**

98 A For the reasons explained in my direct testimony, and given that the absence of
99 information prevented La Capra and the Division from finding that the costs were
100 prudently incurred, I recommended that losses from short-term firm power
101 purchases and sales, and losses from natural gas swaps should not be
102 recovered. Malko Direct at ll. 36-42.

103 **Q Did the Division's Report recommend disallowance of losses based on its**
104 **inability to find prudence?**

105 A No. Even though the Division was unable to find that the costs were prudently
106 incurred, it recommended instead that the Company should be afforded
107 additional time to supply the supporting data recommended and required by the
108 Division. DPU Report at 30.

109 **Q Did the Company provide some additional information?**

110 A Yes. Mr. Hahn states in his Supplemental Direct testimony that the Company
111 provided a breakdown of actual short-term purchases and sales by pricing hub."
112 Hahn Supp. Dir. at ll. 163-169. But, the data provided was not helpful in
113 comparing forecasted with actual purchases and sales. *Id.* Mr. Hahn also
114 reported that, although the Company stated that the physical power transactions
115 were made "[REDACTED]
116 [REDACTED]," the Company [REDACTED]

117 [REDACTED]
118 [REDACTED] *Id.* at 180-
119 190. Hence, Mr. Hahn, again, was unable to arrive at any conclusion about the
120 prudence of these transactions.

121 **Q Why is it important to have information on the need for these transactions?**

122 A The balancing activities of a utility may be due to not only operational necessities
123 arising from changes in load, weather or other inaccuracies in forecasting, but
124 also speculative trading activities. There is no information that would allow the
125 auditors in this case to separate the two. The Company has, in the past,
126 engaged in speculative trading in electric power. In fact, in 1990, PacifiCorp,
127 successfully petitioned the Commission for elimination of its energy balancing
128 account, arguing that if the EBA were eliminated, the Company could invest in
129 generation and then “make off system sales ... and use the margin from those
130 sales to support the Company’s investment.” Pre-filed Direct Testimony of Verl
131 R. Topham, Docket No. 90-035-06 (May, 1990) at 15. The EBA was only
132 recently reinstated and this is the first cost recovery case under the new EBA. It
133 is not known whether the Company has continued to engage in speculative
134 trading since the adoption of the EBA under which it is currently operating. But,
135 now that the ratepayers are at risk for the losses resulting from such trading
136 activities, an adequate prudence review must include an inquiry into the reasons
137 for the trading.

138 **Q If documentation of day-ahead or hourly power positions are not available,**
139 **as Mr. Hahn states, should the Commission assume that losses from those**
140 **purchases and sales were prudent?**

141 A No. Mr. Hahn and the Division were correct in stating in their November 13
142 filings in this case that there is insufficient information to make a determination
143 that these costs were prudently incurred.

144 **Q Did the Company provide any additional information about the Company's**
145 **natural gas hedging policies and practices?**

146 A Apparently not. Mr. Hahn did not identify any such additional information. He
147 stated only that:

148 The information provided on power and gas transactions has
149 been helpful in achieving a greater understanding of them. I do
150 have some additional questions regarding this material and will
151 continue to analyze this material.

152 Hahn Supp. Dir. at ll 194-96. He made no attempt to ascertain whether the
153 natural gas swap losses "were based on the Company following its stated
154 policies and procedures, were prudent, or were in the public interest," which was,
155 after all, the objective of the Division's Report.

156 **Q After receiving the additional information, did Mr. Hahn conduct an**
157 **analysis to determine whether the Company's policies or the practices of**
158 **its managers were prudent concerning natural gas swap transactions and**
159 **related hedging activities?**

160 **A** Again citing a lack of information, Mr. Hahn did not perform any analysis of
161 whether the Company followed its stated hedging policies and procedures,
162 whether those policies and procedures or the actions of its managers were
163 prudent or in the public interest, or whether the sample power and swap
164 transactions he reviewed were prudently entered into. Mr. Hahn stated:

165 In my direct testimony, I describe how I developed a sample of
166 each type of transaction - power and gas - physical and swaps.
167 I noted that the Company generally has not documented nor
168 explained why each of these transactions was entered into. I
169 also identified certain of these transactions in FIGURE 12
170 CONFIDENTIAL and Figure 13 CONFIDENTIAL that should be
171 explained further.

172 Hahn Supp. Dir. at ll. 174-78. He noted that although he received additional
173 information, there were still questions left unresolved:

174 The information provided on power and gas transactions has
175 been helpful in achieving a greater understanding of them. I do
176 have some additional questions regarding this material and will
177 continue to analyze this material. Any additional knowledge
178 gained as the result of further reviews and analyses of this
179 information can be applied later in this proceeding or in future
180 EBA proceedings.

181 Hahn Supp. Dir. at ll. 194-98

182 **Q Did Mr. Hahn recommend any disallowance losses from short-term power**
183 **purchases and sales or natural gas hedging?**

184 A Surprisingly, no. He explained that his failure to recommend an adjustment as
185 follows:

186 Each transaction that was in my sample was generally for a
187 short term and individually the impact on EBA costs was
188 relatively small. Therefore, at this time I make no
189 recommendations to change the requested EBA costs. I do
190 recommend that the Company archive day-ahead position
191 reports to facilitate documentation of the reason for such
192 transactions in the future.

193 *Id.* at 194-202. He seems to say that it is not important to ascertain whether
194 these costs were prudently incurred because they are “relatively small.”

195 **Q Do you agree?**

196 A I do not agree. Mr. Hahn is referring to the variance between forecasted and
197 actual costs. While that amount may be “relatively small,” that is not the amount
198 that is at issue in this EBA docket. As I understand it, the Commission must
199 make a prudence determination of all of the net power costs that were incurred
200 during the EBA period, whether or not those costs were included in base rates.

201 **Q Do you have any other comment on Mr. Hahn’s audit?**

202 A As I stated in my direct testimony, a finding of prudence is essential to cost
203 recovery under the EBA (or, for that matter, for any costs that a utility seeks to
204 recover from ratepayers). Mr. Hahn’s audit focused on whether the variance
205 between forecasted and actual costs was for known and measurable costs, and

206 whether the amount of the costs was adequately documented and accounted for.
207 With respect to short-term power losses, he failed to require an adequate
208 explanation of why the transactions causing the costs were necessary. With
209 respect to hedging losses, he failed to address the following issues relating to
210 prudence, which I discussed in my direct testimony: (1) the role of cost
211 minimization in a hedging policy, (2) diversifying its financial products, (3)
212 flexibility to changing business risks and market conditions, and (4) loss of
213 hundreds of millions of dollars.

214 **Q Does the Division's supplemental testimony reach any conclusion about**
215 **the prudence of losses from short-term sales and purchases or losses from**
216 **natural gas hedging?**

217 A No. Following Mr. Hahn's lead, the Division's supplemental testimony omits any
218 discussion of prudence. See Supplemental Testimony of Matthew Croft

219 **Q Does the Division recommend any disallowance of costs based on its**
220 **inability to determine prudence?**

221 A No. Evidently abandoning the stated purpose of the Report, and without offering
222 any explanation, the Division dropped the subject of prudence altogether in its
223 supplemental testimony.

224 **Q. What did the Company's witness, Brian Dickman, say about the Division's**
225 **failure to recommend that costs be excluded from the EBA deferral on the**
226 **basis of imprudence?**

227 A Mr. Dickman pointed out that the Audit Report did not arrive at a final
228 recommendation on prudence, and that "there were no adjustments proposed
229 based on Company imprudence." He also stated that Mr. Hahn's testimony
230 failed "to introduce any evidence that he claims raises questions about Company
231 prudence in the EBA period." Dickman Supp. Dir. at ll. 49-63.

232 **Q Do you agree that the Division's failure to find imprudence means that**
233 **there should be no adjustments?**

234 A No. The absence of a finding of imprudence is not tantamount to a finding of
235 prudence, especially when prudence is in question and a prudence analysis has
236 not been undertaken. Mr. Hahn and the Division stated repeatedly that they
237 were unable to reach a prudence determination due to the Company's failure to
238 timely provide the necessary information. It would be absurd to conclude that
239 because the Company withheld or failed to preserve the necessary information, it
240 must be deemed to have acted prudently in incurring the costs for which the
241 information is unavailable.

242 **Q Please explain.**

243 A Generally, in cost recovery proceedings, a utility may not always need to
244 demonstrate through affirmative evidence that the costs it incurs are prudent.

245 But, once there has been a challenge to the prudence of certain costs, the utility
246 must come forward with evidence and persuade the Commission that its actions
247 in incurring those costs were prudent.¹ As I understand it, the EBA statute
248 requires a prudence inquiry. The UIEC raised the issue of prudence at the outset
249 of this proceeding, (see Order on EBA Interim Rate Process, Docket Nos. 12-
250 035-67, 09-0354-15, 110-035-T10 (Aug. 30, 1012) at 2-3), and Mr. Hahn and the
251 Division stated in their November 13 filings that they could not find that the costs
252 were prudently incurred. Moreover, as a signatory to the Hedging Collaborative
253 Report the Company acknowledged that it has the burden to demonstrate the
254 prudence of its energy procurement activities. Therefore, Mr. Dickman's
255 statement that the Division has not introduced evidence of imprudence is simply
256 irrelevant. Under the circumstances of this case, the Company must provide the
257 information necessary to demonstrate prudence, which it has failed to do.

258 **Q Has your recommendation changed from the recommendation you made in**
259 **your direct testimony?**

260 A Because the Company has still not shown that losses from short-term sales and
261 purchases and from natural gas swaps were prudently incurred, my
262 recommendation remains unchanged from my direct testimony. The
263 Commission should disallow 100% of the Company's approximately \$ [REDACTED]
264 in Utah jurisdiction natural gas swap losses during the EBA period. The

¹ Dep't of Bus. Reg. v. Pub. Serv. Comm'n, 614 P.2d 1242, 1244-46 (1980).

265 Company was imprudent in implementing a hedging program that fails to
266 consider cost minimization, and without adequately diversifying its portfolio of
267 financial products. It has not followed its own policy of diversification, or its policy
268 to remain flexible to market conditions. It was imprudent for the Company to
269 engage in a program with the potential to incur hundreds of millions of dollars in
270 losses without weighing the benefit of price stability against the cost to
271 ratepayers. In addition, based on the failure of the Company to provide adequate
272 documentation and explanation, I also recommend disallowance of the claimed
273 variance in short-term firm power purchases and sales.

274 **Q Do you have any other recommendations?**

275 A The inability of the Division to reach a prudence determination is largely due to
276 the lack of information produced by the Company. Therefore, I support the
277 additional filing requirements proposed by the DPU and the OCS.

278 **Q Do you recommend any additional filing requirements for use by RMP
279 concerning the EBA?**

280 A Yes, in addition to the additional filing requirements that have been proposed by
281 the Division and the OCS, I recommend that the proposed supplemental
282 requirements in Exhibit JRM-1.1R be approved.

283 **Q Does this conclude your rebuttal testimony?**

284 A Yes.

CERTIFICATE OF SERVICE

Docket No. 12-035-67

I hereby certify that on this 8th day of January 2013, I caused to be emailed, a true and correct copy of the foregoing **NON-CONFIDENTIAL** Rebuttal Testimony of J. Robert Malko on the Division of Public Utilities' Audit Report to:

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