PUBLIC
VERSION

STATE OF INDIANA
BEFORE THE
INDIANA UTILITY REGULATORY COMMISSION

CAUSE NO. 38707-FAC92

APPLICATION OF DUKE ENERGY INDIANA, INC. FOR APPROVAL OF A CHANGE IN ITS FUEL COST ADJUSTMENT FOR ELECTRIC SERVICE, FOR APPROVAL OF A CHANGE IN ITS FUEL COST ADJUSTMENT FOR HIGH PRESSURE STEAM SERVICE, AND TO UPDATE MONTHLY BENCHMARKS FOR CALCULATION OF PURCHASED POWER COSTS IN ACCORDANCE WITH INDIANA CODE § 8-1-2-42, INDIANA CODE § 8-1-2-42.3 AND VARIOUS ORDERS OF THE INDIANA UTILITY REGULATORY COMMISSION

DIRECT TESTIMONY OF
RICHARD C. THOMAS
ON BEHALF OF
STEEL DYNAMICS, INC.

June 5, 2012

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DIRECT TESTIMONY OF RICHARD C. THOMAS ON BEHALF OF STEEL DYNAMICS, INC.

INTRODUCTION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND ADDRESS.

A. My name is Richard Thomas. I operate as an independent consultant. My address is 26 Cold Spring Road, Monroe, CT 06468.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND.

A. I received a Bachelor of Science in Civil Engineering from the University of Arizona. I was Manager Fuels Purchasing for Metropolitan Edison Company and Martin Marietta Cement from 1973 through 1979. I sold coal for C&K Coal Company from 1979 through 1980. I traded coal internationally for CTC-Minemet and Intercarbo from 1980 through 1997. I helped develop the Over-the Counter coal trade for Natsource, LLC beginning in 1997.

During my career, I have been responsible for the purchase of coal and other energy products, the coordination of the transportation of these products both domestically and internationally, the monitoring of quality control, the processing of the products, and the direct as well as brokered sales of coal. I have consulted with producers as well as domestic and international energy traders. I currently teach classes in risk management and trading fundamentals for Coaltrans Conferences and for the Coal Trading Association.

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of Steel Dynamics, Inc. (SDI).

Q. WHAT ASSIGNMENT WERE YOU GIVEN WHEN YOU WERE RETAINED?

A. I was asked to undertake two primary tasks:

1. Review 2011 and 2012 coal purchases made by Duke Energy Indiana, Inc. (DEI).

2. Identify any unreasonable or inefficient purchases or purchasing policies, and suggest recommended changes.

Q. WHAT SPECIFIC INFORMATION DID YOU REVIEW IN CONDUCTING YOUR EVALUATION?

A. I reviewed DEI's filing, testimony, exhibits, and responses to requests for information. I also reviewed information found on web sites operated by this Commission, and by DEI. In addition, I reviewed what was purported to be all DEI spot and long term coal purchasing and transportation contracts in effect during the Test Period in Cause No. 38707-FAC91 (September through November, 2011) and Cause No. 38707-FAC92 (December 2011 through February, 2012).

CONCLUSIONS

Q. WHAT CONCLUSIONS HAVE YOU REACHED?

A. **On the basis of my review and evaluation, I have concluded the following:**

1. **DEI's Hedging Practices Are Deficient.** DEI failed to use all available financial and physical hedges to restrain the rate of increase of its total annual outlays for coal.
2. **DEI's Use of Index based Contract Price Escalation Does Not Produce the Lowest Fuel Cost Reasonably Possible.** DEI's use of indices for long term coal contract price adjustment is not in the best interest of DEI's rate payers.

Based on the foregoing conclusions, I recommend that the Commission disallow $28,564,782 due to DEI's use of long term coal contract escalation provisions that increased contract prices from already high levels, thereby not allowing price relief as the coal market retrenched.

DEI'S HEDGING PRACTICES ARE DEFICIENT

Q. PLEASE ELABORATE ON YOUR CONCLUSION THAT DEI DID NOT USE ALL AVAILABLE HEDGING TOOLS DURING THE TEST PERIOD.

A. DEI entered into a long term coal contract **BEGIN CONFIDENTIAL** **END CONFIDENTIAL** for the purpose of supplying low sulfur coal in anticipation of the enactment of the Cross-State Air Pollution Rules (CSAPR) which was originally scheduled to begin January 1, 2012 (see Batson Direct Testimony in Cause No. 38707-FAC91, Page 7, Lines 16-22). These poorly conceived rules have been under fire since their inception in July 2011 and were finally stayed on December 30, 2011. DEI had to prepare for the potential impact of these rules, however, due to the uncertainty of CSAPR's final implementation, DEI should have purchased a call option for the supply of the potentially required low sulfur coal rather than entering into a firm purchase contract. Call options for physical coal delivery are commonly traded either directly or via the Over the Counter (OTC) market and would have allowed the owner of the option (in this case, DEI) to purchase the coal at the time designated by the option or to allow the option to expire. DEI would have been required to pay a premium negotiated with the option seller for this right, however, the premium paid would have been small compared to the problems DEI now faces in disposing of this unwanted, expensive coal.

DEI purchases the majority of its coal needs via long term contracts with staggered expiration dates. The balance of the coal requirements are purchased using short term, spot agreements. Each year, the staggered expiring portion of the long term agreements plus any required spot purchases are subject to the vagaries of the marketplace. The portion of DEI's long term contract portfolio which is due for replacement in any year and the spot purchases for that year, should be hedged well before the beginning of the year in order to protect against rising prices when the purchases are finally made. DEI's fuels purchasing personnel did not use all available hedging tools that could have mitigated the effect of price volatility on the Company's fuel costs since DEI does not financially hedge its coal purchases due to concerns regarding liquidity and transparency (see DEI's response to SDI's information request 2.21 (a)).

Liquidity and transparency should not be considered detrimental to the use of OTC financial tools unless DEI is using too narrow a focus as to the underlying coal product. The total domestic OTC and CME/NYMEX exchange markets exceeded 300 million tons during 2011 and the international OTC market approaches one billion tons[1]. These large volumes show that liquidity has grown in both financial and physical OTC markets. The large numbers also show that coal is now considered a more fungible commodity since more than half of the traded volumes are financial products. While DEI purchases a majority of its coal in the Illinois Basin due to logistical efficiencies, there is a strong correlation between price movements in the Central Appalachian (CAPP) coals and the Illinois Basin coals (see Exhibit RCT-1). Financial hedging products for these CAPP coals are much more liquid than the financial hedging products available for the Illinois Basin and should, therefore be used until the Illinois Basin hedging volumes improve. No hedge is perfect and some price drivers may vary between the two coal producing areas, however, the aforementioned strong correlation in price movements allows DEI the ability to use the more liquid and transparent CAPP hedge products. Physical and financial hedges can be accomplished by a

[1] Estimates by survey of active OTC coal brokers ICAP United, TFS, GFI, and Evolution Markets.

number of mechanisms including but not limited to (i) forward purchases, (ii) financial swaps, and (iii) call options.

(i). A forward purchase is a purchase of physical coal for a future period as opposed to a purchase for immediate delivery. For example, if today DEI purchased coal for delivery in 2013 or 2014, it would be considered a forward purchase.

(ii). A swap is defined as a financial transaction between two parties to exchange a fixed price for a floating price at some fixed date in the future. The buyer of the swap will receive payment if the price of the commodity increases. This payment can be used to offset the increased price of the commodity when it is later purchased, effectively locking in the price and eliminating any effect from an adverse movement in the coal marketplace.

(iii). A call option provides the owner of the option with the right, but not the obligation, to purchase coal at a predetermined price (i.e., the "strike price"). It provides a 'ceiling' for pricing since the call option owner can exercise the option and take delivery at the strike price if market prices spike higher than the strike price. Using call options as a part of DEI's buying portfolio could also relieve oversupply and high inventory problems caused by reduced coal demand such as those experienced by DEI during 2009, 2010 and currently (See Supplemental Batson Testimony in Cause No. 38707-FAC91). If coal demand is lower than expected, DEI would simply elect not to exercise its option to buy the option coal.

DEI'S USE OF INDEX BASED CONTRACT PRICE ESCALATION DOES NOT PRODUCE THE LOWEST FUEL COST REASONABLY POSSIBLE

Q. PLEASE EXPLAIN YOUR CONCLUSION THAT THE USE OF INDICES TO ADJUST LONG TERM CONTRACT PRICES IS NOT IN THE BEST INTEREST OF DEI'S RATE PAYERS.

A. The use of inflation indices in long term contracts is a form of hedging but it is problematic if market prices are high when the contract is instituted such as was the case in 2008 when coal prices had more than doubled in a matter of weeks.

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When coal market prices are low (i.e., near cost of production), the use of inflation indices or fixed amounts to escalate long term contracts *may* be a logical choice for DEI. However, when market prices have moved upward in a dramatic manner, such as during 2008, the use of inflation indices should not be used. Using inflation indices or fixed escalation amounts, such as DEI did in the cases of the aforementioned contracts denies the buyer (DEI in this case) the opportunity to benefit from a retrenchment in market prices. As the market recedes from its elevated level, the buyer will continue to pay the higher prices plus the inflation or fixed escalation.

RECOMMENDATIONS

Q. WHAT DO YOU RECOMMEND ON THE BASIS OF THESE CONCLUSIONS?

A.

1. I recommend that DEI immediately institute a financial hedging program to protect rate payers from adverse price movements in coal purchases. This program should include all available hedging tools, including but not limited to financial swaps, options (both physical and financial), and forward OTC purchases. A financial hedging program can be implemented which will limit the negative affects of price spikes for the current year and at least two years forward, given existing tools. If DEI had used physical option hedges during the test period, DEI would not be requesting rate payers to pay for the costs of disposing of the high priced coal purchased **BEGIN CONFIDENTIAL** **END CONFIDENTIAL**. Accordingly, the Commission should deny any such request made now or in the future.

2. I recommend that DEI discontinue agreeing to or advocating the use of indices for price adjustments in long term coal contracts. While use of such indices may be a valuable tool when coal market conditions are low and prices are near the cost of coal production, the practice should not be utilized under all coal market conditions. Had DEI fixed the high prices negotiated during 2008-2010 instead of agreeing to escalation provisions, the resulting 2011/2012 price would still be above the current market, but substantially lower than the prices being paid (see RCT-7). This difference translates to

$28,564,782 that DEI would not be asking rate payers to pay. Accordingly, the Commission should deny this amount on the basis of the unreasonable use of indices and fixed percentage escalators which resulted in coal costs that were higher than those reasonably possible. This is a very difficult time for all parties. It is not a time for 'business as usual' since not only is DEI's concern about the financial condition of their coal suppliers valid, but the financial conditions of their power customers is also of grave concern.

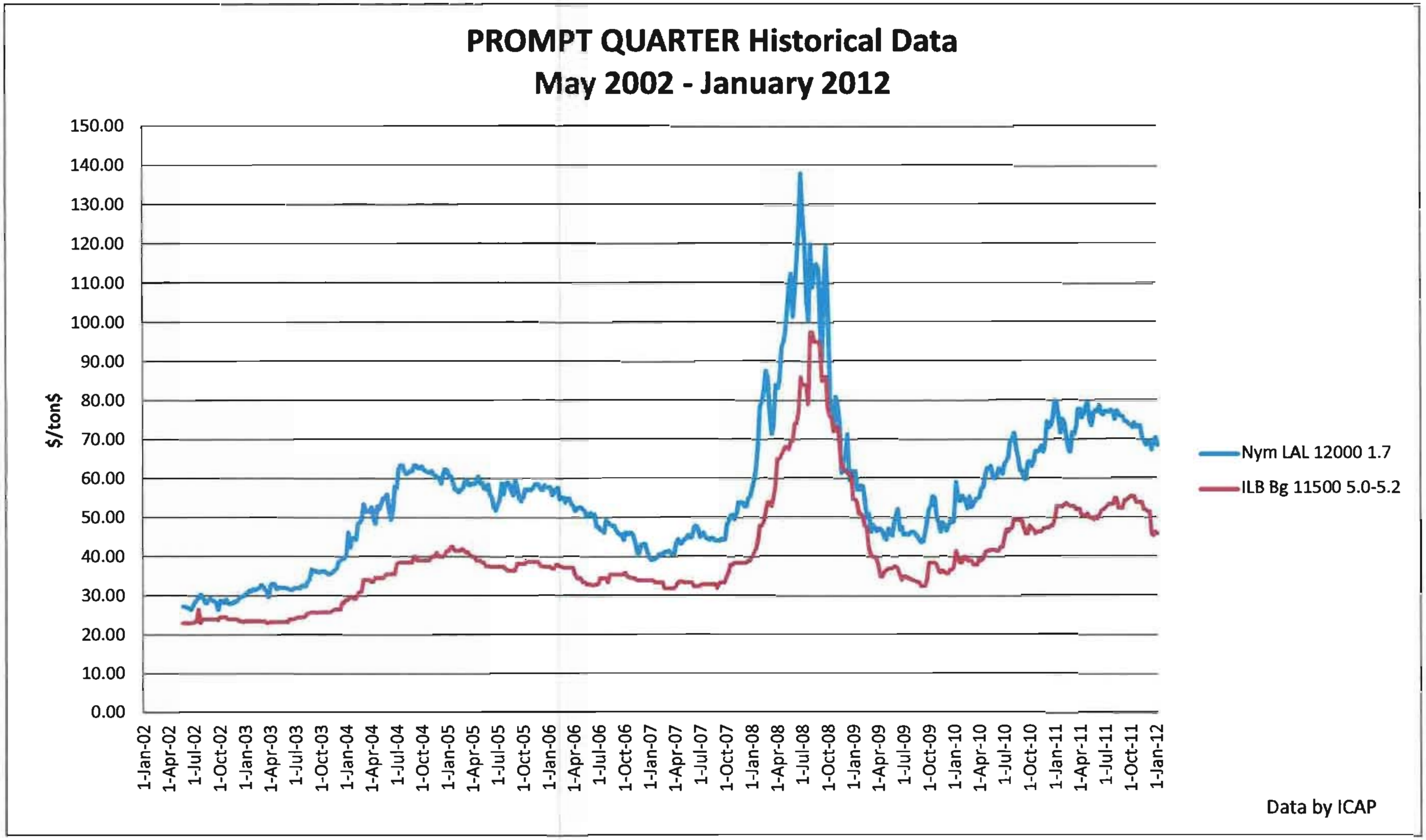
3. I request that the Commission disallow approximately $28,564,782 of DEI's fuel cost based upon Recommendation 2, above.

Q. DOES THAT COMPLETE YOUR DIRECT TESTIMONY?

A. Yes.

EXHIBIT RCT-1

RCT -1


PROMPT QUARTER Historical Data
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120.00
110.00
100.00
90.00
80.00
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60.00
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1-Apr-02
1-Jul-02
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1-Apr-11
1-Jul-11
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1-Jan-12
Nym LAL 12000 1.7
ILB Bg 11500 5.0-5.2
Data by ICAP

EXHIBIT RCT-2
REDACTED FOR PUBLIC VERSION

EXHIBIT RCT-3
REDACTED FOR PUBLIC VERSION

EXHIBIT RCT-4
REDACTED FOR PUBLIC VERSION

EXHIBIT RCT-5
REDACTED FOR PUBLIC VERSION

EXHIBIT RCT-6
REDACTED FOR PUBLIC VERSION

EXHIBIT RCT-7
REDACTED FOR PUBLIC VERSION

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

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AFFIDAVIT OF RICHARD C. THOMAS

I, Richard C. Thomas, hereby declare under the penalties of perjury that the foregoing Direct Testimony of Richard C. Thomas on Behalf of Steel Dynamics, Inc., filed in this docket, is true and correct to the best of my knowledge, information and belief.

STATE OF CONNECTICUT Fairfield) ss Monroe

Subscribed and sworn to before me this 5 day of June, 2012.

Richard C. Thomas

Theresa A. DiGiovanna
Notary Public

My Commission Expires: THERESA A. DIGIOVANNA
NOTARY PUBLIC
My Commission Expires May 31, 2015

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the foregoing *Direct Testimony of Richard C. Thomas (Public)* was delivered electronically or mailed, postage prepaid, in the United States mail, this 6th day of June 2012 to:

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