BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Tariffs of Aquila, Inc. d/b/a Aquila Networks –MPS and Aquila Networks-L&P Increasing Electric Rates for the Service Provided to Customers in the Aquila Networks MPS and Aquila Networks-L&P Service Areas.	))))))	**Case No. ER-2007-0004** Tariff No. YE-2007-0001

CONCURRING OPINION OF CHAIRMAN JEFF DAVIS

This commissioner respectfully concurs with the majority decision in all parts; however, there are at least three points raised in this case worthy of further commentary: (1) Skyrocketing fuel prices are driving large rate increases for Aquila customers and, absent some change of circumstances, it is likely Aquila customers will see significant rate increases over the next few years; (2) This report and order marks the first time the Missouri Public Service Commission has implemented a fuel adjustment mechanism pursuant to Section 386.266 enacted in 2005 by the Missouri General Assembly with the passage of Senate Bill 179; and (3) The ex-parte communication from Pirate Capital in this case illustrates that the source of capital can be as important as the attraction of capital itself when determining what's in the public interest.

This opinion, like all other opinions, is based on the facts and circumstances of this particular case as well as preceding cases this body may recognize. Nothing in this opinion should be construed as to any position this commissioner might take in any case, currently pending or in the future.

1. Rising fuel prices dictated the majority of this rate increase and, absent some change in circumstances, this trend will likely continue.

Subject to the adjustments set out in paragraphs 5, 10 and 13 of the stipulation, all of the parties agreed to an increase of at least $40.6 million for Aquila's MPS territory and at least $12.7 million for its St. Joseph Light & Power property for a total of roughly $53.3 million. The actual award in this case is approximately $58.7 million. Further, the company is receiving a fuel adjustment mechanism (FAC).

This increase follows a $44.8 million rate increase awarded by this commission for both properties in February 2006. As stated in the majority opinion, fuel and purchased-power expenses make up approximately 46 percent of Aquila's total operating costs. These costs rose 13 percent to 20 percent annually over the three-year period ending June 30, 2006. This pattern of increases is of great concern because subsequent increases in fuel costs will necessitate Aquila seeking additional rate increases of a similar magnitude.

The light at the end of the tunnel – the rate stability so many of Aquila's customers are desperately seeking – appears to be years away. Aquila's fuel and purchased-power expenditures have increased rapidly in recent years. This underscores the perils of being a vertically integrated utility with a significant reliance on natural-gas fired generation and purchased power. The general trend appears to be that both the price of natural gas and the demand for purchased power will continue to increase. Those increased costs will ultimately be reflected in increased rates for Aquila customers.

The goal can and must be rate stability for consumers, even though that goal is challenging and may take years to accomplish. Aquila's fuel and purchased-power costs may well remain upwardly volatile until the company acquires more generation to meet both baseload and peak capacity demand. Aquila is taking steps to add generation capacity by partnering with KCP&L to construct the Iatan II Coal Plant and to construct two new natural gas-fueled electricity-generating turbines in Sedalia, Missouri.

While increasing generation capacity is essential to meeting baseload and peak demands for electricity, it is no panacea for Aquila's customers in terms of rate stability. Assuming the Iatan II coal plant is constructed on schedule in 2010, Aquila will be back in front of this commission seeking another substantive rate increase because the costs of power plant construction cannot be put into rates until the plant is "used and useful." (Chapter 393.135 RSMo, 2000) These costs could be compounded by compliance with future emissions requirements, particularly any federal action on carbon dioxide emissions (CO2).

2. This decision marks the first time this commission has implemented a fuel adjustment mechanism (FAC) pursuant to Section 386.266 approved by the General Assembly in Senate Bill 179 (2005 legislative session).

Lately, Aquila's rising fuel and purchased-power costs by themselves are enough to cause rate shock when those costs are eventually passed through to customers in the form of a rate case. Skyrocketing fuel and purchased power prices can compound rate risk for consumers because, when they necessitate a rate case, the company will also seek recovery of their rate case expenses as well as other expenses.

In 2005, the Missouri General Assembly enacted Senate Bill 179 to provide this commission with the option of using a fuel-adjustment mechanism as a tool to establish just and reasonable rates between rate case filings by incorporating market cost changes for prudent, necessary fuel and purchased-power costs.

More than 25 other states can use this method of utility rate regulation. It smoothes the impact of fuel-cost volatility spikes on consumers, minimizes rate shock resulting from the eventual pass-through of fuel and purchased power costs due to regulatory lag and spares both consumers and taxpayers the expense of a rate case when the principal cost driver is the cost of fuel and purchased power.

This commission recognizes the hardship rate volatility can place on all classes of consumers – residential, commercial and industrial. Further, we are all acutely aware of the need to institute safeguards to ensure fuel adjustment clauses do not allow utility service providers to incur fuel costs in an imprudent manner.

That being said, a line-item surcharge allowing a utility to recover its prudently incurred fuel and purchased-power costs is a necessary evil in the case of this particular company. In a time of rapidly rising fuel and purchased-power prices, there is no way a company like Aquila can earn its allowed return on equity by reducing its expenses by tens of millions of dollars in other areas to offset increased fuel and purchased-power costs. In short, fuel and purchased-power increases are dramatically outpacing the ability of the company to absorb these costs. When those expenses already amount to almost half of the company's total expenses, no amount of increased efficiency can offset tens of millions of dollars in new expenses.

The ability to earn an allowed return on equity is important. These earnings attract and sustain investment the company needs to expand generating capacity and maintain essential infrastructure. There is no disputing the Aquila system could use more investment.

Critics of Aquila will argue Aquila is responsible for its own difficulties. There is no doubt Aquila management shares some responsibility in creating this dilemma. Other than PSC staff's assertion that Aquila should have built and kept the Aries plat, no testimony has been offered in this proceeding or any other previous proceeding that said Aquila should have undertaken a plan to construct other electric generation alternatives a decade ago. In fact, the conventional wisdom of the late 90's was that that the price of natural gas would remain relatively stable and no one ever anticipated the price of natural gas peaking at more than $10.00/mmbtu. If those assumptions were correct, natural gas fired generation would have proven to be more cost-competitive with coal-fired generation.

These facts, when combined with the costly and exhaustive permitting process required by the Missouri Department of Natural Resources (DNR) in granting emissions permits, make it highly unlikely Aquila would have ever been able to construct a coal plant under those conditions. Accordingly, it is very difficult to accurately and proportionately balance the culpability of Aquila's management for the challenges the company now faces in containing costs related to providing reliable and affordable utility services to its customers.

All of the proposed FAC mechanisms in this case had some facet that was unappealing. Aquila's proposal to recover 100 percent of its fuel increase costs was technically sound, but failed to ensure prudent and necessary pass-through because the company incurred no risk of financial loss if it failed to prudently manage its fuel costs. The 95 percent pass-through adopted by the majority in this case is reasonable in that it allows the company to recover all or most of its fuel and purchased power costs above $200 million, while encouraging the company to be prudent. For instance, if fuel and purchased power costs increase by $30 million in one year to a level of $230 million total -- a likely scenario based on the testimony presented in this case -- the company will recover $27 million of those costs and lose $3 million.

A company like Aquila might be able to make up a $3 million shortfall and, based on judgment and experience, such a shortfall is reasonable under the circumstances. Thus, in my opinion, this approach is most reasonable under the circumstances facing Aquila and the customers it serves.

The other proposals considered by the PSC would have excessively penalized the company for fuel and purchased power costs far beyond its control. This would make it extremely difficult for the company to reinvest in infrastructure and to attract the investment capital necessary to maintain infrastructure and expand generation capacity.

I found the other proposed cost-sharing mechanisms unreasonable for the following reasons:

-an interim energy charge or I.E.C. similar to the one proposed in this case cost Aquila more than $20 million since their last rate case decision in February 2006. Accordingly, I did not feel comfortable adopting the methodology proposed by the PSC staff in this case.

-the 50-50 sharing proposal proposed by several parties of the parties is unfair for a company like Aquila. In scenarios such as that referenced above, Aquila has no means of possibly offsetting a loss of $15 million or more on an annual basis.

-the Wyoming Plan sponsored by AARP has some attractive features similar to the IEC in that it contained a deadband, which would require the utility to absorb costs within a certain range, and encouraged proportionate sharing with no cap. If the market for fuel and purchased power were less volatile, this proposal definitely would merit strong consideration; however, in an era of upward cost volatility, the deadband prohibits the utility from recovering a significant portion of its prudently incurred costs at the outset.

-Although intriguing, an accounting authority order (AAO) would be something this commissioner would gladly consider if this commission had no other alternative. The weakness of the AAO is that it will be thrown into the next rate case. Parties will make all sorts of arguments to disallow those expenses and the company will either agree to take less than they are otherwise entitled in settlement or run the risk of the commission arbitrarily making downward adjustments in other areas because the recovery of the AAO expenses has the potential of being such a large issue.

Absent certainty of fuel cost variances, some aspects of rate setting are like rate design in that they are more art that science. Although the parties are to be commended for coming to an agreement on how the process should work, their extreme positions left this commission in the position of having to try develop a FAC mechanism that would be just and reasonable to all parties.

Aquila should be very mindful that the majority of this commission took a bold step in awarding Aquila a fuel adjustment mechanism. This commission and the General Assembly will be watching. If Aquila fails to adopt a proper hedging strategy, fails to follow its hedging strategy or abuses the discretion given to it by this commission in any other way, this commissioner will not hesitate to modify or reject Aquila's FAC application in a future proceeding.

3. The ex-parte communication from Pirate Capital in this case illustrates the point that the source of capital is as important as the attraction of capital itself when determining what's in the public's best interest.

A. Concerns regarding the attraction of capital:

Attraction of capital is essential for all utilities, especially those who need to spend large sums of money to enhance reliability, improve infrastructure and add new generation. This is particularly true regarding baseload generation, which is more expensive and takes longer to construct.

Aquila is a vertically integrated utility needing to make significant investments in all three of these areas. This commission has to avoid the temptation of being punitive in rate proceedings to the extent it leaves a company vulnerable to problems caused by undercapitalization and inadequate earnings potential.

Missouri utilities, including Aquila, seem to have no problem attracting investment capital. However, recent events such as the collapse of the Amaranth hedge fund and its effect on the futures market for natural gas, the proposed acquisition of Texas Utilities (TXU) by private equity firms and Pirate Capital's rattling of the saber in the middle of this rate case begs the question of who's going to actually run the company and whether some investors require greater regulatory scrutiny.

Although the issue is not squarely in front of us in this case, the generally accepted principle that "cash is cash" may no longer be true when a group of new, more active investors pushes its way through the boardroom doors, and if the short-term interests of those investors collide with and ultimately prove detrimental to the long-term benefit of ratepayers – the public interest.

For instance, a five-year plan designed to reduce debt and improve Aquila's capital structure could ultimately increase the company's return in a rate case at the expense of delaying improvements necessary to enhance the reliability of the Aquila system. This type of action might be detrimental to the current generation of Aquila ratepayers in terms of reliability and risk further rate increases to the next generation of Aquila customers.

This Commission is likely to view a conscious decision by utility management to purchase power and pass it through a fuel adjustment mechanism, rather than construct appropriate generation resources as detrimental to ratepayers. Neither of these issues is before this commission today, but they are foreseeable, particularly where a company has demonstrated questionable decision-making ability in the past. This commission must be vigilant against conduct that is not in the long-term best interests of the state and its ratepayers.

B. Concerns regarding Aquila management decisions affecting the company's ability to attract capital:

The commission staff -- led by Bob Schallenberg, Director of the PSC's Utility Services Division -- and others here at the Commission have consistently taken a long-range view of utility planning – spanning 30 years or longer.[1] These views are most evident in cases where the prudence of constructing new generation assets is an issue. In those cases, the PSC staff has taken positions in favor of Missouri electric utilities owning their own electric generation because it is more reliable to have generation facilities located near the customers being served and cheaper once the costs are depreciated over a period of thirty years or longer. Companies that followed this strategy and built excess generation capacity, like KCP&L and Ameren UE, have used off-system sales of their excess electricity to subsidize costs to their regulated utility customers.

Both utilities and customers have benefited under this regulatory framework. Ameren UE and KCP&L generated earnings for their investors and avoided rate increases for almost two decades, while actually reducing the rates paid by their customers over that same period. This accomplishment is no small feat and provides strong support for the long-term approach espoused by Mr. Schallenberg and the rest of the PSC staff in this regard.

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1 Equally important to note is that, to the best of this commissioner's knowledge, the PSC staff has always opposed acquisition premiums being passed through to utility ratepayers and the Missouri PSC has never approved such a premium.

In contrast to Ameren UE and KCP&L, Aquila purchases a substantial portion of the electricity it needs to meet customer demands. Aquila even divested its interest in the Aries plant and then unsuccessfully tried to re-acquire the plant. The evidence in this case shows Aquila's fuel and purchased power expenses have risen rapidly and all relevant information at our disposal indicates that these costs *will continue to rise* -- the only question is how much?

Aquila needs more baseload generation and, according to the PSC staff, at least two more gas-fired turbines. Constructing power plants is expensive and these facilities constitute only a portion of Aquila's capital concerns. Based on the PSC staff's depreciation studies, Aquila's distribution system is one of the oldest in the state and likely in need of further investment. It could be argued that investments should have already been made, but simply weren't made because Aquila did not have the cash flow to make them.

Last year, the Office of Public Counsel (OPC) filed a request seeking a management audit of Aquila in case number EO-2006-0356. The PSC Staff performed a limited audit and Mr. Mills filed a response raising some very valid points on behalf of OPC in response to those findings on October 31, 2006. This commission subsequently issued an order "accepting" the report and directing Aquila to comply with all of the recommendations contained therein on March 13, 2007. Although the order was silent as to the issue, it is noteworthy that KCP&L's proposed acquisition of Aquila was announced in January 2007.[2] Had the proposed acquisition not been announced, it is almost a certainty that Aquila's management would have faced more scrutiny of its

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2 See Case No. EM-2007-0374

management decisions and this commission would be entertaining further suggestions from Mr. Mills' office. Pending the outcome of that case, we still might be considering further steps regarding Aquila management.

Mr. Mills is correct in that there are ample grounds for questioning the prudence of Aquila's management, past and present. These include:

-Management decisions to pursue unregulated business ventures that eventually caused Aquila to hemorrhage money, lose its investment grade status and some would say neglect its customers for years;

-The decision of Aquila to sell its interest in the Aries plant to Calpine and the subsequent mishandling of the zoning, siting and construction of the South Harper generating facility which will be a source of controversy for this commission, the courts and the legislature for years to come.

-A subsequently corrected "accounting error" discovered in a previous rate case that under-funded employee pension benefits;

-Aquila's decisions that led the company to pay $25 million to settle claims with the Commodities Futures Trading Commission (CFTC) and the PSC's subsequent lawsuit against Aquila Inc., Aquila Merchant Services, Inc., and other energy marketers seeking monetary damages for allegations of natural gas price manipulation.

C. How should this commission resolve lingering allegations of imprudence by Aquila management?

In fairness to Aquila's current management, I am not sure if different management would have been able to perform better given the same circumstances. Although I might agree with the PSC staff, OPC and other interested parties on a philosophical level, the commission employs a "reasonable person standard" to determine whether the company's decision was reasonable under the circumstances. Imprudence on the part of a utility is difficult to prove under this standard for two reasons: First, the company is usually able to put forth some evidence its managers were acting prudently under the circumstances; and second, damages are often difficult, if not impossible, to quantify. That being said, when one considers the totality of the circumstances, Mr. Mills is justified in his desire that this commission keep a tight leash on Aquila.

There is no question Aquila's decisions have been detrimental to its ratepayers. That detriment is difficult, if not impossible, to quantify; nor is it feasible to calculate whether or not those decisions should have been dealt with by this commission in previous rate proceedings subsequent to the alleged imprudent behavior actually occurring. There is no clear answer to this question and these issues will continue to haunt Aquila management for years to come regardless of who's in charge.

Respectfully submitted,

Jeff Davis
Chairman

Dated at Jefferson City, Missouri,
on this 17th day of May, 2007.