BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its Aquila Networks—MPS and Aquila Networks—L&P Missouri Service Areas.	)))))	**Case No. ER-2007-0004** Tariff No. YE-2007-0001

STAFF'S POSTHEARING BRIEF

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STAFF'S POSTHEARING BRIEF

On July 3, 2006, Aquila, Inc. filed tariff sheets to implement a general electric rate increase for service it provides to its Missouri customers in and about Kansas City and St. Joseph, Missouri under the names Aquila Networks-MPS and Aquila Networks-L&P, respectively. The Commission suspended the effective date of the tariff sheets and opened Case No. ER-2007-0004.

The Staff, with leave of the Commission, filed its Prehearing Brief one day late on March 30, 2007, addressing all the issues listed in the listing of issues for resolution by the Commission filed with the Commission on March 22, 2007. On April 4, 2007, a number of the parties in the case filed their Stipulation and Agreement as to Certain Issues. No party objected to that agreement. On April 12, 2007, the Commission held an on-the-record proceeding to address the Stipulation and Agreement, and on April 12, 2007, the Commission issued its *Order Approving Stipulation and Agreement as to Certain Issues*. The Stipulation and Agreement resolved all issues except those relating to rate of return, orders the treatment of the unamortized balance of the accounting authority orders the Commission issued for the Rebuild and Western Coal Conversion of Aquila's Sibley generating facility, and fuel cost recovery. Therefore, this brief is limited to those remaining contested issues. As with its prehearing brief, the Staff has organized this brief to follow the listing of issues filed March 22, 2007. In this brief the Staff does not repeat the arguments and support it presented in its prehearing brief, except to the extent necessary to present its arguments and additional support here. The Staff believes the most significant issues of the remaining contested issues are those pertaining to Aquila's rate of return (Issue 1) and proposed fuel cost recovery mechanism (Issue 15).

REVENUE REQUIREMENT

Rate of Return

1. Return on Common Equity: What return on common equity should be used for determining Aquila's rate of return?

NOTE: An alternative phrasing of this issue appears in the listing of issues filed in this case on March 22, 2007.

Staff Position: Using traditional and accepted methodologies, Staff estimates Aquila's Cost of Common Equity as a range of 9.0 – 10.25, midpoint 9.625. Given that the average awarded ROE for electric utilities in 2006 was 10.36, Staff's recommendation of 9.625 is within the Zone of Reasonableness extending from 9.36 to 11.36. Nothing in Aquila's recent performance supports an ROE at the high end of the Zone of Reasonableness.

2. Capital Structure: What capital structure should be used for determining Aquila's rate of return?

Settled: Staff and Aquila have agreed to utilize Aquila's 2006 year-end corporate capital structure, which consists of 51.83 percent debt and 48.17 percent equity, for rate-making purposes in this case. (Tr. 6:294.)

3. Cost of Debt: What cost of debt should be used for determining Aquila's rate of return?

Settled: The cost of debt to the Aquila Networks MPS division is 6.668 percent, and the cost of debt for the L&P division is 7.8698 percent. (Tr. 6:295.)

Introduction

The only remaining dispute in the area of Rate of Return is over the cost of common equity. There is no remaining dispute in this case about either capital structure or embedded cost of debt.

The Cost of Capital

The Commission must determine the cost of common equity, or return on equity (ROE), which is a component of Aquila's cost of capital. Capital is the money used by a business to acquire assets and conduct operations.[1] Capital is obtained either by borrowing money or by selling ownership shares, that is, stock. Where capital is raised by borrowing, the creditors have the right to be repaid with interest; that right is extinguished when the debt has been repaid. Where capital is raised by selling stock, the shareholders acquire the right to receive a proportionate share of the profits of the enterprise for as long as they hold their stock. Because profits are what remain when all expenses have been paid, the rights of the shareholders are subordinate to the rights of the creditors.[2] Thus, the shareholders are subject to greater risk than the creditors because nothing may be left over after the creditors are paid. The creditors are also subject to risk, of course, which is the risk that the debtor will not pay as agreed.

The Commission's Task

The determination of ROE is an important and difficult task.[3] The task is important because each "basis point" of profit is worth many thousands of dollars that Aquila's ratepayers -- Missouri working families and small business owners -- will have to provide by paying their electric bills.[4] The task is difficult because, while the cost of debt may be readily determined from the instruments that embody the debts, ROE must be estimated through complex analysis of

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[1] *Black's Law Dictionary* 200 (7th ed., 1999).
[2] *Black's, supra,* 1226.
[3] *In the Matter of Missouri Gas Energy,* 12 MoPSC3d 581, 591 (*Report & Order,* issued Sep. 21, 2004) ("*MGE R&O"*); *In the Matter of The Empire District Electric Co.,* 13 MoPSC3d 350, 370 and 372 (*Report & Order,* issued Mar. 10, 2005) (*"Empire I R&O"*); *In the Matter of The Empire District Electric Co.,* Case No. ER-2006-0315 (*Report & Order,* issued Dec. 21, 2006) at 15-16 (*"Empire II R&O"*); *In the Matter of Kansas City Power & Light Co.,* Case No. ER-2006-0314 (*Report & Order,* issued Dec. 21, 2006) at 20 (*"KCPL R&O"*).
[4] Staff estimates each basis point to be worth $68,000 for MPS and $15,000 for L&P.

share prices, expected growth rates and risk, against the background of current and anticipated general economic conditions.[5] The Commission is left to parse and weigh the conflicting opinions of the various expert witnesses, all of whom are eminently qualified and who, using much the same data and methods, have wildly differing conclusions.[6] The undersigned has had occasion to comment before on the significant positive correlation between the expert's recommended ROE and the litigation goal of the expert's employer. The expert recommendations offered in this case are set out below:[7]

Analyst	ROE
Hadaway (Aquila) (1st)	11.50
Hadaway (Aquila) (2nd)	11.25
Gorman (SIEU-FEA-SJIG)	10.00
Parcell (Staff)	9.625[8]

Dr. Hadaway's recommendations, unlike those of Mr. Parcell and Mr. Gorman, were reached by adjusting the results of his comparable company analysis upwards through the addition of an "adder" to reflect the allegedly unusual degree of construction risk facing Aquila:[9]

Analyst	Result of Comparative Analysis	"Adder"	ROE
Hadaway (Aquila) (1st)	11.25	0.25	11.50
Hadaway (Aquila) (2nd)	10.75	0.50	11.25

Analyzing the Expert Testimony

The Commission can find some guidance in completing this task in the legal constraints that its determination must satisfy. The Commission must award a "fair and reasonable" return

[5] *MGE R&O* 591; *Empire I R&O* 369. *See* Aquila's Pre-hearing Brief at 6.
[6] *MGE R&O* 591; *Empire I R&O* 372; *KCPL R&O* 21.
[7] Ex. 241.
[8] Parcell actually recommended a range from 9.0 to 10.25; 9.625 is the midpoint of that range. *Id.;* Parcell Direct: 2-4, 30.
[9] Tr. 321-22 (Hadaway).

to Aquila's equity investors.[10] Too little is an unconstitutional taking;[11] too much is an unconscionable windfall. The right amount – the "just and reasonable" amount -- is a return "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties[.]"[12] The right amount is also "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital."[13] The right amount is thus one that is fair to both the utility's investors and the utility's customers.[14] Aquila's expert witness, Dr. Hadaway, admits as much: "If a utility earns its market cost of equity, neither its stockholders nor its customers should be disadvantaged."[15]

There are thus two legal standards that guide the Commission's determination: the "commensurate return" standard and the "credit maintenance" standard.[16] Aquila's own expert, Dr. Hadaway, testified:[17]

> [T]he return authorized by [a] utility regulatory body such as this Commission -- such as the Commission should be commensurate with return on investment [in] other enterprises having corresponding risks. The return should also be sufficient to ensure confidence [in] the financial integrity of the utility so as to maintain its credit and attract capital so that it is able to properly discharge its public duties.

These legal standards can be readily transformed into analytical tools by which the Commission can assess the recommendations of the experts and reach a just and reasonable conclusion. The

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[10] *St. ex rel. Missouri Public Service Co. v. Fraas,* 627 S.W.2d 882, 886 (Mo. App., W.D. 1981).
[11] *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 690, 43 S.Ct. 675, 678, 67 L.Ed. 1176, 1181 (1923).
[12] *Id.,* 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-1183.
[13] *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S. 591, 603, 64 S.Ct. 281, 288, 88 L.Ed. 333, 345 (1943).
[14] *St. ex rel. Valley Sewage Co. v. Pub. Serv. Comm'n.,*515 S.W.2d 845 (Mo. App., K.C.D. 1974); Aquila's Pre-hearing Brief at 7.
[15] Aquila's Pre-hearing Brief at 7, quoting Dr. Hadaway.
[16] *See* Aquila's Pre-hearing Brief at 6-7. Note that the "commensurate return" standard necessarily embodies the notion of attraction of capital. Mentioned by the Supreme Court in *Hope. See* FN 10 and Tr. 317-18 (Hadaway): "The average of the group represents those companies that Aquila and all other similarly situated utilities [will] compete with in the capital markets."
[17] Tr. 308-309.

"commensurate return" standard is embodied in the "Zone of Reasonableness" (ZOR) analysis that this Commission has used at least since September 2004.[18] That analysis compares the ROE recommendations offered by the testifying experts to the national average of ROEs awarded in the industry under consideration.[19] The "credit maintenance" standard, on the other hand, constitutes a "floor" below which the ROE cannot be lawfully set.[20] This standard is met by consideration of the credit-rating effect of the ROE award.

1. A Commensurate Return

The ZOR is defined as extending one hundred basis points – one percentage point – above and one hundred basis points below the recent national average of ROE awards in the appropriate regulated industry.[21] The national average ROE award for electric utilities last year was 10.36%,[22] so the ZOR extends from 9.36% to 11.36%. At hearing, a question was raised as to just how the national average used in the ZOR analysis is to be calculated.[23] The Commission has never yet engaged in the exercise of making adjustments to the reported national average for use in the ZOR analysis, but has simply used the raw figure.[24]

[18] *MGE R&O* 593; *Empire I R&O* 375; *Empire II R&O* 24; *KCPL R&O* 21.
[19] *Id.*
[20] Tr. 312 (Hadaway): "[T]he second sentence is more of a floor."
[21] *Id.;* Tr. 379 (Hadaway), 486 (Parcell).
[22] Ex. 240, p. 7; Tr. 380; *but see* Tr. 527 (10.3%, Gorman).
[23] *See* Public Counsel's cross-examination of Dr. Hadaway, Tr. Vol. 6.
[24] *MGE R&O* 592: "In a survey of regulatory decisions from around the country, as reported by Regulatory Research Associates, the average allowed return in the gas utility industry for 2002 and 2003 was 11%."; *Empire I R&O* 357: "16. The industry national average ROE for electric utilities in 1st Quarter 2004 was 11.0%."; *Empire II R&O* 26: "In light of the comparable companies' average ROE at or near 10.9%, the national average ROE of 10.5%, and the perceived risks associated with investment in Empire (including the downgrade of Empire's credit rating to the lowest investment grade after this case was filed), the Commission concludes that 10.9% is the reasonable and appropriate ROE for Empire."; *KCPL R&O* 21: "In a survey of regulatory decisions from around the country, as reported by Regulatory Research Associates, the average allowed return in the electric utility industry for the third quarter of 2006 was 10.06%. That same study revealed that for the first quarter of 2006, the average ROE for electric utilities was 10.38%; for the second quarter, 10.69%. The average of those three ROEs is approximately 10.37%; thus, the Commission finds that it should set return on equity somewhere in a range from 9.37% to 11.37%." (citations omitted.) On cross, Dr. Hadaway admitted that he was unaware of any case in which the PSC had excluded T&D companies when calculating the national average for purposes of the Zone of Reasonableness. Tr. 450.

Analyst	ROE	ZOR
Hadaway (Aquila) (1st)	11.50	Above
Hadaway (Aquila) (2nd)	11.25	Within
Gorman (SIEU-FEA-SJIG)	10.00	Within
Parcell (Staff)	9.625[25]	Within

The Commission has established a principle, based on its application of the ZOR analysis, that expert recommendations outside of the ZOR are discarded and receive no further consideration.[26] The Commission recently stated, "Because the return on equity recommended by DOE falls outside of the 'zone of reasonableness', the Commission will discard it and find that it merits no further discussion."[27] Therefore, Dr. Hadaway's original recommendation must be discarded because it is outside of the ZOR.[28]

2. Sufficient to Maintain Credit and Attract Capital

Aquila does not presently have an investment grade bond rating.[29] Aquila was downgraded in 2002 from Triple-B ratings (i.e., investment grade) to Caa1 (Moody's), B (S&P), and B- (Fitch); each of these are non-investment grade.[30] Aquila's present bond ratings are as follows:[31]

Aquila's Current Bond Ratings	
Moody's	B2
S & P	B-
Fitch	B-

Staff's expert witness, David Parcell, testified that the mid-point of his recommended

[25] Parcell actually recommended a range from 9.0 to 10.25; 9.625 is the midpoint of that range. *Id.;* Parcell Direct: 2-4, 30.
[26] *KCPL R&O* 21-22.
[27] *Id.*
[28] Both of Dr. Hadaway's comparable company analyses, prior to the "adder," were within the ZOR. Tr. 321-22.
[29] Tr. 316, 412 (Hadaway).
[30] Parcell Direct, p. 11.
[31] *Id,* at 14. .

range would produce an interest coverage level for MPS within the benchmark range for a BBB-rated utility.[32] In addition, the debt ratios for both MPS and L&P are within that benchmark for a BBB-rated utility.[33] Thus, since the lowest recommendation meets the "credit maintenance standard," any of the recommendations that are within the ZOR are acceptable.

"Adders and Subtracters"

Unlike Parcell and Gorman, Hadaway takes the position that the result of the comparative company analysis must be adjusted upward to reflect Aquila's unique construction risk.[34] Both Mr. Parcell and Mr. Gorman testified that Hadaway's use of an "adder" to inflate his ROE recommendation was improper. Parcell testified:[35]

> [T]rying to -- to micromanage or take part and add the parts up is – is not the way to go about it. * * * [I]t's not an additive process where you go pick and choose certain risks and assign numeric value to them and come out [with] something. That's why you have people like Standard & Poor's who assigned the risk profile, for example, to Aquila of F-6 which is deemed satisfactory. It's the middle range of generation utilities. Standard & Poor's considers fuel price risk like everything else, like all the parts that's in there. And all those factor are there when Standard & Poor's gives Aquila a risk profile of six, which is the middle of the road for a generation company. That's what's important to me as an analyst, not individual risk factors which Standard & Poor's would consider in its risk profile. * * * [Y]ou can't take potential risk of a utility or any other company and put them on a bulletin board and say, Well, you have risk of fuel, you have risk of inflation, you have risk of this, that and the other and assign a numeric value to it and add it up or -- or, worse yet, just choose the ones you want.

Likewise, Mr. Gorman testified:[36]

> I relied on S&P's business profile score for a utility company which considers construction risk, regulatory risk, management risk, service area economy risk. * * * Well, if they added [construction risk] to my authorized return on equity, it would be redundant with it because they have already been built into my recommendation.

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[32] Parcell Direct, p. 31 and Sch. 15.
[33] *Id.*
[34] Tr. 312, 321-322.
[35] Tr. 490, 492, 496.
[36] Tr. 534, 535.

This game of finding reasons to add an upward adjustment to the results of the comparative company analysis is one that the Commission has seen repeatedly. In the recent KCPL rate case, upward adjustments were urged to reflect (1) unusual construction risk (50 basis points), (2) off-system sales risk (526.35 basis points), and (3) general management excellence (50 to 100 basis points).[37] Likewise, in the recent Empire District Electric Company rate case, Dr. Vander Weide – then testifying for Empire – proposed an "adder" of 40 basis points to account "for the difference in the perceived financial risk of [the] proxy companies in the marketplace and the financial risk implied by [his] recommended capital structure for Empire."[38] Dr. Vander Weide later proposed a similar "adder" for AmerenUE based on the same consideration.[39]

The concept of risk is particularly subject to manipulation by analysts. First, as Parcell and Gorman testified, all of the classic financial analysis methodologies take the risk of the investment into account; thus, no "adder" or "subtracter" is necessary. Second, the use of such an upward adjustment is a violation of the comparative company ROE analysis required by the United States Supreme Court in *Hope* and *Bluefield.* It is important to remember that those cases were written to explain why utility investors could not expect bloated and exorbitant returns. The use of an "adder" to evade the results of the required comparative analysis is contrary to both the letter and the spirit of the controlling cases and may expose the Commission's decision to a heightened risk of reversal on appeal.

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[37] *In the Matter of Kansas City Power & Light Co.,* Case No. ER-2006-0314 (*Staff's Post-hearing Reply Brief and True-up Brief,* Docket Item No. 520, filed November 27, 2006), pp. 44-46.

[38] *In the Matter of The Empire District Electric Co.,* Case No. ER-2006-0315 (*Pre-hearing Brief of Staff of Public Service Commission,* Docket Item No. 191, filed September 6, 2006), p. 37 (*quoting* Vander Weide's Direct Testimony filed in that case, pp. 4 and 6).

[39] *In the Matter of AmerenUE,* Case No. ER-2007-0002 (*taff's Post-hearing Brief,* Docket Item No. 797, filed April 20, 2007), p. 94.

Conclusion

On account of all of the foregoing, Staff urges the Commission to award a just and reasonable ROE to Aquila, selecting from among the recommendations that are within the ZOR and not permitting any "adder":

Analyst	ROE
Hadaway (Aquila) (2nd)	10.75[40]
Gorman (SIEU-FEA-SJIG)	10.00
Parcell (Staff)	9.00 – 10.25

Thus, the Commission should choose a result within the range defined by the expert recommendations, which extends from 9.00 to 10.75, midpoint 9.875. As Mr. Gorman explained, the just and reasonable result is somewhat below the national average of 10.36, and is necessarily even lower if the Commission awards a FAC to Aquila:[41]

> First, cost of capital in today's marketplace justifies a return of around 10 percent for a company with Aquila's regulated risk profile. And, second, there are some going-forward risks that I think justify a 10 percent rather than something a little less than 10 percent for Aquila. Specifically, I've recognize their current construction activities. I've recognized the – the limited financial isolation of the Missouri operations relationship to the total company and the need for the Missouri operations to be able to track capital of necessary infrastructure investments here in Missouri. So that, I believe, would support a 10 percent return on equity as being a little higher than what I would recommend for other utility companies such as what I've recommended recently for Ameren and some other companies that -- that don't have those -- the same degree of risk that I think Aquila does, but lower than the industry average from prior years because the prior year trend is for reducing authorized return on equity down to where the -- the debt cost was adjusted many years ago. Authorized returns on equity have simply not caught up to the market in reducing utilities' common equity costs in line with what the market is doing immediately. So that is the general thought process I went through in arriving at my 10 percent return on equity recommendation. * * * [I]mplementation of a fuel adjustment mechanism would reduce the operating risk of this company and I think would justify a lower return on equity.

[40] "Adder" eliminated. Hadaway's initial, unadjusted recommendation of 11.25, while within the ZOR, was abandoned by Aquila when Hadaway filed his Rebuttal testimony.
[41] Tr. 527-528, 532.

Gorman quantified that reduction of risk at about 30 basis points, yielding an ROE of approximately 9.7, close to the midpoint of the range defined by the experts' recommendations.[42]

Rate Base Issues

6. Accounting Authority Orders (AAOs): Should the unamortized balance of the accounting authority orders the Commission issued for the Rebuild and Western Coal Conversion of Aquila's Sibley generating facility be included in Aquila Networks-MPS's rate base?

Staff Position: Yes. The Commission authorized these accounting authority orders in Case Nos. ER-90-101, EO-91-247 and ER-93-37. The unamortized balances the Commission authorized in those cases should continue to be included in the rate base calculations until such time as the amortization period is complete.

AAO's are to be considered on a case-by-case basis,[43] and the Commission can revisit the issue and is not bound by its prior determinations. However, the public policy analysis previously determined by the Commission remains sound:

> The Commission determines that there is substantial evidence of the significant impact of the Sibley projects on MoPub's financial status. The $55,978,891 in outlays associated with the Sibley projects represent nearly all of MoPub's capital expenditures since May 1990. The amount deferred from January 1, 1992 through June, 1993 is $3,069,797, of which $1,625, 495 was deferred from January, 1993 through June, 1993. The net income impact of the 1993 deferral represents approximately 10 percent of MoPub's estimated income for this time period. MoPub would experience a significant reduction in its estimated 1993 earnings if the Sibley deferrals were not reflected in rates. MoPub estimates that a write-off of the Sibley deferrals would reduce its return on equity by more than one percentage point.[44]
>
> …the Commission finds that other factors support the recovery of the deferral costs. The innovative approach taken by MPS in completing the two projects is an important factor. The construction of the project was extended over several

[42] Tr. 532.

[43] "Because rates are set to recover continuing operating expenses plus a reasonable return on investment, only an extraordinary event should be permitted to adjust the balance to permit costs to be deferred for consideration in a later period." *State ex rel. Public Counsel,* 858 S.W.2d at 814.

[44] Report and Order on Rehearing, *In the matter of Missouri Public Service, a division of Utilicorp United, Inc.'s proposed tariffs to increase rates for electric service provided to customers in the Missouri service area of the Company,* Case No. ER-93-37, 2 Mo.P.S.C.3d 206, 209-10 (June 18, 1993).

> years and has permitted MPS to return Sibley to service for peak use periods. Also, the projects themselves have extended the life of the Sibley plant by twenty years and have brought the plant into closer compliance with Clean Air Act standards. These factors have benefited ratepayers and will benefit ratepayers into the future. These ratepayer benefits are important factors.[45]

Additionally, Mr. Klote for Aquila testified that the main objective was to minimize the harm to customers, meet peak demand, and curtail generation needed in the future.[46] Also, Mr. Williams testified to the uniqueness of the construction project, entailing limited shut-downs rather than a complete shut-down of the project during construction.[47] Finally, the Commission has found:

> … these costs should be amortized over 20 years which is the approximate extended life of the plant. The Commission finds that this approach matches the payments of the costs by the ratepayers for the rebuilding with their enjoyment of its benefits.[48]

Staff has consistently applied the Commission's methodology in each Aquila rate case and the rate cases of its predecessor company since Case No. ER-90-101. The capital expenditures and the related AAO authorized by the Commission are just like any other capital expenditure in that they are given rate base treatment (return on the investment) as well as a recovery of the related costs through depreciation/amortization expense recovery.[49]

The Sibley Rebuild Program and The Sibley Western Coal Conversion Project were unique, extraordinary construction projects undertaken in an atypical way to ensure the company could continue to provide adequate service during peak periods.[50] The AAOs were designed to cover construction accounting as the plant work was done, as the work was completed in small

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[45] Report and Order on Rehearing, *In the matter of Missouri Public Service, a division of Utilicorp United, Inc.'s proposed tariffs to increase rates for electric service provided to customers in the Missouri service area of the Company,* Case No. ER-93-37, 2 Mo.P.S.C.3d 230, 236-37 (February 25, 1994).
[46] Tr. Vol. 5, p. 101, ll. 20-24.
[47] Tr. Vol. 5, p. 163, l. 25 – p.165, l.20.
[48] Report and Order, *In the matter of Missouri Public Service for authority to file tariffs increasing rates for electric service provided to customers in the Missouri service area of the company*, Case No. ER-90-101, 30 P.S.C. (N.S.) 320, 340 (October 5, 1990).
[49] Staff witness Williams Rebuttal, p. 5, ll. 10-20.
[50] Tr. Vol 5., p. 111, ll. 10-18.

increments during fall and spring outages so the plant would be available during the summer peaking period.[51] These projects represent major capital additions to plant in service, rather than extraordinary maintenance expenditures resulting from an extraordinary occurrence like in an ice storm. The deferred costs included in the AAO authorized by the Commission for the life extension of Sibley should be treated the same way as the other capital costs for these projects, and afforded rate base treatment. Absent AAO treatment, these amounts would have been lost as a result of booking these costs directly to expense following completion of the projects.[52] By receiving the AAOs, the company avoided the cost of filing a rate case each year and during the Coal Conversion Project period.[53] Allowing a continuation of construction accounting of major capital projects by an AAO and including those construction costs in rate base provides an incentive for the utility to commit significant capital investment on a timely basis.[54]

The Commission has the regulatory authority to grant a form of relief to a utility in the form of an accounting technique—an AAO.[55] An AAO allows the utility to defer and capitalize certain expenses until the time it files its next rate case, and it protects the utility from earnings shortfalls and softens the blow which results from extraordinary construction programs.[56] The Commission has already granted the AAOs and incorporated them in prior rate cases and should proceed to do so again here.

<u>Fuel Cost Recovery</u>

15. Should the Commission authorize Aquila to utilize a fuel and purchased power recovery mechanism consisting of periodic rate adjustments outside

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[51] Tr. Vol. 5, p. 152, ll. 15-23.
[52] Tr. Vol. 5, p. 96, ll. 15-24.
[53] Tr. Vol. 5, p. 102, ll. 5-12; p. 123, l. 21 - p.124, l.5; Tr. Vol. 5, p. 139, l. 9 - p. 140, l. 2.
[54] Staff witness Williams Rebuttal, p. 6, l. 19 - p. 7, l. 5.
[55] *Missouri Gas Energy v. Public Service Commission State of Missouri,* 978 S.W.2d 434, 436 (Mo. App. 1998).
[56] Id. at 436.

> of rate proceedings or an interim energy charge to reflect increases and decreases in its prudently incurred fuel and purchased power costs, including transportation as authorized by law?

NOTE: An alternative phrasing of this issue appears in the listing of issues filed in this case on March 22, 2007. It is the Staff's position and recommendation to the Commission that it authorize an interim energy charge in this case

Introduction

Although the Staff believes the use of historical costs is generally the most reliable approach to determining fuel prices, because it is extremely difficult to develop fuel costs in the current energy market, the Staff agrees with Aquila that a non-traditional approach is appropriate to address Aquila's fuel and purchased power costs in this proceeding. The combination of a) the high volatility that has characterized the natural gas and purchased power markets in recent years, and b) Aquila's relatively heavy reliance on both gas-fired generation and purchased power, calls for something other than the traditional single-point approach to determining the fuel and purchased power costs to be included in Aquila's revenue requirement.[57] Aquila has proposed a Fuel Adjustment Clause ("FAC") in what is referred to as a total pass-through fuel clause. The Staff opposes this fuel clause because it does not contain sufficient incentives for Aquila to minimize its fuel and purchased power costs. Instead, the Staff recommends that the Commission implement an Interim Energy Charge ("IEC"). The Legislature has specifically empowered the Commission to authorize either mechanism in recently enacted Section 386.266 (often referred to as "Senate Bill 179") of the Missouri statutes. If, however, the Commission rejects use of an IEC mechanism in this case, the Staff recommends that the Commission authorize Aquila to use the alternative fuel mechanism (Alternative FAC") advocated by the

[57] Featherstone Direct, Ex. 206, p. 20, l. 19 – p. 21, l. 6; p. 24, ll. 9-10; p.25, l.18 – p. 26, l. 12.

Sedalia Industrial Energy Users' Association ("SIEUA") and Ag Processing Inc a Cooperative [with St. Joseph Industrial Group] ("AGP") (collectively, "SIEUA-AGP"), and presented in the rebuttal testimony of their witness, Donald Johnstone.[58] This Alternative FAC provides incentives to encourage the Company to seek out low cost fuel and purchased power options.[59]

Note Regarding Heat Rate Testing Issue

A sub-issue, which arose between Aquila and the Staff, concerns the methodology that Aquila should use to conduct heat rate testing on its generation units in connection with its application for a Fuel Adjustment Clause. The Staff notes that during the hearing, it reached agreement with Aquila as to how this matter should be handled on a going-forward basis. That agreement appears as Exhibit 242 in the hearing record. Accordingly, the Staff does not further address this heat rate testing matter in this brief.

Aquila's Proposed Fuel Adjustment Clause

Under Aquila's proposal, periodically the difference between the costs of fuel and purchased power built into base rates and the costs that Aquila actually incurs for these items would be determined. An "FAC factor" would then be calculated for purposes of distributing this difference to customers. In its direct filing, Aquila proposed that off-system sales margins ("OSS margins") be included in base rates and that deviations from the base amount be shared with customers on a 50/50 basis using the FAC mechanism. Among other items to be flowed through Aquila's proposed FAC are "[a]ll hedge costs, settlement costs and benefits," insurance proceeds related to fuel and purchased power for generation outages, and Commission-approved capacity contracts that are less than one year in duration. The proposal also called for quarterly adjustments (provided that they were of a significant size) to commence six months after the

[58] Johnstone Rebuttal, Ex. 504.
[59] Featherstone Surr., Ex., p. 18, l. 32 – 19, l. 2.

adjustment is accumulated. Any adjustment amounts would accrue interest calculated monthly at Aquila's weighted average short-term cost of debt.[60]

In its surrebuttal filing, Aquila modified its original proposal. Most importantly, Aquila changed its proposed 50/50 sharing between Aquila and its customers of deviations in off-system sales margins from the base amount. Aquila dropped its "50% sharing" method for off-system sales and agreed to reflect all off-system sales margins in the FAC.[61] Aquila also extended its proposed recovery period from quarterly to annually, as suggested by Office of the Public Counsel witness Russell Trippensee. In addition, the tariff sheet included as Schedule DRW-1 to Aquila witness Dennis Williams' testimony was corrected as requested by Mr. Trippensee, and the original proposal was modified to incorporate separate loss factors by rate class and voltage level, in response to the recommendations of industrial intervenor witnesses Donald Johnstone and Maurice Brubaker.[62]

The Staff's Proposed Interim Energy Charge

The Staff opposes Aquila's FAC proposal, and instead recommends implementation of an IEC, a fuel recovery mechanism that the Commission is now specifically empowered by Section 386.266 RSMo. Supp. 2006, to authorize electric utilities to use. This IEC mechanism would be similar to that previously implemented for both Aquila in Case No. ER-2004-0034 and The Empire District Electric Company in Case Nos. ER-2001-299 and ER-2004-0570. A base (or

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[60] Williams Direct, p. 3, l. 16 – p. 4, l. 16.
[61] This is not entirely clear. Live testimony from Aquila witness Dennis Williams indicated that the Company had not completely moved to a new position on this issue. Mr. Williams stated: "I don't believe we necessarily said we were changing. I think we -- we accepted some proposals or -- in fact, we would be happy with the original proposal we made. What we were doing was looking at other proposals then made by parties. And those that made sense, we said we can live with those as well. So we -- we were accepting, but not really necessarily changing. We were saying we could change and agree to those changes." However, in discussing the modification of Aquila's proposal regarding OSS margins, Mr. Williams stated: "Aquila is not currently proposing a sharing of off-system sales margins." Later in his surrebuttal, Mr. Williams stated: "Aquila agrees that a sharing of off-system sales is not appropriate at this time and is proposing that all off-system sales margins should flow through the FAC mechanism." (Williams Surr., Ex. 34, p. 7, ll. 10-11; p. 9, ll. 7-8).
[62] Williams Surr., Ex. 34, p. 7, ll. 9-20.

floor) level of estimated fuel and purchased power costs would be included in permanent rates. An additional portion of strictly variable costs up to a forecast (or ceiling) level would be collected via an IEC surcharge based on the kWh usage of Aquila's customers. Specifically, the Staff recommends that the floor amount reflect a price of $6.00 per MMBtu for natural gas and $55.00 per MWH for variable purchased power (*i.e.*, energy). The corresponding prices reflected in the ceiling amount would be $9.00 per MMBtu of natural gas and $90.00 per MWH of purchased energy.[63] The IEC surcharge would generate approximately $50 million, about 80% (or approximately $40 million) of which would be associated with MPS, and the remainder (or approximately $10 million) with L&P.[64]

Relative to the IEC previously implemented for Aquila in Case No. ER-2004-0034, additional costs should be included; *i.e.*, a) the costs and benefits associated with Aquila's hedging program, which was in its infancy when Aquila's first IEC was implemented; and b) the current cost of coal purchased when C.W. Mining breached its coal supply contract with Aquila (with the C.W. Mining cost reflected in base rates).[65] Moreover, the effects of any other unusual events similar to the extended outage of Aquila's Sibley generating station should be taken into account in the prudence audit and considered in any future IEC, so as to allow a better identification of pure price effects.[66]

The effective period of the IEC should be two years. Although the Staff contemplated an IEC term of as much as three years, the Staff believes that, in light of the now-pending

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[63] TR. 755, ll. 15 – 756, l. 12.
[64] Featherstone Surr., p. 14, ll. 5-7.
[65] Inclusion of both of these items is consistent with the Stipulation And Agreement As To Certain Issues, filed on April 4, 2007 and approved by the Commission on April 12, 2007.
[66] Featherstone Direct, Ex. 206, p. 33, l. 9 – p. 36.

acquisition of Aquila by Great Plains Energy Inc. (the parent of Kansas City Power & Light Company), an IEC period of two years appears to the Staff to be more appropriate.[67]

A true-up audit would be conducted following the expiration of the IEC. If, upon the completion of the audit, Aquila's prudently incurred variable fuel and purchased power costs are within the range defined by the ceiling and floor amount of the IEC, customers would receive a refund equal to the amount collected minus the prudently incurred actual costs. If those actual costs are below the floor amount, customers would receive a refund equal to the total amount collected under the IEC, and Aquila would retain the difference between the base amount and the actual cost. If actual costs exceed the amount collected, Aquila, not its customers, would absorb the amount of the excess. Any refund amounts determined to be due to customers as a result of the true-up audit would be returned with interest.[68]

Argument

The Staff believes that the IEC is the most appropriate mechanism for addressing the issue of fuel and variable purchased power cost recovery during times when prices reflect the level of volatility that has characterized these markets in recent years. A properly designed IEC permits the sharing between the Aquila utility and its customers of the risk associated with recently experienced natural gas and purchased power price volatility. The IEC creates a range of variable fuel and purchased power prices within which Aquila will be assured of recovering all of its prudently incurred fuel and purchased power costs, and Aquila's customers will not be paying any more than those costs after the true-up.[69] The mechanism affords customers a period of stability regarding electricity prices during its effective period. In addition, the IEC provides incentives for Aquila to run its plants efficiently, and to minimize the cost of its fuel and

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[67] Tr. 706, ll. 15-17.
[68] Featherstone Direct, Ex. 206, p. 11, l. 16 – p. 12, l. 10; p.14, ll. 30-32.
[69] *Id.* at p. 12, l. 4; p. 14, l. 28.

purchased power, both to avoid incurring costs above the forecast level and to take advantage of opportunities to drive costs below the base level.[70]

The IEC has been used in three recent rate cases, two involving The Empire District Electric Company and one involving Aquila. One of the two Empire IECs was successful; the other, arguably, was not. Aquila claims that it did not have a successful experience with its IEC, which was implemented in Case NO. ER-2004-0034. The claim ignores the fact that Aquila's high fuel and purchased power costs during the effective period of its IEC were due in large part to two particular occurrences; *i.e.*, the breach by C.W. Mining of its coal supply agreement with Aquila, and the extended maintenance outage at Aquila's Sibley plant. As a result of the coal supply problem, Aquila had to pay almost twice the price for its high Btu supply of coal burned at its Sibley and Lake Road generating facilities. With the exception of Iatan, Sibley is the lowest cost coal-fired plant owned by Aquila. In addition to these two events, Aquila's IEC mechanism was adversely affected by the way in which Aquila booked its fuel costs between the MPS and L&P divisions. The collection of the IEC revenues was different from the way two divisions booked fuel costs, which caused problems with the two IEC calculations. Together, these occurrences had a dramatic impact on Aquila's fuel and purchased power costs and consequently, on its inability to fully recover those costs under its previous IEC. In fact, as Staff witness Featherstone noted, "While natural gas prices may have been high during the period of the 2004 IEC, they did not contribute to the majority of the under-recovery of costs to date—the coal contract and Sibley outage caused the majority of the under-recovery."[71] Because these occurrences are obviously different in nature from price fluctuations in the fuel and purchased

[70] Tr. 714, ll. 20-23.
[71] Featherstone Direct, Ex. 206, p. 36, ll. 12-15.

power markets, which the IEC mechanism was intended to address, the Staff is much less inclined to pronounce Aquila's last IEC a failure.

The Staff opposes Aquila's FAC proposal primarily because the mechanism, with its full pass-through of Aquila's prudently incurred costs to its customers, virtually eliminates the traditional ratemaking incentives for Aquila to reduce its costs of fuel and purchased power. Like other parties, the Staff is concerned that the loss of these incentives will cause customers to have to pay higher fuel and purchased power costs. As Staff witness Featherstone noted in live testimony, "I think they have much less incentive under a [full] pass-through fuel clause. It's human nature. It takes a lot of work to operate an electric system. It takes a lot of work to negotiate contracts."[72, 73]

While acknowledging that "[t]he level of incentive under a regime without an FAC is probably different,"[74] in live testimony Company witness Williams attempted to downplay the power of the incentives that would all but disappear as a result of implementation of Aquila's FAC. According to Mr. Williams, incentives in Aquila's core business are not terribly significant. Instead, only incentives connected with Aquila expanding into a business outside of its core business would have a significant impact on its actions.[75] Mr. Williams states:

> If -- when we're talking about a fuel adjustment clause, that applies to our core business. And that's why I'm saying -- I think we would run our core business just as we always have. But if -- if someone wants to encourage us to move outside of our core business into a new line of business, then perhaps an incentive would be appropriate.[76]

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[72] TR. 715, 715, ll. 3-6.
[73] It also takes a lot of work, and perhaps some luck to be able to determine how hard a utility negotiated to achieve a certain price on a sale or purchase contract.
[74] Tr. 634, ll. 17-18
[75] Tr. 632-638.
[76] Tr. 637, ll. 14-20.

The argument is, at best, unconvincing. Apart from Aquila, no party disputes that the strong incentives produced by regulatory lag under the traditional ratemaking approach would be greatly diminished, if not completely eliminated, were the Commission to adopt Aquila's FAC proposal**.** By contrast, the IEC preserves those incentives in cost ranges above and below the amounts represented by the IEC floor and ceiling, respectively. Considering this along with the rate stability afforded by the IEC during its effective period, the IEC is much more akin to traditional ratemaking for electric utilities than Aquila's FAC.[77]

<u>The prudence review is no panacea.</u>

Aquila claims that the threat of a prudence review will provide sufficient incentive for it to reduce fuel and purchased power costs.[78] Indeed, Aquila witness Steve Fetter, a former Commissioner at the Michigan Public Service Commission, refers to the review as "the greatest hammer of all."[79] Incredibly, Mr. Fetter was unable to identify even one instance in Michigan or any other state in which a prudence disallowance occurred under a fuel adjustment clause.[80] The Staff strongly disagrees with Mr. Fetter that the prudence review will provide Aquila with sufficient incentive for a number of reasons, as discussed below.

First of all, in comparison to a traditional rate case, the burden of proof regarding a disallowance in an FAC prudence review shifts to the party proposing the disallowance.[81] Normally in a general rate case, the utility would have the burden to prove that costs should be included in the revenue requirement calculation. However, when the issue is a refund to ratepayer of monies already collected and pocketed by the utility[82], as a practical matter, the

[77] Tr. 714, ll. 13-14.
[78] Williams Rebuttal, Ex. 33, p. 10, l. 23.
[79] Fetter Rebuttal, Ex. 9, p. 7, l. 19.
[80] Tr. 587, ll. 2 – 588, l. 14.
[81] Tr. 715, ll. 24-25; 794, ll. 11-13.
[82] Tr. 625, ll. 13-15.

party seeking the disallowance (often the Staff) will have the burden to show that the disallowance is justified.

The burden shift reflects this fundamental difference between a prudence audit under an FAC regime and one performed as part of a general rate case. Prudence audits under either a total pass-through fuel clause or an IEC are an after-the-fact review of fuel and purchased power costs. In contrast, both the utility and the Staff in a traditional rate case use historical information as inputs to the fuel model and use annualized weather-adjusted load requirements to determine fuel costs. This traditional process removes abnormal conditions and reflects full annualized pricing on a going-forward basis, which is certainly not an after-the-fact process. In fact, most of the adjustments that occur during the course of determining fuel expense in a rate case process do not relate to imprudence at all, but rather, are annualization and normalization adjustments. Moreover, in a typical rate case situation, prudence disallowances, which are made strictly on a going-forward basis, usually occur in the context of a proceeding in which the utility will receive an overall rate <u>increase</u>.

Because of the completely different focus between after-the-fact prudence reviews of a fuel clause and the traditional rate case process, the FAC reviews will very likely be much more contentious. On the witness stand, Staff witness Featherstone described from a utility point of view, the likely mindset of utility personnel that could well cause them to drag their feet and be much more defensive in a prudence review:

> I already have the money. I don't want to give it up. I certainly don't want to be cited with imprudence because we know what that means. It might be my job if I'm a utility guy. And I'd be caught with the adjustment, so I don't have a lot of incentive to cooperate. I'm going to do just the bare minimum. And I may not have a lot of incentive to provide the documents necessary to do a full review.[83]

[83] Tr. 744, ll. 18-25.

Furthermore, common sense says that, in the absence of any incentives to hold down on the costs of fuel and purchased power, the utility will be less diligent in its efforts to do so.[84] As AARP witness Nancy Brockway[85] stated:

> And if [the utility] has no reason to fear costs going up, if it just flows them immediately through to customers, then it doesn't have the same drive to be efficient, and it can sit back and focus its management attention on something else. And the customers then would pay higher costs than they should have paid because the company simply wasn't driven to be as efficient as possible.[86]

Aquila noted that a pass-through process in the form of the Purchased Gas Adjustment/Actual Cost Adjustment ("PGA/ACA") process, which includes a true-up with a prudence review, is already in place in Missouri for the state's natural gas local distribution companies ("LDCs"). The Staff believes, however, that the electric utility prudence audit process discussed above promises to be considerably more complex than it is for the PGA/ACA process.[87] AARP witness Nancy Brockway, who has experience with FACs and LDC prudence issues confirmed this view, stating that LDC prudence reviews are largely concerned with hedging issues, and that:

> It's much more complicated un the electric industry because there are hundreds and thousands of decisions that the electric company has control over which may or may not have an impact on the length of an outage. . . but in a coal plant, although it's somewhat simpler than a nuclear plant, it's still a fairly complicated machine, and there's a tremendous amount of attention that has to be paid to a lot of details.[88]

Indeed a major Staff concern with respect to the FAC prudence review is that the complexity and sheer volume of materials that the Staff will need to examine will make it extremely difficult to even identify instances of imprudence on the part of Aquila, much less to

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[84] Tr. 751, ll. 24 - 752, l. 1;
[85] Ms. Brockway is a former commissioner on the New Hampshire Public Utilities Commission, also with experience with the Massachusetts and Maine commissions. Brockway Surr., Ex. 601, p. 3, ll. 28-33.
[86] Tr. 845, ll. 19 – 846, l. 1.
[87] Featherstone Surr., Ex. 208, p. 5, l. 14 – p. 6, l. 2.
[88] Tr. 879, ll. 1-23.

develop sufficient evidence to prevail in a proceeding."[89, 90] Just in terms of the volume of work, a whole host of matters will need to be analyzed and evaluated, including, "plant outages, heat rates, fuel and purchased power prices, the complexities of operating power plants, the dynamic of the market place for selling and purchasing power, and many other items.[91] In a traditional rate case, many of these issues are resolved by the use of a fuel model, which yields the variable cost of fuel and purchased power. All electric companies use a fuel model to assist in the determination of fuel and purchased power costs in a rate case. Staff uses a fuel model in each of these electric rate cases, as well.

During the hearing, Staff witness Featherstone identified some specifics regarding the volume of material and the detail that the Staff would have to consider in such an audit, including the following[92]:

- dramatic increase in the number of transactions reviewed

- long-term natural gas and coal contracts, natural gas and coal spot prices, purchase power agreements, off-system sales, pricing structure mechanisms, plant operations, forced and scheduled outages of each power plant, power plants' efficiencies and operations, maintenance/improvements that were or were not done; the capital additions and budget process, capacity need/reservations on the natural gas transmission system, freight/transportation, hedging costs, affiliate transactions,

- specifically in the case of Aquila's proposed FAC: fuel handling costs---labor and the associated maintenance and equipment cost

- depending on the circumstance, possibly daily transactions

- costs of longer term contracts would have to be specifically examined.

Furthermore, the level of scrutiny required in a proper prudence review will necessarily be ratcheted up.[93] Mr. Featherstone gave the example of the unexpectedly long outage at

[89] Tr. 715, ll. 19 – 716, l. 2; Featherstone Surr., Ex. 208, p. 5, l. 11 – p. 6, l. 2.
[90] AARP witness Nancy Brockway testified that when she was on the New Hampshire commission, the standard for prudence was one "that would stand up in a court of law." (Tr. 847, ll. 17-23).
[91] Featherstone Direct, p. 13, ll. 15-19.
[92] Tr. 720-730.

Aquila's Sibley plant, and described the Staff's approach under traditional ratemaking in comparison to what might well occur under an FAC.

> I think under traditional rate-making, we took the position -- we were aware of it. We -- in fact, I visited the plant, talked with the superintendent, kind of got an overview of what happened, provided some -- did some discovery and received some documents and looked at those and concluded that because the traditional rate-making process allowed for an averaging of that outage through the -- the fuel model, that we would not pursue the issue and not present the issue, we would not identify -- it would not rise up to an impact.
>
> When you have a situation where you're doing a total pass-through of -- for fuel clauses where those higher costs of generation and purchase power is going to be passed through, you might -- you might tend to look at that in a much different light and conclude much different -- much differently because you're no longer in the position where you can just simply take it and average or add out or spread out those additional costs.[94]

In addition, because of the inherent complexity of many of these matters, a proper review may very well prove costly. AARP witness Nancy Brockway testified that such audits will necessarily include not only accounting personnel, but also engineers. She further stated that, in her experience, it was on the engineering side that "some of the really difficult prudence issues come up, the ones that are very hard to pin down. And that, as I say, although we had some excellent engineering staff, they had other duties, too. We almost always hired out, and it would be 100 to $200,000 a case for outside assistance."[95]

It is true that, as Aquila sought to establish at the hearing, generally the same matters would need to be audited under the Alternative FAC proposal of SIEUA-AGP witness Donald Johnstone, which the Staff would favor as a fall-back alternative to its IEC. However, in the case of an audit of the Alternative FAC proposal, the dollar amount at issue would be only 50% of the amount in play under the Company's FAC proposal. Because of this substantial reduction in the

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[93] Tr. 721, ll. 25 – 722, l. 3.
[94] Tr. 719, ll. 9 – 720, l. 1.
[95] Tr. 881, ll. 17-23.

amount that could be passed through to customers, the pressure on the prudence reviewer to uncover bad decision making, and thus improper costs, could be lessened if the Commission were to adopt the Alternative FAC proposal.[96] This could potentially relieve the Staff and other parties of the need to do as detailed a review of the fuel mechanism. Conversely, under Aquila's total pass-through approach, a much higher degree of review will be required. The Staff would note also that, in the case of its recommended IEC, the prudence audit would be conducted only once in a two-year period (*i.e.*, upon the expiration of the IEC), versus twice during the same two-year period with either fuel adjustment clause mechanism currently being proposed.

Under Aquila's proposed total pass-through of fuel cost increases, there is no limit to how high fuel costs ultimately can go for customers. This is lessened somewhat by the use of the Alternative FAC. The use of an IEC approach provides an upper limit, or cap, as to high fuel costs can go, thus providing some protection to Aquila's customers. If fuel and purchased power prices increase dramatically above the cap, Aquila could file for a rate increase case, which would allow for a full investigation of the reasons fuel costs increased. Thus, the IEC provides for a better protection from the impacts of high fuel costs.

By asserting that the audit requirements of the FAC will be daunting, the Staff does not mean to suggest that it is incapable carrying out the task. If the Commission sees fit to order an FAC, the Staff will do what is necessary, although it may require additional staffing.[97]

<u>Inappropriate cost items are included in Aquila's proposed FAC.</u>

The Staff strongly recommends that only variable fuel and purchased power costs, including variable transportation costs, be included in any fuel cost recovery mechanism.[98] Regardless of the mechanism---the IEC, the Alternative FAC, or the Company's proposed total

[96] Tr. 757, ll. 11-20.
[97] Tr. 730, ll. 22-25.
[98] Tr. 756, ll. 19 – 757, l. 3; 734, ll. 22 – 735, l. 3.

pass-through mechanism---costs such fuel handling, fly-ash removal and demand charges should not be included in the fuel mechanism. Senate Bill 179 was intended to address fuel price volatility and the resulting increases in fuel and purchased power costs, not the relatively small dollar non-variable costs of fuel that do not significantly fluctuate from one year to the next. These types of largely fixed costs are more appropriately dealt with in a rate case and reflected in base fuel costs in base rates charged Aquila's customers.

In particular, while Aquila proposes to exclude demand charges for long-term capacity contracts, its FAC proposal includes demand charges for Commission-approved purchased power capacity contracts with a duration of less than one year. The Staff is opposed to inclusion of such demand charges for any capacity contracts regardless of their duration for two reasons. First, they should not be included because these demand charges are fixed rather than variable costs and relate to costs that can be thought of more like capital costs in nature, as they are made to reserve capacity.[99] Second, the Staff is opposed to Aquila's short-sighted use of a series of short-term contracts to meet its growing capacity needs. Staff has taken issue with Aquila's capacity planning in the last several years, claiming Aquila has placed too great a reliance on short-term capacity contracts.[100] Allowing Aquila to pass demand costs for short-term capacity contracts through in an FAC would mean that Aquila could, in effect, always meet its growing load requirements through short-term capacity, thus creating another disincentive for it to build generating units. In addition, only customers would be assuming the risk of the associated volatility.[101]

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[99] Featherstone Rebuttal, Ex. 207
[100] Tr. 707, ll. 25 – 708, l. 17..
[101] Mantle Surr., Ex. 218, p. 5, l. 16 – p. 6, l. 4.

Alternative FAC

If the Commission decides to authorize an FAC for Aquila in this proceeding rather than an IEC, the Staff recommends the Alternative FAC sponsored in the testimony of SIEUA-AGP witness Donald Johnstone, not the FAC proposed by Aquila.[102] Staff witness Featherstone cited with favor a number of principles and features of the Alternative FAC, including a two-year time limit on the mechanism, a longer accumulation period[103], and inclusion of performance standards for the production facilities to provide protection from unusual outages that may occur while the Alternative FAC is in place.[104] The most important feature of the Alternative FAC is its inclusion of a sharing mechanism, making it "a much fairer approach than what is being proposed by Aquila in this case."[105] The sharing proposal would provide Aquila with incentives to operate its plants as efficiently as possible.

Aquila's assertion that the sharing mechanism proposed as part of the Alternative FAC would prevent it from recovering its prudently incurred fuel and purchased power costs is simply incorrect. If prudently incurred costs increase in one time period, they might very well decrease in a subsequent period. When those two time periods are considered in total, it is possible that the utility would recover *more* than its prudently incurred fuel and purchased power costs. Indeed, Aquila witness Williams so acknowledged when presented with such an example, stating: "Under that hypothetical, I would say that the company would have, in that situation, been allowed to achieve even more than its prudently incurred fuel and purchase power costs."[106] Notwithstanding Mr. Williams' subsequent statement on redirect examination concerning the

[102] Johnstone Rebuttal, Ex. 504.
[103] Under Aquila's modified proposal, the recovery periods are the same for both proposals (*i.e.*, one year).
[104] Featherstone Surr., p. 18, l. 10 – p. 19, l. 1.
[105] Featherstone Surr., Ex. 208, p. 17, ll. 9-20.
[106] Tr. 643, ll. 21-24.

likelihood of the scenario presented[107], the fact is that ultimately nobody knows what future fuel and purchased power prices will be. In addition, a failure to recover the entirety of Aquila's prudently incurred fuel and purchased power expenses in a particular time period could be offset by lower costs in other areas, thereby allowing Aquila to earn a fair rate of return. Of course, such savings are made possible by the fact that other areas of expenditure are governed by traditional regulation, with its inherent incentives, courtesy of regulatory lag.

It is important to note that the sharing proposal in the Alternative FAC is not the type of sharing where shareholders are required to absorb the increase in fuel costs. During the hearing, it was pointed out that the 50% sharing in the Alternative FAC relates to the increases and decreases above the base amounts in rates for fuel and purchased power costs. The 50% increases and decreases would be passed through in the Alternative FAC, unlike 100% proposed in Aquila's FAC. The other 50% of the Alternative FAC would be treated just like those costs are today---in the traditional ratemaking approach. That is, these costs increases and decreases would be collected in rates through efficiencies of the rate setting process. As other costs go down, which invariably happens, or as revenues increase as result of higher demands or through growth of customers and usage, all or a portion of Aquila's share of any post-audit incremental cost increase will, in effect, be recovered from customers. It is not the intent for shareholders to have to provide funds for any prudently incurred fuel and purchased power costs.[108]

[107] Tr. 670, ll. 24 – 672, l. 4.
[108] Tr. 732, ll. 21 – 733, l. 7.

Conclusion

Section 386.266 RSMo gives the Commission broad authority with regard to providing utilities a fuel cost recovery mechanism. Indeed, Section 386.266.4 gives the Commission the authority to "approve, modify, or reject adjustment mechanisms" proposed by utilities. This rate case provides the first opportunity the Commission has to address a fuel cost recovery mechanism for Aquila, and any change from traditional ratemaking should be carefully considered. Although, in a more normal energy market environment, the Staff would prefer traditional ratemaking for determination of fuel and purchased power costs using the powerful incentives in that process, the Staff recommends the use of some type of fuel cost recovery mechanism in this case. The Staff's first preference is the use of an IEC recovery mechanism. However, if the Commission decides against an IEC approach, Staff supports the Alternative FAC identified by the SIEUA-AG witness Johnstone. Either the IEC or the Alternative FAC provides much more protection to Aquila's customers than does the proposal supported by Aquila. Aquila's FAC provides no incentives for the Company to operate its fuel and purchased power costs efficiently or in a least cost manner.

In crafting Section 386.266, the Missouri Legislature recognized the importance of incentives. Subsection 1 of that statute states:

> Subject to the requirements of this section, any electrical corporation may make an application to the commission to approve rate schedules authorizing an interim energy charge, or periodic rate adjustments outside of general rate proceedings to reflect increases and decreases in its prudently incurred purchased-power costs, including transportation. The commission may, in accordance with existing law, include in such rate schedules features designed to provide the electrical corporation with <u>incentives</u> to improve the efficiency and cost-effectiveness of its fuel and purchased power procurement activities. (Emphasis added.)

The Staff strongly recommends that the Commission avail itself of the Legislature's invitation to incorporate incentives into an authorized fuel recovery mechanism in this proceeding in the form of the Staff's recommended IEC.

As noted above, if the Commission decides instead to implement an FAC, the Staff would recommend the form of the Alternative FAC as clearly superior to Aquila's total pass-through FAC proposal. In the event, however, that the Commission decides to reject both the Staff's IEC recommendation and the Alternative FAC, in favor of the FAC proposed by Aquila, the Staff would urge the Commission: a) to limit costs eligible for FAC treatment to variable fuel and purchased power costs, and b) to include the above-mentioned modifications set out in the Company's surrebuttal filing, and especially the one concerning off-system sales margins; *i.e.*, that the difference in OSS margins from the level included in base rates be included in the FAC, but with no sharing of those differences, post-audit. Any such amounts would then flow entirely to Aquila's customers.

CONCLUSION

For the reasons stated herein and in Staff's Prehearing Brief filed March 30, 2007, the Commission should adopt the Staff's positions on the remaining contested issues in this case.

WHEREFORE the Staff submits the foregoing as its posthearing brief for this case.

Respectfully submitted,

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I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record this 27th day of April 2007.

/s/ Nathan Williams