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 Services Provided	)	**<u>Case No. ER-2007-0004</u>**
to Customers in the Aquila Networks – MPS and	)	Tariff No. YE-2007-0001
Aquila Networks – L&P Service Areas	)	

REPORT AND ORDER

Issue Date: May 17, 2007

Effective Date: May 27, 2007

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 Services Provided to Customers in the Aquila Networks – MPS and Aquila Networks – L&P Service Areas	)))))	 **<u>Case No. ER-2007-0004</u>** Tariff No. YE-2007-0001

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REGULATORY LAW JUDGE: **Cherlyn D. Voss**

REPORT AND ORDER

I. Background

A. Procedural History

On July 3, 2006, Aquila, Inc., d/b/a Aquila Networks – MPS and Aquila Networks – L&P (“Aquila”) filed proposed tariff sheets, Tariff File No. YE-2007-0001, designed to implement a general rate increase for retail electric service. The matter was opened and denominated ER-2007-0004. The new rates contained therein were designed to produce additional gross annual electric revenues of $94,500,000 in Aquila’s MPS operating division, and $24,400,000 in Aquila’s L&P operating division, excluding gross receipts, sales, franchise, and occupational taxes. The proposed increase would result in a 22% and 22.1% increase, respectively, over existing revenues. The tariff sheets proposed an effective date of August 2, 2006.

The Commission issued its Suspension Order and Notice on July 5, 2006, suspending the proposed tariff sheets for 180 days plus six months from the original proposed effective date, that is, until May 31, 2007. In the same order, the Commission directed notice of Aquila’s tariff filing be provided to interested parties and the public. The Commission also established July 31 as the deadline for submission of applications to intervene.

The Sedalia Industrial Energy Users Association (“SIEUA”), AG Processing, Inc. (“AG Processing”), the City of St. Joseph, Missouri, the City of Kansas City, Missouri, Union Electric Company, d/b/a AmerenUE (“AmerenUE”), the Missouri Department of Natural Resources (“DNR”), AARP, and the Federal Executive Agencies (“FEA”), submitted timely applications and were allowed to intervene. Subsequently, The Commercial Group and the

County of Jackson, Missouri filed late applications to intervene and were also allowed to intervene.

On August 2, 2006, the Commission established the test year for this case as the 12-month period ending December 31, 2005, adjusted and updated for any known and measurable changes through June 30, 2006. The Commission deferred making a decision as to whether to order any further true-up in this case until the parties were prepared to offer further recommendations. The parties subsequently agreed that no further true-up was needed, and no further true-up was ordered. On August 22, 2006, the Commission established a procedural schedule that included dates for the filing of prepared testimony and set an evidentiary hearing to begin on April 4.

The Commission conducted five local public hearings within Aquila's service territory at which the Commission heard comments from Aquila's customers and the public regarding Aquila's request for a rate increase. Public hearings were held in Lee's Summit on January 22, 2007, in Nevada and Sedalia on January 23, and in St. Joseph on January 24.

The parties prefiled direct, rebuttal and surrebuttal testimony. The evidentiary hearing began on April 4, 2007, and continued through April 12, at the Commission's offices in Jefferson City, Missouri. The Commission heard the testimony of 21 witnesses; 112 exhibits were offered during the hearing, including the pre-filed testimony of the witnesses. Most of those exhibits were admitted, some over objection preserved for appeal, and some of which were admitted after a portion was stricken. The Commission took administrative notice of some of the exhibits not admitted.

II. Discussion

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact and conclusions of law. The positions and arguments of all of the parties have been considered by the Commission in making this decision. Failure to specifically address a piece of evidence, position or argument of any party does not indicate that the Commission has failed to consider relevant evidence, but indicates rather that the omitted material was not dispositive of this decision. [1]

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[1] In making its Findings of Fact and Conclusions of Law, the Commission is mindful that it is required, after a hearing, to "make a report in writing in respect thereto, which shall state the conclusion of the commission, together with its decision, order or requirement in the premises." Section 386.420.2, RSMo 2000. Because Section 386.420 does not explain what constitutes adequate findings of fact, Missouri courts have turned to Section 536.090, which applies to "every decision and order in a contested case," to fill in the gaps of Section 386.420. *St. ex rel. Laclede Gas Co. v. Pub. Serv. Comm'n of Mo.,* 103 S.W.3d 813, 816 (Mo. App., W.D. 2003); *St. ex rel. Noranda Aluminum, Inc. v. Pub. Serv. Comm'n,* 24 S.W.3d 243, 245 (Mo. App., W.D. 2000). Section 536.090 provides, in pertinent part:

> Every decision and order in a contested case shall be in writing, and . . . the decision . . . shall include or be accompanied by findings of fact and conclusions of law. The findings of fact shall be stated separately from the conclusions of law and shall include a concise statement of the findings on which the agency bases its order.

Missouri courts have not adopted a bright-line standard for determining the adequacy of findings of fact. *Glasnapp v. State Banking Bd.,* 545 S.W.2d 382, 387 (Mo. App. 1976). Nonetheless, the following formulation is often cited:

> The most reasonable and practical standard is to require that the findings of fact be sufficiently definite and certain or specific under the circumstances of the particular case to enable the court to review the decision intelligently and ascertain if the facts afford a reasonable basis for the order without resorting to the evidence. *Id.* (*quoting* 2 Am.Jur.2d Administrative Law § 455, at 268).

Findings of fact are inadequate when they "leave the reviewing court to speculate as to what part of the evidence the [Commission] believed and found to be true and what part it rejected." *St. ex rel. Int'l. Telecharge, Inc. v. Mo. Pub. Serv. Comm'n,* 806 S.W.2d 680, 684 (Mo. App., W.D. 1991) (quoting *St. ex rel. Am. Tel. & Tel. Co. v. Pub. Serv. Comm'n,* 701 S.W.2d 745, 754 (Mo. App., W.D. 1985)). Findings of fact are also inadequate that "provide no insight into how controlling issues were resolved" or that are "completely conclusory." *St. ex rel. Monsanto Co. v. Pub. Serv. Comm'n*, 716 S.W.2d 791, 795 (Mo. banc 1986) (relying on *St. ex rel. Rice v. Pub. Serv. Comm'n,* 359 Mo. 109, 220 S.W.2d 61 (1949)).

A. Jurisdiction

The record shows that Aquila operates generation plants for the purpose of generating electricity for sale at retail. The Commission concludes that Aquila is thus an electrical corporation within the intendments of Section 386.020(15) and a public utility pursuant to Section 386.020(42), RSMo Supp. 2004.[2] The Commission thus has jurisdiction over Aquila's services, activities, and rates pursuant to Sections 386.020(42), 386.250 and Chapter 393.

B. Burden of Proof

Section 393.150.2 provides in part, "At any hearing involving a rate sought to be increased, the burden of proof to show that the increased rate or proposed increased rate is just and reasonable shall be upon the . . . electrical corporation . . . and the commission shall give to the hearing and decision of such questions preference over all other questions pending before it and decide the same as speedily as possible."

C. Ratemaking Standards and Practices

The Commission is vested with the state's police power to set "just and reasonable" rates for public utility services,[3] subject to judicial review of the question of

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[2] Unless otherwise specified, all statutory references are to the Revised Statutes of Missouri (RSMo), revision of 2000.

[3] Section 393.130, in pertinent part, requires a utility's charges to be "just and reasonable" and not in excess of charges allowed by law or by order of the commission. Section 393.140 authorizes the Commission to determine "just and reasonable" rates.

reasonableness.[4] A "just and reasonable" rate is one that is fair to both the utility and its customers;[5] it is no more than is sufficient to "keep public utility plants in proper repair for effective public service, [and] . . . to insure to the investors a reasonable return upon funds invested."[6] In 1925, the Missouri Supreme Court stated:[7]

> The enactment of the Public Service Act marked a new era in the history of public utilities. Its purpose is to require the general public not only to pay rates which will keep public utility plants in proper repair for effective public service, but further to insure to the investors a reasonable return upon funds invested. The police power of the state demands as much. We can never have efficient service, unless there is a reasonable guaranty of fair returns for capital invested. * * * These instrumentalities are a part of the very life blood of the state, and of its people, and a fair administration of the act is mandatory. When we say "fair," we mean fair to the public, and fair to the investors.

The Commission's guiding purpose in setting rates is to protect the consumer against the natural monopoly of the public utility, generally the sole provider of a public necessity.[8] "[T]he dominant thought and purpose of the policy is the protection of the public . . . [and] the protection given the utility is merely incidental."[9] However, the Commission must also afford the utility an opportunity to recover a reasonable return on the assets it

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[4] *St. ex rel. City of Harrisonville v. Pub. Serv. Comm'n of Missouri*, 291 Mo. 432, 236 S.W. 852 (1922); *City of Fulton v. Pub. Serv. Comm'n*, 275 Mo. 67, 204 S.W. 386 (1918), *error dis'd,* 251 U.S. 546, 40 S.Ct. 342, 64 L.Ed. 408; *City of St. Louis v. Pub. Serv. Comm'n of Missouri*, 276 Mo. 509, 207 S.W. 799 (1919); *Kansas City v. Pub. Serv. Comm'n of Missouri*, 276 Mo. 539, 210 S.W. 381 (1919), *error dis'd,* 250 U.S. 652, 40 S.Ct. 54, 63 L.Ed. 1190; *Lightfoot v. City of Springfield*, 361 Mo. 659, 236 S.W.2d 348 (1951).

[5] *St. ex rel. Valley Sewage Co. v. Pub. Serv. Comm'n*, 515 S.W.2d 845 (Mo. App., K.C.D. 1974).

[6] *St. ex rel. Washington University et al. v. Pub. Serv. Comm'n*, 308 Mo. 328, 344-45, 272 S.W. 971, 973 (Mo. banc 1925).

[7] *Id.*

[8] *May Dep't Stores Co. v. Union Elec. Light & Power Co.*, 107 S.W.2d 41, 48 (Mo. App. 1937).

[9] *St. ex rel. Crown Coach Co. v. Pub. Serv. Comm'n*, 179 S.W.2d 123, 126 (Mo. App. 1944).

has devoted to the public service.[10] "There can be no argument but that the Company and its stockholders have a constitutional right to a fair and reasonable return upon their investment."[11]

The Commission has exclusive jurisdiction to establish public utility rates,[12] and the rates it sets have the force and effect of law.[13] A public utility has no right to fix its own rates and cannot charge or collect rates that have not been approved by the Commission;[14] neither can a public utility change its rates without first seeking authority from the Commission.[15] A public utility may submit rate schedules or "tariffs," and thereby suggest to the Commission rates and classifications which it believes are just and reasonable, but the final decision is the Commission's.[16] Thus, "[r]atemaking is a balancing process."[17]

Ratemaking involves two successive processes.[18] First, the determination of the "revenue requirement," that is, the amount of revenue the utility must receive to pay the costs of producing the utility service while yielding a reasonable rate of return to the

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[10] *St. ex rel. Utility Consumers Council, Inc. v. Pub. Serv. Comm'n*, 585 S.W.2d 41, 49 (Mo. banc 1979).

[11] *St. ex rel. Missouri Public Service Co. v. Fraas*, 627 S.W.2d 882, 886 (Mo. App., W.D. 1981).

[12] *May Dep't Stores*, *supra,*107 S.W.2d at 57.

[13] *Utility Consumers Council*, *supra*, 585 S.W.2d at 49.

[14] *Id.*

[15] *Deaconess Manor Ass'n v. Pub. Serv. Comm'n*, 994 S.W.2d 602, 610 (Mo. App., W.D. 1999).

[16] *May Dep't Stores*, *supra,*107 S.W.2d at 50.

[17] *St. ex rel. Union Elec. Co. v. Pub. Serv. Comm'n*, 765 S.W.2d 618, 622 (Mo. App., W.D. 1988).

[18] Missouri recognizes two distinct ratemaking methods: the "file-and-suspend" method and the complaint method. The former is initiated when a utility files a tariff implementing a general rate increase and the second by the filing of a complaint alleging that the subject utility's rates are not just and reasonable. *See Utility Consumers Council*, *supra,* 585 S.W.2d at 48-49; St. ex rel. Jackson County v. Pub. *Serv. Comm'n*, 532 S.W.2d 20, 28-29 (Mo. banc 1975), *cert. denied*, 429 U.S. 822, 50 L.Ed.2d 84, 97 S.Ct. 73 (1976).

investors.[19] The second process is rate design, that is, the construction of tariffs that will collect the necessary revenue requirement from the ratepayers. Revenue requirement is usually established based upon a historical test year that focuses on four factors:[20] (1) the rate of return the utility has an opportunity to earn; (2) the rate base upon which a return may be earned; (3) the depreciation costs of plant and equipment; and (4) allowable operating expenses.[21] The calculation of revenue requirement from these four factors is expressed in the following formula:

$$RR = C + (V - D) R$$

where:	RR	=	Revenue Requirement;
	C	=	Prudent Operating Costs, including Depreciation Expense and Taxes;
	V	=	Gross Value of Utility Plant in Service;
	D	=	Accumulated Depreciation; and
	R	=	Overall Rate of Return or Weighted Cost of Capital.

The return on the rate base is calculated by applying a rate of return, that is, the weighted cost of capital, to the original cost of the assets dedicated to public service less accumulated depreciation.[22]

The Public Service Commission Act vests the Commission with the necessary authority to perform these functions. Section 393.140(4) authorizes the Commission to prescribe uniform methods of accounting for utilities and Section 393.140(8) authorizes the

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[19] *St. ex rel. Capital City Water Co. v. Missouri Pub. Serv. Comm'n*, 850 S.W.2d 903, 916 n. 1 (Mo. App., W.D. 1993).

[20] In the present case, the test year was established as the twelve months ending December 31, 2005, updated and adjusted for known and measurable changes through June 30, 2006. *In the Matter of the Tariff of Aquila, Inc., d/b/a Aquila Networks – MPS and Aquila Networks – L&P Increasing Rates for Service Provided to Customers in the Aquila Networks – MPS and Aquila Networks L&P Service Areas,* Case No. ER-2007-0004 (*Order Establishing Test Year and Deferring Decision on a True-up* at 2.)

[21] *Id., citing* Colton, "Excess Capacity: Who Gets the Charge From the Power Plant?," 34 Hastings L.J. 1133, 1134 & 1149-50 (1983).

[22] *See St. ex rel. Union Elec. Co. v. Pub. Serv. Comm'n*, 765 SW2d at 622.

Commission to examine a utility's books and records and, after hearing, to determine the accounting treatment of any particular transaction. In this way, the Commission can determine the utility's prudent operating costs. Section 393.230 authorizes the Commission to value the property of electric utilities operating in Missouri, that is, to determine the rate base.[23] Section 393.240 authorizes the Commission to set depreciation rates and to adjust a utility's depreciation reserve from time-to-time as may be necessary.

The Revenue Requirement is the sum of two components: first, the utility's prudent operating expenses, and second, an amount calculated by multiplying the value of the utility's depreciated assets by a Rate of Return. For any utility, its fair Rate of Return is simply its composite cost of capital. The composite cost of capital is the sum of the weighted cost of each component of the utility's capital structure. The weighted cost of each capital component is calculated by multiplying its cost by a percentage expressing its proportion in the capital structure. Where possible, the cost used is the "embedded" or historical cost; however, in the case of Common Equity, the cost used is its estimated cost.

D. Section 386.266 Authorizations and Standard Pertaining to Fuel and Purchased Power Cost Recovery Mechanisms

Section 386.266.1, the statute that allows the Commission to establish a fuel adjustment clause, provides as follows:

> 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 fuel and purchased-power costs, including transportation. The commission may, in accordance

[23] Section 393.135 expressly prohibits the inclusion in electric rates of costs pertaining to property that is not "used and useful."

> with existing law, include in such rate schedules features designed to provide the electrical corporation with incentives to improve the efficiency and cost-effectiveness of its fuel and purchased-power procurement activities.

Section 386.266.4, sets out some of the provisions that must be included in a fuel adjustment clause, and subsection 4(1) establishes the standard to be used in evaluating a fuel adjustment clause. Subsection 4 reads as follows:

> The commission shall have the power to approve, modify, or reject adjustment mechanisms submitted under subsections 1 to 3 of this section only after providing the opportunity for a full hearing in a general rate proceeding, including a general rate proceeding initiated by complaint. **The commission may approve** such rate schedule after considering all relevant factors which may affect the cost or overall rates and charges of the corporation, **provided that it finds that the adjustment mechanism** set forth in the schedules:
>
> (1) Is reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity;
> (2) Includes provisions for an annual true-up which shall accurately and appropriately remedy any over- or under-collections, including interest at the utility's short-term borrowing rate, through subsequent rate adjustments or refunds;
> (3) In the case of an adjustment mechanism submitted under subsections 1 and 2 of this section, includes provisions requiring that the utility file a general rate case with the effective date of new rates to be no later than four years after the effective date of the commission order implementing the adjustment mechanism. …case;
> (4) In the case of an adjustment mechanism submitted under subsections 1 or 2 of this section, includes provisions for prudence reviews of the costs subject to the adjustment mechanism no less frequently that at eighteen-month intervals, and shall require refund of any imprudently incurred costs plus interest at the utility's short-term borrowing rate. (emphasis added).

As set out above, Section 386.266.4(1), states that to be approved by the Commission, any mechanism must be reasonably designed to help the company earn its allowed return on equity. The statute expressly allows the Commission to accept, reject or modify the mechanism; however, it does not allow the Commission to impose a different standard of review.

Further, Section, 386.226.7, provides the Commission may:

> take into account any change in business risk to the corporation resulting from implementation of the adjustment mechanism in setting the corporation's allowed rate of return in any rate proceeding, in addition to any other changes in business risk experienced by the corporation.

Additionally, Subsection 9 of that statute requires the Commission to promulgate rules to "govern the structure, content and operation of such rate adjustments, and the procedure for the submission, frequency, examination, hearing and approval of such rate adjustments." In compliance with the requirements of the statute, the Commission promulgated Commission Rules 4 CSR 240-3.161 and 4 CSR 240-20.090, which establish in great detail the procedures for submission, approval, and implementation of a fuel adjustment clause. Finally, Subsection 9 specifically authorizes a utility to apply for a cost recovery mechanism under that section before the Commission had adopted those rules.

Commission Rule 4 CSR 240-20.090(4)(A) requires an electric utility with a fuel adjustment clause "to file one (1) mandatory adjustment to its FAC[24] in each true-up year coinciding with the true-up of its FAC." That section authorizes an electric utility with a fuel adjustment clause "to also file up to three (3) additional adjustments to its FAC within a true-up year. With the timing and number of such additional filings to be determined in the general rate proceeding establishing the FAC and in general rate proceedings thereafter."

Commission Rule 4 CSR 240-20.090(9) requires the rate design of any rate adjustment mechanism ("RAM") requested under 4 CSR 240-20.090 to "reflect differences

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[24] As used in this Commission Rule, "FAC" is an acronym for fuel adjustment clause.

in losses incurred in the delivery of electricity at different voltage levels for the electric utility's different rate classes." That section also requires an electric utility requesting a RAM to have "conducted a Missouri jurisdictional system loss study within twenty-four (24) months prior to the general rate proceeding in which it request its initial RAM." The Commission has authority to grant a waiver of any requirement contained in Commission Rule 4 CSR 240-20.090 pursuant to 4 CSR 240-20.090(15) which states: "Provisions of this rule may be waived by the commission for good cause shown after an opportunity for a hearing."

Commission Rule 4 CSR 240 3.161(2)(P) requires an electric utility requesting to establish a RAM as described in 4 CSR 240-20.090(2) to file, "a proposed schedule and testing plan with written procedures for heat rate tests . . . to determine the base level of efficiency for each of the units." The Commission has authority to grant a waiver of any requirement contained in Commission Rule 4 CSR 240-3.161 pursuant to 4 CSR 240-3.161(16) which states: "Provisions of this rule may be waived by the commission for good cause shown."

Although the term "good cause" is frequently used in the law,[25] the rule does not define it. Therefore, it is appropriate to resort to the dictionary to determine its ordinary meaning.[26] Good cause "generally means a substantial reason amounting in law to a legal excuse for failing to perform an act required by law," or to put it more concisely, a "[l]egally sufficient ground or reason."[27] Similarly, "good cause" has also been judicially defined as a

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[25] *State v. Davis*, 469 S.W.2d 1, 5 (Mo. 1971).

[26] *See State ex rel. Hall v. Wolf*, 710 S.W.2d 302, 303 (Mo. App. E.D. 1986) (in absence of legislative definition, court used dictionary to ascertain the ordinary meaning of the term "good cause" as used in a Missouri statute); *Davis*, 469 S.W.2d at 4-5 (same).

[27] *Black's Law Dictionary* 692 (6th ed. 1990).

"substantial reason or cause which would cause or justify the ordinary person to neglect one of his [legal] duties."[28] Of course, not just *any* cause or excuse will do. To constitute *good* cause, the reason or legal excuse given "must be real not imaginary, substantial not trifling, and reasonable not whimsical."[29] And some legitimate factual showing is required, not just the mere conclusion of a party or his attorney.[30] Moreover, a finding of good cause "lies largely in the discretion of the officer or court to which the decision is committed" and "depends upon the circumstances of the individual."[31]

E. Authority to Issue an Accounting Authority Order

The Court of Appeals has held that the Commission has the regulatory authority to grant a form of relief to a utility in the form of an accounting technique, an AAO.[32] An AAO allows a 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.[33]

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[28] *Graham v. State*, 134 N.W. 249, 250 (Neb. 1912). Missouri appellate courts have also recognized and applied an objective "ordinary person" standard. *See, e.g., Cent. Mo. Paving Co. v. Labor & Indus. Relations Comm'n*, 575 S.W.2d 889, 892 (Mo. App. W.D. 1978) ("[T]he standard by which good cause is measured is one of reasonableness as applied to the average man or woman.") *Id*.

[29] *Belle State Bank v. Indus. Comm'n*, 547 S.W.2d 841, 846 (Mo. App. S.D. 1977). *See also Barclay White Co. v. Unemployment Compensation Bd.*, 50 A.2d 336, 339 (Pa. 1947) (to show good cause, reason given must be real, substantial, and reasonable). *Id*.

[30] *See generally Haynes v. Williams*, 522 S.W.2d 623, 627 (Mo. App. E.D. 1975); *Havrisko v. U.S.*, 68 F.Supp. 771, 772 (E.D.N.Y. 1946); *The Kegums*, 73 F.Supp. 831, 832 (S.D.N.Y. 1947).

[31] *Wilson v. Morris*, 369 S.W.2d 402, 407 (Mo. 1963); Matter of Seiser, 604 S.W.2d 644, 646 (Mo. App. E.D. 1980).

[32] *Missouri Gas Energy v. Public Service Commission State of Missouri*, 978 S.W.2d 434 (Mo. App. 1998).

[33] *Id*.

F. Overview

1. Aquila's Proposed General Rate Increase

As filed, Aquila's proposed tariffs sought additional gross annual Missouri jurisdictional revenue of approximately $94.5 million annually in Aquila's MPS operating division and $24.4 million annually in Aquila's L&P operating division, or a 22% and 22.1% increase respectively. Aquila currently serves approximately 235,763 customers in its MPS service territory and approximately 65,313 customers in its L&P service territory.

2. Aquila's Operations

Based in Kansas City, Missouri, Aquila is an investor-owned utility providing retail electric service to 1 million customers in Missouri, Kansas, Colorado, Iowa and Nebraska. Aquila provides retail electric service to customers in Missouri in and about Kansas City and St. Joseph, Missouri under the names Aquila Networks-MPS and Aquila Networks-L&P, respectively. As of December 31, 2005, Aquila had 204,506 residential electric customers, 28,431 small general service customers, 1,199 large general service customers, 155 large power service customers, and 1,472 lights customers in 235 communities in 34 counties.

3. The Other Parties

Intervenor SIEUA is an unincorporated voluntary association consisting of large commercial and industrial users of natural gas and electricity in and around Sedalia, Missouri.

Intervenor AG Processing, Inc., operates a processing facility in St. Joseph, Missouri, and is a large industrial customer of Aquila.

Intervenor St. Joseph, Missouri, is a municipality of the State of Missouri and its residents and commercial interests are customers of Aquila. St. Joseph is also a large consumer of energy supplied by Aquila.

Intervenor Kansas City, Missouri, is a municipality of the State of Missouri and its residents and commercial interests are customers of Aquila. Kansas City is also a large consumer of energy supplied by Aquila.

Intervenor AmerenUE is a regulated electric and gas utility that operates in Missouri and elsewhere.

Intervenor AARP is a nonprofit, nonpartisan membership organization that advocates for people who are 50 years of age or older. AARP has members in Missouri who receive electric service from Aquila and will be affected by the outcome of this case.

Intervenor the Federal Executive Agencies' members include the United States Department of Defense, the United States Department of Energy, and other Federal Executive Agencies, which have offices, facilities or installations in the service territory of Aquila and which purchase utility service from Aquila.

Intervenor the Commercial Group's members are JCPenney Corporation, Inc., Lowe's Home Centers, Inc., and Wal-Mart Stores East, LP.

Intervenor Jackson County, Missouri is a political subdivision of the State of Missouri and its residents and commercial interests are customers of Aquila. Jackson County is also a large consumer of energy supplied by Aquila.

The Missouri Department of Natural Resources ("DNR") is an executive branch department authorized and established by Chapter 640, RSMo. Sections 640.150 through 640.185 charge the Department with certain responsibilities with respect to energy.

The Public Counsel ("OPC") is appointed by the Director of the Missouri Department of Economic Development and is authorized to "represent and protect the interests of the public in any proceeding before or appeal from the public service commission[.]"[34]

The Staff of the Commission traditionally appears as a party in Commission proceedings and is represented by the Commission's General Counsel, an employee of the Commission authorized by statute to "represent and appear for the Commission in all actions and proceedings involving this or any other law [involving the Commission.]"[35]

G. The Issues

As required by the procedural schedule, the parties jointly filed a list of issues to be determined by the Commission. The parties also filed prehearing briefs setting out their positions and arguments with respect to each issue. In setting out the issues developed by the parties and the parties' stated positions on those issues, the Commission seeks only to inform the reader of these items. The parties' framing of the issues may not accurately reflect the material issues under the applicable statutes and rules. Those issues, as

[34] Sections 386.700 and 386.710.

[35] Section 386.071.

formulated by the parties, are fully recited at the beginning of the discussion of each issue, and are set forth below.[36]

1. Proposed Fuel Adjustment Clause:

A. Should the Commission authorize Aquila to use a fuel and purchased power recovery mechanism allowed by 4 CSR 240.20.090?
   - i. What standard should the Commission use in determining whether to allow Aquila to use a fuel and purchased power adjustment mechanism?
   - ii. What portion of fuel and purchased power costs should be recovered by a recovery mechanism rather than by base rates?
   - iii. Should a fuel and purchased power adjustment mechanism include recovery of any demand charges?
   - iv. Should a fuel and purchased power adjustment mechanism require definitive production standards for recovery of fuel and purchased power costs via the mechanism?

   a. Proposed Adjustment Clause: If the Commission authorized Aquila to use a fuel adjustment clause, how should it be structured?
      - i. What recovery period should be used in the fuel adjustment clause?
      - ii. What line losses adjustment should be included in determining the fuel cost adjustment?
      - iii. How often should the fuel adjustment clause be adjusted?
      - iv. Should the fuel adjustment require a phase-in (cap) for sharp changes in fuel or purchased power costs?
      - v. What heat rate testing of generation plants should be conducted?

   b. Interim Energy Charge: If the Commission authorizes Aquila to use an interim energy charge, how should it be structured?
      - i. What natural gas costs/prices should be included in the charge?
      - ii. What coal costs/prices should be included in the charge?
      - iii. What purchased power costs/prices should be included in the charge?

[36] Only the issues and sub-issues not resolved by the two unanimous stipulations are shown. The numbering of the issues is unchanged from the original list. The parties' positions on the issues are discussed, to the extent necessary, elsewhere in this order.

iv. Should the interim energy charge be established and true-up on a divisional basis (for MPE and for L&P separately) or on a unified basis (MPS and L&P combined)?
v. Additional items to consider include treatment of off-system sales and hedging program cost/benefits.

As outlined by the parties, this issue appears very complicated. However, there are actually only three primary questions for the Commission to decide:

a. Should the Commission authorize Aquila to use a fuel adjustment mechanism to address its fuel and purchased power costs as provided for under Section 386.266 RSMo?
b. If a fuel adjustment mechanism is appropriate, should the Commission authorize Aquila to implement an interim energy charge or a fuel adjustment clause?
c. How should any authorized interim energy charge or fuel adjustment clause be constructed?

Therefore, this Order will address these three issues, together with their attendant sub-issues that also must be decided, as restated. All of the issues and sub-issues pertaining to the establishment of a fuel adjustment clause are contained within these three restated issues.

As noted earlier in this Report and Order, the rates Aquila will be allowed to charge its customers are based on a determination of the company's revenue requirement. Aquila's revenue requirement is the sum of operating and maintenance expenses, depreciation expenses, taxes, and a reasonable return on the net value of property used and useful in serving its customers.[37] A revenue requirement is based on the costs and income the company experienced during a historical test year. For this case, the test year was established as 12-month period ending December 31, 2005, adjusted and updated for any known and measurable changes through June 30, 2006. The Commission will use the expenses and revenues measured during the test year to predict the expenses the

[37] Parcell Direct, Ex. 221, Page 5, lines 10-14.

company will be allowed to recover in future rates. Expenses that may be incurred in the future generally are not included in the rate calculations.

Under traditional rate-making procedures, at the end of the rate case the Commission establishes the rates an electric utility can charge. Once rates are established, the utility cannot change those rates without filing a new rate case and restarting the review process. However, in 2005, the Missouri legislature passed a law allowing the Commission to establish a mechanism for an electric utility to make periodic rate adjustments outside of general rate proceedings to reflect increases and decreases in its prudently incurred fuel and purchased-power costs.[38] The sort of mechanism envisioned by the statute is generally known as a fuel adjustment clause.

Section 386.266.7 provides that the Commission may:

> take into account any change in business risk to the corporation resulting from implementation of the adjustment mechanism in setting the corporation's allowed rate of return in any rate proceeding, in addition to any other changes in business risk experienced by the corporation.

Subsection (9) required the Commission to promulgate rules to "govern the structure, content and operation of such rate adjustments, and the procedure for the submission, frequency, examination, hearing and approval of such rate adjustments." In compliance with the requirements of the statute, the Commission promulgated Commission Rule 4 CSR 240-3.161, which establishes in great detail the procedures for submission, approval, and implementation of a fuel adjustment clause.

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[38] Section 386.266, RSMo (2006 Cum. Supp.).

a. Should the Commission authorize Aquila to use a fuel adjustment mechanism to address its fuel and purchased power costs as provided for under Section 386.266 RSMo?

i. Sufficiency of Aquila's Filed Request. In his prefiled direct testimony, Public Counsel witness Ryan Kind indicated he could not locate information required by several sections of 4 CSR 240-3.161(2) in Aquila's fuel adjustment clause filing.[39] Mr. Kind did not identify what specific information he believed was missing from the filing, or what additional information Aquila needed to file to comply with that rule. Instead, Mr. Kind criticized Aquila for failing to include with its fuel adjustment clause filing a guide to the information that was responsive to each of the pertinent filing requirements.[40]

In response to a Public Counsel data request, Aquila provided to all parties a guide identifying the location in Aquila's direct testimony where the information required by each section of the Commission rules is located.[41] Following receipt of that guide, Mr. Kind filed his rebuttal testimony in which he did not indicate that he continued to find Aquila's fuel adjustment clause filing was deficient for failure to comply with any statutory requirement or Commission Rule.[42] Under cross-examination, Mr. Kind again alleged that Aquila's initial fuel adjustment clause filing was deficient in that it failed to comply with 4 CSR 240-3.161(2)(O), (Q) and (R).[43] However, Public Counsel does not argue in either its Prehearing or Posthearing brief that Aquila's fuel adjustment clause filing was, or continues to be, deficient as to any Commission Rule.

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[39] Kind Direct, Ex. 401, pages 15 - 16.

[40] *Id*.

[41] Williams Rebuttal, Ex. 33, page 8, line 21 to page 9, line 4.

[42] Kind Direct, Ex. 401, pages 15-16.

[43] Tr. pages 901- 902, and pages 927- 928.

In their Post Hearing Brief, SIEUA and AG-P allege Aquila failed to comply with 4 CSR 240-3.161(H) in that its fuel adjustment clause filing lacked a "complete explanation of all costs that shall be considered for recovery" under the proposed fuel adjustment clause.[44]

Findings of Fact: The Commission finds the testimony of Aquila witnesses Dennis Williams and H. Davis Rooney contains all the information required by each of the three provisions challenged by Public Counsel.[45] Further, no witness, aside from Mr. Kind, suggested Aquila's fuel adjustment clause filing failed to comply with any of these three provisions. The Commission finds Aquila's fuel adjustment clause filing complies with 4 CSR 240-3.161(2)(O), (Q) and (R).

While the Commission may not agree that all items Aquila seeks to flow through its proposed fuel adjustment clause are appropriate, the Commission finds Aquila's proposed fuel adjustment clause tariff contains a very thorough explanation of all costs Aquila seeks authority to flow through its proposed fuel adjustment clause. Consequently, Aquila also meets the filing requirements of 4 CSR 240-3.161(H).[46]

Conclusions of Law: Based upon its review of Aquila's fuel adjustment clause filing and the evidence presented in this case, the Commission concludes that Aquila's fuel adjustment clause filing complies with all applicable statutory requirements and Commission Rules, except: 1) 4 CSR 240-20.090(9), which requires line loss factors to be included in any fuel adjustment clause filing and requires a utility to have conducted a line

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[44] Post Hearing Brief of Sedalia Industrial Energy Users Association and AG Processing, Inc., pages 55 – 56.

[45] Rooney Direct, Ex. 23, page 27, line 1 to page 29, line 14; Williams Direct, Ex. 32, page 3, line 10 to page 11, line 5 and Sch. DRW-1; Williams Rebuttal, Ex. 33, page 8, line 19 to page 9, line 4. See also: 4 CSR 240-3.161(2)(O), (Q) and (R).

[46] Aquila's Proposed electric tariffs, P.S.C. MO. No. 1 Original Sheet Nos. 124 and 125, part of the original tariff filing on July 3, 2006, that resulted in the establishment of this case.

loss study within twenty-four months of making a fuel adjustment clause filing; and 2) 4 CSR 240-3.161(2)(P), which requires an electric utility filing to establish a RAM as described in 4 CSR 240-20.090(2) to file "a proposed schedule and testing plan with written procedures for heat rate tests."

ii. Appropriateness of a Waiver of 4 CSR 240-20.090(9). Section 386.266(9) specifically authorizes an electric utility to apply for a cost recovery mechanism under that section before the Commission had promulgated its rules pertaining to fuel and purchased power cost recovery mechanism. The draft rules under consideration at the time of Aquila's filing made recognition of line losses in the fuel adjustment clause optional;[47] however, the rules as finally adopted made recognition of the line losses mandatory.[48]

The issue of Aquila's failure to include appropriate line loss factors, and what line loss factors Aquila should have included in its fuel adjustment clause filing, were raised and addressed by the parties in prefiled testimony,[49] during the evidentiary hearing,[50] and in prehearing and posthearing briefs. In his direct testimony, SIEUA, AG-P, and FEA witness Maurice Brubaker noted Aquila's failure to include line loss factors in its fuel adjustment clause filing and testified as to what factors should have been used.[51] After reviewing Mr. Brubaker's testimony, Aquila witness Dennis Williams agreed that based upon the

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[47] July 17, 2006 Missouri Register, Vol. 31, No. 14, page 1078.

[48] Final Order of Rulemaking in Case No. EX-2006-0472 (4 CSR 240-20.090) pages 6-7.

[49] Brubaker Direct (Rate Design), Ex. 501, pages 3-6; Williams Surrebuttal, Ex. 34, page 7.

[50] Tr. pages 623 and 647.

[51] Brubaker Direct (Rate Design), Ex. 501, pages 3-6.

language contained in 4 CSR 240-20.090(9), as ultimately adopted by the Commission, the line loss factors proposed by Mr. Brubaker should be included in Aquila's fuel adjustment clause filing.[52]

The line loss factors proposed by Mr. Brubaker and agreed to by Aquila are based upon Aquila's most recent line loss study, which was completed in 2002. Two parties have objected to using the 2002 line loss factors because they are based upon a line loss study conducted more than twenty-four months before Aquila's fuel adjustment clause filing. However, those two parties, SIEUA and AG-P, are also the very parties whose witness recommended the using the line loss factors from the 2002 study.

In the Stipulation and Agreement as to Certain Issues, Aquila's fuel and purchased power cost was set at approximately $200,000,000 for a test year ending December 2005, updated for known and measurable changes through June 30, 2006. Aquila has experienced an increase in its fuel and purchased power cost of between 13 and 20% annually for each of the last 3 years.[53] Based upon evidence presented to the Commission in this case, there is strong reason to believe this trend will continue.[54] If fuel and purchased power costs increase by 15% annually, absent some type of cost adjustment mechanism, Aquila would under recover its prudently incurred fuel and purchased power costs by approximately $30,000,000 in the 12 months following the conclusion of this case, and as much as $90,000,000 over the next 24 months.[55] This likely

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[52] Williams Surrebuttal, Ex. 34, page 7.

[53] Tr. page 782

[54] Featherstone Direct, Ex. 206, pages 8-9; Tr. pages 920-922 and 941, Aquila Net, Inc., d/b/a Aquila Networks – MPS and Aquila Networks – L&P 2005 Form 10-K Report.

[55] *Id*.

scenario would result in Aquila losing an unconscionable amount of money where no party was prejudiced by Aquila's failure to comply with a technicality of a Commission rule.

Accordingly, good cause exists to grant Aquila a waiver, as provided for under 4 CSR 240-20.090(15), from the following requirements contained in 4 CSR 240-20.090(9): 1) the requirement to include line loss factors in its original fuel adjustment clause filing, and 2) the requirement to include line loss factors in its fuel adjustment clause that are based upon a line loss study completed within twenty-four months of that fuel adjustment clause filing.

The question then becomes what line loss factors should be included in any fuel adjustment clause mechanism approved by the Commission. No party offered testimony suggesting the line loss factors proposed by Mr. Brubaker and taken from Aquila's 2002 line loss study were inappropriate. The line loss factors recommended by Mr. Brubaker are reasonable and should be included in any cost adjustment mechanism authorized for Aquila.

Findings of Fact: Aquila's failure to include sufficient and appropriate line loss factors was sufficiently addressed in the record, as noted above. The Commission finds Aquila's failure to have conducted a line loss study within twenty-four months of filing a request for a fuel adjustment clause, and its failure to include line loss factors in its original filing were reasonable, given that the draft rule in place when Aquila made that filing did not require line loss factors. Further, the Commission finds no party was prejudiced by Aquila's failure to have conducted a line loss study within twenty-four months of filing a request for a fuel adjustment clause, and its failure to include line loss factors in its original filing. Further, the Commission finds rejecting Aquila's fuel adjustment clause request based upon a marginal filing oversight unconscionable, because, as addressed above, it would likely cause Aquila to lose a significant amount of money. Accordingly, the Commission finds good cause exists to grant Aquila a waiver, as provided for under 4 CSR 240-20.090(15), from the following requirements contained in 4 CSR 240-20.090(9): 1) the requirement to include line loss factors in its original fuel adjustment clause filing, and 2) the requirement to include line loss factors in its fuel adjustment clause that are based upon a line loss study completed within twenty-four months of that fuel adjustment clause filing.

Having reviewed Mr. Brubaker's proposal, the Commission finds the line loss factors recommended by Mr. Brubaker are reasonable and should be included in any cost adjustment mechanism authorized for Aquila.

Conclusions of Law: Although the Commission had not yet adopted final rules governing fuel adjustment clauses when Aquila filed its rate case in July of 2006, Aquila's inclusion of a fuel adjustment clause request under Section 386.266 RSMo (Cum. Supp. 2006)[56] was appropriate. As noted above, Section 386.266(9) specifically permitted such an application prior to the promulgation of final rules. The Commission concludes Aquila's waiver request meets the standards under 4 CSR 240-20.090(15) for good cause and permits it to waive both the requirement to include line loss factors in its original fuel adjustment clause filing, and the requirement to include line loss factors based upon a line loss study completed within twenty-four months of that fuel adjustment clause filing.

[56] All references to Section 386.266 are to the 2006 Cumulative Supplement unless otherwise noted.

The Commission concludes the line loss factors recommended by Mr. Brubaker may lawfully be used in any cost adjustment mechanism authorized for Aquila. Aquila is still subject to all other requirements contained in 4 CSR 240-20.090(9).

iii. Appropriateness of a Waiver of 4 CSR 240-3.161(2)(P). Commission Rule 4 CSR 240 3.161(2)(P) requires an electric utility seeking to establish a RAM as described in 4 CSR 240-20.090(2) to file "a proposed schedule and testing plan with written procedures for heat rate tests . . . to determine the base level of efficiency for each of the units." As part of its fuel adjustment clause filing, Aquila included a schedule for heat rate and/or efficiency testing that identified, but did not set out in written detail, testing procedures. Under Aquila's proposal, testing would be conducted in accordance with Southwest Power Pool (SPP) criteria – specifically, Section 12.1 – Electrical Facility Ratings.[57]

Staff witness Michael Taylor testified that Aquila provided Staff with additional details concerning the SPP rating testing procedures in response to a data request.[58] Mr. Taylor further testified that he did not believe the SPP procedures identified by Aquila would satisfy the requirements of the applicable rule, in that they would not yield meaningful conclusions regarding the heat rates and/or efficiency of Aquila's generating plants.[59] Mr. Taylor then suggested several alternate sources for testing procedures.[60] No

[57] Rooney Direct, Ex. 24, page 27, lines 3-11.

[58] Taylor Rebuttal, Ex. 227, page 3, line 4 to page 4, line 2.

[59] *Id*. at pages 5-6.

[60] *Id*.

witnesses aside from Aquila witness Mr. Rooney and Staff witness Mr. Taylor provided testimony on this issue.

During the evidentiary hearing Staff and Aquila offered Exhibit 242, which was admitted into evidence. Exhibit 242 set out a proposed resolution to Staff's heat rate and/or efficiency testing concerns that was agreeable to Staff and Aquila (242 Proposal). Under the 242 Proposal, if the Commission authorizes a RAM, Aquila must complete a proposed heat rate and/or efficiency schedule and a proposed testing plan with written procedures as described in 4 CSR 240-3.161(2)(P) that are agreeable to all parties to this case. The 242 Proposal would also require Aquila to have that plan completed no less than sixty days before the effective date of a tariff filing seeking a rate adjustment under a fuel adjustment clause or the filing of its initial application for a true-up an interim energy charge.[61]

SIEUA and AG-P also argue that Aquila's fuel adjustment clause filing should be rejected for failure to comply with 4 CSR 240-3.161(2)(P).[62] Their argument is based solely upon Staff witness Mr. Taylor's analysis of Aquila's filing. In their Post Hearing Brief SIEUA and AG-P decline to address or even acknowledge the 242 Proposal, which alleviated Mr. Taylor's concerns.

Findings of Fact: Having reviewed the arguments and evidence presented by each witness, the Commission finds Aquila made a good faith effort to comply with the requirements of 4 CSR 240-3.161(2)(P). Further, as set out above, the Commission finds Aquila would likely experience significant financial hardship if the Commission rejected its fuel adjustment clause based upon a filing oversight. Accordingly, the Commission finds

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[61] Ex. 242.

[62] Post Hearing Brief of Sedalia Industrial Energy Users Association and AG Processing, Inc., pages 54 - 55.

good cause exists to grant Aquila a waiver of that provision, as provided for under 4 CSR 240-3.161(16).

The Commission further finds the 242 Proposal to be reasonable with one exception. The Commission does not believe it is appropriate to require the written procedures to be agreed to by all non-Aquila parties to ER-2007-0004, given that parties who believe a RAM is never appropriate could block adjustments under an approved RAM by opposing even reasonable procedures.

Conclusions of Law: Commission Rule 4 CSR 240 3.161(2)(P) requires an electric utility seeking to establish a RAM as described in 4 CSR 240-20.090(2) to file "a proposed schedule and testing plan with written procedures for heat rate tests . . . to determine the base level of efficiency for each of the units." Accordingly, the Commission finds good cause exists to grant Aquila a waiver of that provision, as provided for under 4 CSR 240-3.161(16).

In light of the concerns noted above, the Commission concludes it is reasonably necessary to require, in connection with the establishment of a rate adjustment mechanism, that Aquila develop a heat rate and/or efficiency testing schedule and plan under the terms set out in Exhibit 242, with the following conditions. First, in the event any party to ER-2007-0004 opposes the written heat rate and/or efficiency testing procedures ultimately proposed by Aquila, Aquila may file a motion with the Commission seeking approval of those procedures. Second, Aquila must have finalized procedures that are either agreed to by the parties, or approved by the Commission, in place no less than sixty days before the effective date listed on the tariff for Aquila's initial fuel adjustment clause adjustment filing.

iv. Determining Whether a Fuel Cost Adjustment Mechanism is Appropriate. Aquila has requested a fuel adjustment clause in this rate case and has modified the details of its proposed fuel adjustment clause several times during the course of this proceeding in response to concerns expressed by various parties. The details of the fuel adjustment clause Aquila asks the Commission to approve are found in the surrebuttal testimony of Dennis R. Williams,[63] as modified by further concessions set out in Aquila's Post Hearing Brief at pages 43 to 47. The fuel adjustment clause Aquila proposes would net 100% of off-system sales revenue against fuel and purchased power costs. In other words, off-system sales revenue increases would offset rising fuel and purchased power costs. The proposed fuel adjustment clause would spread recovery or return of over or under-collections over a subsequent 12-month period, and no more than two to four fuel adjustment clause rate adjustments would be allowed per true-up year. Only fluctuations in actual fuel costs, fuel transportation costs, and purchase power costs would be flowed through the proposed fuel adjustment clause. The fuel adjustment clause would also contain provisions for heat rate testing and line loss factors.

While Section 386.266 allows the Commission to approve a fuel adjustment clause,[64]the statute does not **require** the Commission approve a fuel adjustment clause. Instead, it specifically gives the Commission authority to **accept**, **reject or modify** a proposed fuel adjustment clause after giving an opportunity for a full hearing in a general rate case.[65] The statute does not, however, provide specific guidance on when a fuel

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[63] D. Williams Surrebuttal, Ex. 34, page 6, line 10 to page 9 line 22, and Sch. DRW-1.

[64] Section 386.266, in effect overturns a 1979 Missouri Supreme Court decision finding the Missouri Commission did not have statutory authority to authorize a fuel adjustment clause for residential customers. *State ex rel. Utility Consumers Council of Mo., Inc.*, 585 S.W.2d, at. 49.

[65] Section 386.266.4, RSMo (Cum. Supp. 2006).

adjustment clause should be approved, other than requiring them to be reasonably designed to allow the utility a reasonable opportunity to earn its allowed return on equity.

While Missouri has not allowed electric utilities to use a fuel adjustment clause since 1979, fuel adjustment clauses are common in other states. In fact, other than Missouri, all but two of the 29 non-restructured states without retail competition allow their electric utilities to apply to recover fuel and purchased power costs through some type of fuel adjustment clause.[66] Therefore, other states' experiences with fuel adjustment clauses can be instructive for this Commission in making its decision whether to grant Aquila's request for a fuel adjustment clause.

Several parties proposed financial standards that a company should have to meet before any cost recovery mechanism would be authorized. Aquila argues that if its fuel adjustment clause filing meets the mechanical filing requirements of Section 386.266 RSMo and Commission Rules 4 CSR 240-20.090 and 4 CSR 240-3.161(2)(A) through (S), it should be approved. As addressed above, the Commission found Aquila's fuel adjustment clause filing complies with all applicable statutory requirements and Commission Rules, except specific provisions of: 1) 4 CSR 240-20.090(9) and 2) 4 CSR 240-3.161(2)(P) from which the Commission herein grants Aquila waivers. However, in making a determination as to the appropriateness of authorizing a cost recovery mechanism, the Commission must weigh many factors, including the standard for review contained in Section 386.266.

[66] Tr. p. 818, lines 16 – 23.

As addressed above, in addition to setting out basic requirements for inclusion in any authorized cost adjustment mechanism, Section 386.266.4 sets out the following standard for the Commission to use when evaluating a cost recovery mechanism:

> 4. The commission shall have the power to approve, modify, or reject adjustment mechanisms submitted under subsections 1 to 3 of this section . . . The commission may approve such rate schedules after considering all relevant factors which may affect the costs or overall rates and charges of the corporation, **provided that it find that the adjustment mechanism set forth in the schedules:**
>
> **(1) Is reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity**. (emphasis added)

Public Counsel Witness Ryan Kind argued a cost recovery mechanism should not be approved absent a showing the company faces a "substantial threat to its financial viability if it did not have a fuel adjustment clause in effect that would recover some or all of the increased costs of fuel and purchased power in between rate cases."[67] Mr. Kind gives no indication what would constitute a sufficient threat. As set out in detail above, the evidence in this case supports a conclusion Aquila will likely under recover tens of millions of dollars without a RAM. The Commission is not sure if that would qualify as a "substantial threat to financial viability" under Mr. Kind's analysis, but it illustrates that Mr. Kind's analysis is unduly burdensome, vague and should be rejected.

Further, the Commission considered and dismissed similar arguments for an earnings threshold for eligibility to use a cost recovery mechanism in the formal rulemaking docket for 4 CSR 240-20.090. Specifically, the Commission found "an earnings threshold for eligibility to use a RAM is contrary to the intent of the legislature, as articulated in

[67] Kind Direct, Ex. 401, page 3, line 17 to page 15, line 3.

SB 179.[68] Therefore, no such eligibility criteria will be included in the rule."[69] Mr. Kind's proposed standard is contrary to the standard for approval contained in Section 386.266.4(1), which requires that for the Commission to approve an adjustment mechanism it must be "reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity."

SIEUA, AG-P and FEA witness Donald Johnstone argued the Commission should not authorize a fuel adjustment clause for a utility absent a showing of "acute need," which he defined as requiring "a substantial financial need must be shown by the utility."[70] Mr. Johnstone further stated that for any fuel adjustment clause "to be approved, there ought to be more than a mere convenience to the utility."[71] Mr. Johnstone further suggested the negative effects on customers must be weighed against the benefit to the company.

The Commission agrees a fuel adjustment clause should not be authorized for the mere "convenience" of a utility. However, Mr. Johnstone's "acute need" standard is too vague to be useful in evaluating a fuel adjustment clause request. Like Public Counsel's "substantial threat to its financial viability" standard, Mr. Johnstone's "acute need" standard is contrary to both the intent of the legislature in passing Section 386.266 RSMo, and the approval standard contained in Subsection 386.266.4(1).

Nancy Brockway, an independent consultant who appeared as a witness for AARP, testified that she served as a Commissioner on the New Hampshire Public Utilities Commission from 1998 to 2003, as a senior staff member of the Maine Public Utilities

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[68] SB 179 has been codified at Section 386.266 RSMo (Cum. Supp. 2006).

[69] Final Order of Rulemaking, Case No. EX-2006-0472 (September 21, 2006).

[70] Johnstone Rebuttal, Ex. 505, p. 9, lines 12 – 15.

[71] *Id*.

Commission from 1983 to 1986, and as a hearing officer and General Counsel for the then-Massachusetts Department of Public Utilities from 1986 to 1991. Since leaving the New Hampshire Commission in 2003, Ms. Brockway has provided consulting services to many different groups and testified before a wide variety of state, federal and international agencies and groups on a wide variety of issues. Ms. Brockway further testified that as a staff advocate, hearing officer and Commissioner, she participated in numerous fuel adjustment clause proceedings, and has provided testimony on the potential problems associated with a fuel adjustment clause.[72]

Ms. Brockway testified a cost adjustment mechanism should only be used for utility costs that meet the following three qualifications:

1. They represent a significant portion of a utility's costs;
2. they fluctuate significantly; and
3. the costs are outside the utility's control.[73]

Ms. Brockway supported the use of these criteria based upon her experience with fuel adjustment clauses as a former Commissioner, hearing officer and staff advocate.

The qualifications, or criteria, proposed by Ms. Brockway appear to be well accepted in the regulatory community, and are similar to the criteria presented to the Commission in Union Electric Company, d/b/a AmerenUE's pending rate case.[74] Further, while Aquila's witnesses challenged the standards and requirements for fuel adjustment clause approval suggested by other witnesses, they did not challenge the validity of the

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[72] Brockway Surrebuttal, Ex. 601, page 3, line 28 to page 4, line 9.

[73] Brockway Surrebuttal, Ex. 601, page 4, lines 13 through 27, adopting the Direct Testimony of Ronald Binz, Binz Direct, Ex. 600, page 6, lines 21-25.

[74] See: Case No. ER-2007-0002, Ex. 502, Direct Testimony of Michael L. Brosch, p. 16, lines 3-16.

criteria presented by Ms. Brockway. Rather, Aquila contends its proposed fuel adjustment clause meets those criteria.

Brockway's first criterion is whether fuel and purchased power represent a significant portion of a utility's costs. Fuel and purchased power expense is the largest item of expense Aquila incurs, comprising approximately 46% of the company's total operation and maintenance expense.[75] No party disputed these figures. Clearly, Aquila's fuel and purchased power expenses are substantial and meet the first criterion.

The second criterion described by Brockway is that the costs to be tracked must fluctuate significantly, in other words, they must be volatile. Aquila was able to demonstrate its fuel costs will likely be increasing in coming years. No party challenged Aquila's contention that its fuel costs have increased between 13% and 20% annually for each of the past three years, or that its fuel costs are likely to continue to increase into the future.[76] Further, unlike many companies, Aquila does not have contracts in place to cover the bulk of its future fuel and purchased power needs.[77]

Staff witness Cary Featherstone, who has been a Staff utility auditor for twenty-seven years and has testified in dozens of Commission cases,[78] testified high volatility has characterized the purchased power and natural gas markets in recent years, combined with Aquila's heavy reliance on both purchased power and gas-fired generation, make it very difficult to predict with a reasonable degree of certainty fuel costs for Aquila using either

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[75] D. Williams Surrebuttal, Ex. 34, page 5, lines 3 – 7.

[76] *Id*. at page 6, lines 3-8.

[77] Tr. p. 656 lines 13-17, Tr. p. 659 lines 13-18, and Ex. 415.

[78] Featherstone Direct, Ex. 206, Schedule CGF 1.

historical or forecasted levels.[79] Aquila's fuel and purchased power expenses have been and are likely to continue to be volatile and meet the second criterion.

The third criterion is whether the costs are outside the utility's control. The cost items that would be tracked in a fuel adjustment clause are coal, coal transportation, natural gas, oil, nuclear fuel, and purchased power. Aquila generates its electricity from natural gas and coal-fired power plants,[80] and also utilizes a large amount of purchased power.[81] The price of natural gas, coal, and railroad freight rates to transport that coal are established by national, and in some cases, international markets. Aquila does not have control over those prices. Similarly, Aquila does not have control over the prices it must pay for purchased power.

When a utility's fuel and purchased power costs are oscillating in that way, the time consuming rate-making process cannot possibly keep up with the swings. Further, rate cases are difficult and expensive endeavors for the Commission and intervening parties, as well as for the utility. As a result, in those circumstances a fuel adjustment clause may be needed to protect both the utility and its ratepayers from inappropriately low or high rates.

Findings of Fact: The Commission finds Public Counsel's criteria of showing a "substantial threat to its financial viability if it did not have a fuel adjustment clause in effect that would recover some or all of the increased costs of fuel and purchased power in between rate cases," unreasonable, unduly burdensome and overly vague.

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[79] Featherstone Direct, Ex. 206, p. 20, lines 1 – 13.

[80] Neff Direct, Ex. 14, Page 3, Lines 14-15.

[81] Stipulation and Agreement as to Certain Issues, Schedule 3.

The Commission finds that a fuel adjustment clause should not be authorized for the mere "convenience" of a utility, but finds that the higher standard of "acute need" is unreasonable and overly vague.

The Commission finds the criteria proposed by Ms. Brockway to be reasonable. The Commission finds Aquila's proposed fuel adjustment mechanism meets all three criteria, as more fully discussed above.

After carefully considering the evidence and arguments of the parties, balancing the interests of ratepayers and shareholders, based on the evidence presented at this hearing and on the Commission's evaluation of Aquila's situation as it currently exists, the Commission finds a RAM is appropriate to address Aquila's fuel and purchased power costs in this proceeding. The Commission cannot, however, guarantee that Aquila's circumstances will justify its continued appropriateness in any future rate proceeding.

Conclusions of Law: The new statute (section 386.266) allows the Commission to approve a fuel adjustment clause. The statute does not require that the Commission approve a fuel adjustment clause. Instead, it specifically gives the Commission authority to accept, reject or modify a proposed fuel adjustment clause after giving an opportunity for a full hearing in a general rate case. Having considered Aquila's request after hearing, the Commission concludes "that an earnings threshold for eligibility to use a RAM is contrary to the intent of the legislature, as articulated in SB 179."[82] As such, the Commission concludes Aquila has met the requirements of section 386.266, and it would be reasonable and in the public interest to permit Aquila to use an adjustment mechanism.

[82] SB 179 has been codified at Section 386.266 RSMo (Cum. Supp. 2006).

The Commission concludes Public Counsel's proposed standard is vague, unduly burdensome and contrary to the standard for approval contained in Section 386.266.4(1), which requires that for the Commission to approve an adjustment mechanism it must be "reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity." Likewise, the Commission concludes Mr. Johnstone's "acute need" standard to be too vague to be useful and contrary to both the intent of the legislature in passing Section 386.266, and the approval standard contained in Subsection 386.266.4(1).

After carefully considering the evidence and arguments of the parties, and balancing the interests of ratepayers and shareholders, the Commission agrees with Aquila and Staff and concludes that a RAM method is appropriate to address Aquila's fuel and purchased power costs in this proceeding.

b. Should the Commission authorize Aquila to implement an interim energy charge or a fuel adjustment clause?

The Commission must now determine what fuel adjustment mechanism is the proper means by which Aquila should recover its volatile fuel costs. To do so, the Commission must balance the need to afford Aquila relief from extreme volatility in fuel and purchased power costs against the need to preserve a financial incentive for Aquila to control its fuel cost.

Staff argues that an interim energy charge is the most appropriate mechanism for addressing the issue of variable fuel and purchased power costs given the recent and continuing fuel and purchased power price volatility. Staff first argues that, unlike a fuel adjustment clause, an interim energy charge affords customers a period of stability regarding electricity prices during its effective period.[83] Staff witness Cary Featherstone proposed the implementation of an interim energy charge similar to that previously implemented for Aquila following a stipulation and agreement in ER-2004-0034.[84]

To implement such an interim energy charge, the Commission would first establish a base level (or floor) for estimated fuel and purchased power costs that would be included in permanent rates. Then, the Commission would authorize the collection of an additional portion of strictly variable costs up to a forecasted level (the ceiling) via an interim energy charge surcharge based on the kWh usage of Aquila's customers. Mr. Featherstone recommended a floor amount reflect a price of $6.00 per MMBtu for natural gas, $55.00 per MWH for variable purchased power, and $21 per ton for high Btu blend coal.[85] Mr. Featherstone next recommended prices reflected in the ceiling amount be $9.00 per MMBtu of natural gas, $90.00 per MWH of purchased energy, and $40 per ton for high Btu blend coal.[86]

Mr. Featherstone further recommended the effective period for the interim energy charge be two years, with a true-up audit to be conducted at the termination of the interim energy charge.[87] If, upon completion of the true-up audit, Aquila's prudently incurred variable fuel and purchased power costs were within the range defined by the ceiling and floor amounts of the interim energy charge, customers would receive a refund equal to the

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[83] Tr. page 714, lines 20-23.

[84] Featherstone Direct, Ex. 206, page 11, line 13 to page 33, line 21.

[85] Featherstone Rebuttal, Ex. 207, page 6; and Tr. page 755, line 15 to page 756, line 12.

[86] *Id*.

[87] Tr. page 706, lines 15-17.

amount collected minus the prudently incurred actual costs. Any refund amounts due to customers would be returned with interest.[88]

The Commission agrees with Staff that an interim energy charge would afford customers with a period of rate stability. However, on the date an interim energy charge goes into effect the utility's customers are forced to pay the difference between the floor and ceiling rates as an upfront charge. If the ceiling is set too high the customer will be overpaying for up to two years. If the interim energy charge ceiling is set too low, especially if it is set significantly below actual purchased power costs, a utility will not recover its prudently incurred fuel costs.

The Commission has used the interim energy charge in two recent cases, both with equally poor results. In The Empire District Electric Company's (Empire's) recent rate case, the Commission found Empire's interim energy charge had resulted in an annual under-recovery of prudently-incurred fuel and purchased power costs totaling $26.8 million.[89] Similarly, under Aquila's most recently implemented, and subsequently terminated, interim energy charge, Aquila under-recovered its fuel and purchased power costs by approximately $34 million within approximately 20 months.[90]

Staff next argues an interim energy charge is preferable to a fuel adjustment clause because it provides incentives for a utility to run its plants effectively, and to minimize the cost of its fuel and purchased power, both to avoid incurring costs above the forecast level and to take advantage of the opportunities to drive costs below the base

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[88] Featherstone Direct, Ex. 206, page 11, line 16 to page 12, line 10; and page 14 lines 30-32.

[89] Report and Order, Case No. ER-2006-0315 (December 21, 2006) pages 44-45.

[90] Tr. page 596, lines 4 through 8.

level.[91] The Commission finds Staff's argument unpersuasive in these circumstances. The Commission finds a fuel adjustment clause better addresses Aquila's current situation, and prudence reviews, including some type of incentive mechanism to encourage Aquila to behave prudently, best allow this Commission to set rates that are both just and reasonable for consumers.

While the Commission agrees with Staff that an interim energy charge can be a useful tool to ease the effect of volatility in the price of purchased power, the Commission does not believe it is a superior method to the fuel adjustment clause given the facts in this case.

Findings of Fact: The Commission finds, although an interim energy charge may afford customers a period of rate stability, the possibility of over or under-recovery of prudently incurred fuel costs, as discussed above, outweighs any rate stability benefit. Accordingly, the Commission finds a fuel adjustment clause is preferable to an interim energy charge, because a fuel adjustment clause allows the utility a greater opportunity to recover its actual, prudently incurred fuel costs.

The Commission finds Staff's argument unpersuasive in these circumstances. The Commission finds a fuel adjustment clause better addresses Aquila's current situation, and prudence reviews, including some type of incentive mechanism to encourage Aquila to behave prudently, best allow this Commission to set rates that are both just and reasonable for consumers.

Conclusions of Law: In this instance, the Commission believes a fuel adjustment clause is preferable to an interim energy charge, because a fuel adjustment

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[91] Tr. page 714, lines 20 through 23.

clause allows the utility a greater opportunity to recover its actual, prudently incurred fuel costs. While the Commission agrees with Staff that an interim energy charge can be a useful tool to ease the effect of volatility in the price of purchased power, the Commission does not believe it is a superior method to the fuel adjustment clause given the facts in this case. Further, given the significant under-recovery that resulted from the two most recently approved interim energy charges, the Commission is not certain an interim energy charge would satisfy the approval standard contained in Section 386.266.4(1), in that, an interim energy charge arguably is not reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity. The Commission concludes Aquila should be authorized to implement a fuel adjustment clause in this case.

c. How should the fuel adjustment clause be structured?

The Commission must now consider what form that fuel adjustment clause should take.

i. What costs should be recoverable through the fuel adjustment clause? Aquila originally proposed to recover through its fuel adjustment clause all costs recorded in Federal Energy Regulatory Commission ("FERC") Accounts 501, 509, 547, and 555. In addition to the actual costs of fuel and purchased power, these accounts also included related costs, such as unit train lease, depreciation, and maintenance costs; freeze/dust suppression costs; fuel handling costs; costs associated with fly-ash removal; gas reservation charges; and demand charges for purchased power contracts with terms in excess of one year. After considering objections of various parties, Aquila has agreed these costs will be recovered exclusively through base rates.[92] Aquila continues to believe, however, that hedging costs and demand charges related to purchased power contracts with terms of one year or less should be recovered through the fuel adjustment clause.[93]

Staff witness Cary Featherstone argues only variable fuel and purchased power costs, including variable transportation costs, should be included in a fuel adjustment clause.[94] Specifically, Mr. Featherstone contends it is inappropriate to include demand charges for any capacity contracts, regardless of their duration, for two reasons. First, Mr. Featherstone points to the fact that demand charges are fixed costs to reserve capacity, and as such are more like plant investment cost than fuel or purchased power cost. Second, Staff opposes Aquila's use of short-term contracts to meet its growing capacity needs. Staff argues that allowing Aquila to pass on this type of cost would allow Aquila to meet its growing load requirements through short-term capacity, thus creating another disincentive for it to build generating units and placing all the risk of future fuel and purchased power cost increases on its customers.[95] Mr. Featherstone's analysis is persuasive.

Findings of Fact: The Commission finds a reasonable fuel adjustment clause should be straightforward and simple to administer, retain some incentive for company efficiency, and be readily auditable and verifiable through expedited regulatory review. The Commission can find no probative evidence in the record to support a finding that hedging costs or demand charges related to purchased power contracts with terms of one year or

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[92] Post-Hearing Brief of Aquila, Inc., pages 43 through 44.

[93] *Id*. at page 44.

[94] Featherstone Rebuttal, Ex. 207, page 8, lines 10 through 20.

[95] Tr. page 707, line 25 to page 708, line 17.

less should be recovered in a different manner than purchased power contracts with longer terms. The Commission agrees with Staff, and finds that demand charges are fixed costs to reserve capacity, and as such are more like plant investment cost than fuel or purchased power cost. This is the case irrespective of the length of the purchased power contract. Further, if demand charges on short term contracts are allowed to flow through the fuel adjustment clause, Aquila would be encouraged to forgo entering long term contracts in favor of short term contracts.

Conclusions of Law: The Commission concludes it would be improper to allow Aquila to flow hedging costs or demand costs associated with any purchased power contract through its fuel adjustment clause. The Commission concludes Aquila will only be allowed to flow variable fuel and purchased power costs, including variable transportation costs, through its fuel adjustment clause.

ii. What recovery period should be used? Aquila witness Dennis Williams originally proposed four, quarterly recovery periods. However, faced with opposition from all parties, Mr. Williams changed his position on this issue and stated that the company would agree to the single, annual recovery period proposed by Industrials' witness Mr. Johnstone.[96] No party opposed the use of a single recovery period.

Findings of Fact: The Commission finds a single recovery period is appropriate in that it would benefit Aquila's rate payers by mitigating the effect of seasonal variations in fuel and purchased power costs.[97]

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[96] D. Williams Direct, Ex. 32, pages 3-5; D. William Surrebuttal, Ex. 34, pages 6-7; and Aquila's Post Hearing Brief, page. 43.

[97] Johnstone Rebuttal, Ex. 505, page 22.

Conclusions of Law: The Commission concludes a single annual recovery period is reasonable and lawful under section 386.266.

iii. What line loss adjustments should be included? Although the draft rules under consideration at the time of the company's filing made recognition of line losses in a fuel adjustment clause optional, 4 CSR 240-20.090 (the Commission's Fuel Adjustment Clause Rule), as finally adopted, makes recognition of line losses mandatory. Aquila's original proposed fuel adjustment clause assumed every customer class had the same line losses and charged every customer on the system the same average loss factor.[98] It is inappropriate to use a single loss factor for all customers, because line losses vary depending upon the facilities used to supply customer needs.[99] To conform to the Commission's Fuel Adjustment Clause Rule and appropriately account for variances in line losses, these differences in line loss factors must be recognized in the fuel adjustment clause.[100]

SIEUA, AG-P and FEA expert witness Maurice Brubaker included a table of "Losses and Loss Multipliers," detailing the line loss factors he recommended be included in any fuel adjustment clause ordered in this case.[101] After considering his recommendation and proposed factors, Aquila recommended his proposal be adopted by the Commission as part of any fuel adjustment clause it approves.[102] No other party took a position on this issue.

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[98] Brubaker Direct, Ex. 501, page 3, lines 11-17.

[99] *Id*. page 3, line 18 to page 4, line 2.

[100] *Id*.

[101] Id. at page 4

[102] Aquila's Post Hearing Brief, page 44.

Findings of Fact: The Commission finds the line loss factors proposed by Mr. Brubaker and supported by Aquila are appropriate and should be included in the fuel adjustment clause.

Conclusions of Law: The Commission concludes line loss factors must be recognized in the fuel adjustment clause. The Commission further concludes line loss factors proposed by Mr. Brubaker conform to the requirements of the rule.

iv. What heat rate testing of generation plants should be conducted? As addressed in detail above at pages 27 to 29 under the heading, "Appropriateness of a Waiver of 4 CSR 240-3.161(2)(P)," the Commission finds Aquila should be: 1) granted a waiver of Commission Rule 4 CSR 240-3.161(2)(P), and 2) required to have finalized procedures for heat rate and/or efficiency testing that are either agreed to by the parties, or approved by the Commission, in place no less than sixty days before the effective date listed on the tariff for Aquila's initial fuel adjustment clause adjustment filing.

Findings of Fact: The Commission finds the 242 Proposal to be reasonable with one exception. The Commission does not believe it is appropriate to require the written procedures to be agreed to by all non-Aquila parties to ER-2007-0004, given that parties who believe a RAM is never appropriate could block adjustments under an approved RAM by opposing even reasonable procedures.

Conclusions of Law: As addressed in detail above at pages 27 to 29 under the heading, "Appropriateness of a Waiver of 4 CSR 240-3.161(2)(P), the Commission concludes it is reasonably necessary to require, in connection with the establishment of a rate adjustment mechanism, that Aquila develop a heat rate and/or efficiency testing schedule and plan under the terms set out in Exhibit 242, with the following conditions. First, in the event any party to ER-2007-0004 opposes the written heat rate and/or efficiency testing procedures ultimately proposed by Aquila, Aquila may file a motion with the Commission seeking approval of those procedures. Second, Aquila must have finalized procedures that are either agreed to by the parties, or approved by the Commission, in place no less than sixty days before the effective date listed on the tariff for Aquila's initial fuel adjustment clause adjustment filing.

v. How often should the fuel rate be adjusted? Originally Aquila proposed quarterly adjustments. However, in its Post Hearing Brief, Aquila advised the Commission that it did not oppose semi-annual adjustments.[103] Aquila's revised position is in agreement with SIEUA, AG-P and FEA witness Donald Johnstone, who proposed that any fuel adjustment clause authorized for Aquila should include two adjustment periods per year to decrease the impact of seasonal variations in both customer usage patterns and fuel and purchased power costs.[104]

Only Public Counsel witness Russell Trippensee suggested Aquila should only be allowed to adjust its fuel adjustment clause once per year.[105] Mr. Trippensee argued annual adjustments would decrease the impact of seasonal variations in both customer usage patterns and fuel and purchased power costs.[106] However, no party, including Public

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[103] Post-Hearing Brief of Aquila, Inc., page 44-45.

[104] Johnstone Rebuttal, Ex. 505, page 22.

[105] Trippensee Rebuttal, Ex. 402, pages 4-8.

[106] *Id*.

Counsel, recommended the inclusion of a single adjustment period in either its prehearing or posthearing brief.

Aquila witness Dennis Williams testified that a single adjustment period would not be reasonable for three reasons. First, annual adjustments could result in rate shock to customers given the recent trends toward large annual increases in fuel and purchased power costs. Second, there would be carrying charges associated with delayed recovery. Third, annual adjustments are inconsistent with the objective of Section 386.266 RSMo to allow full and timely recovery of prudently-incurred fuel and purchased power costs.[107]

Findings of Fact: The Commission finds Mr. Williams' testimony on the issue more persuasive, and further finds two adjustments per year will adequately decrease the impact of seasonal variations in both customer usage patterns and fuel and purchased power costs. Accordingly, the Commission finds Aquila's fuel adjustment clause should provide for two adjustments per year.

Conclusions of Law: An electric utility with a fuel adjustment clause must file at least one adjustment to its fuel adjustment clause in each true-up year coinciding with the true-up of its fuel adjustment clause.[108] The Commission has discretion to authorize any utility with a fuel adjustment clause to file up to three additional adjustments to its fuel adjustment clause within a true-up year.[109] The Commission concludes it may lawfully limit the adjustments to twice each year.

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[107] Williams Surrebuttal, Ex. 34, pages 10–12.

[108] 4 CSR 240-20.090(4)(A).

[109] *Id*.

vi. Should the fuel adjustment clause require a phase-in for sharp changes in fuel or purchased power costs, contain a "soft cap"?

SIEUA, AG-P and FEA witness Donald Johnstone proposed that any rate increase resulting from increased fuel and purchased power cost flowing through the fuel adjustment clause be limited to a "soft cap" of 3% annually."[110] Any amount in excess of the "soft cap" would be recovered with interest in the 12-month period immediately following the standard 12-month recovery period.[111] Further, although Aquila's fuel adjustment clause proposal does not include a "soft cap," Aquila does not oppose such a cap provided it is set at a reasonable level of at least 6% annually.[112]

While a "soft cap" might prevent customers' bills from rising significantly during the first year of the fuel adjustment clause, the Commission is concerned that any "soft cap" could result in those same customers facing greater price increases in the future, especially if current upward trends in fuel and purchased power costs continue.[113] AARP witness Nancy Brockway argues convincingly that it is not appropriate to include a "soft cap" in the approved fuel adjustment clause, because it would simply defer certain increases to future periods with interest, and likely result in even greater rate shock.[114]

Findings of Fact: The Commission finds, as recommended by witness Nancy Brockway, a "soft cap" to be inappropriate, due to the potential for rate shock.

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[110] Johnstone Rebuttal, Ex. 505, page 24, line 10 to page 25, line 9.

[111] *Id*.

[112] Williams Surrebuttal, Ex. 34, pages 24-25.

[113] As discussed infra, Aquila has experienced a 13-20% annual increases in fuel and purchased power costs over the last three years.

[114] Tr. page 863.

Conclusions of Law: The Commission concludes it has the discretion in the application of a "soft cap," which is not warranted in this instance.

vii. Should the fuel adjustment clause include performance standards? As part of their "alternative" fuel adjustment clause, SIEUA, AG-P and FEA asked the Commission to adopt specific performance standards that would apply to the coal-fired generating plants that Aquila uses to satisfy its base load power requirements.[115] SIEUA, AG-P and FEA witness Donald Johnstone argued the standards are necessary to protect consumers from the expense of higher-cost replacement power Aquila might have to acquire if there is an outage in one of its lower-cost base load units.[116] However, unless Aquila imprudently shuts down a base load facility, it should be allowed to recover reasonable costs for purchasing replacement power while such a facility is non-operational. Accordingly, for Mr. Johnstone's proposal to be reasonable, the Commission would have to assume Aquila would imprudently shut down one of its base load generating facilities. The Commission has no reason to believe Aquila would do this. In any event, the prudence of any replacement power cost purchased due to Aquila's shutting down of a base load unit should be addressed in the annual prudence reviews included in Aquila's proposed fuel adjustment clause.

Findings of Fact: The Commission finds it unreasonable to assume Aquila might imprudently shut down one of its base load generating facilities. The Commission further finds the prudence of any replacement power cost purchased due to Aquila's

[115] Johnstone Rebuttal, Ex. 505, page 16, line 17 through page 18, line 2.
[116] *Id*.

shutting down of a base load unit should be addressed in the annual prudence reviews included in Aquila's proposed fuel adjustment clause.

Conclusions of Law: The Commission concludes it has sufficient remedies available to deter imprudent action by Aquila and regular performance reviews are required under the law to detect imprudent action. The Commission finds no performance standards shall be included in the fuel adjustment clause.

viii. At what level, or under what formula, should over or under collection of fuel and purchased power costs be passed through the fuel adjustment clause?

Aquila's proposed fuel adjustment clause provides for a complete pass-through of 100% of prudently incurred fuel and purchased power costs above or below the amount included in base rates.[117] Aquila argues this assures customers will only bear the actual cost of fuel and energy that the Company prudently incurs in order to provide service.

AARP witness Nancy Brockway and SIEUA, AG-P and FEA witness Donald Johnstone each recommended the Commission only authorize Aquila to flow 50% of its prudently incurred fuel and purchased power costs above those in base rates through the fuel adjustment clause (50% flow-through).[118] They contend this type of sharing mechanism must be incorporated into any fuel adjustment clause to ensure Aquila will act prudently in procuring the fuel and purchased power necessary to provide service to its

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[117] Williams Rebuttal, Ex. 33, pages 11-12; and Williams Surrebuttal, Ex. 34, pages 17-23.

[118] Brockway Surrebuttal, Ex. 601, pages 6-7; Tr. page 881, lines 17–23; Johnstone Rebuttal, Ex. 505, page 13, line 10 to page 15, line 10.

customers.[119] They further argue prudence reviews are ineffectual, in that they are an imperfect tool for catching inefficiency and eliminating its effects from rates.[120]

Aquila witness Dennis Williams objects to the proposed 50% flow-through because it would: 1) prohibit Aquila from collecting from customers a portion of its fuel and purchased power costs, even if those costs were determined to have been prudently incurred, and 2) prohibit customers from receiving the full benefit of any decreases in fuel and energy costs.[121]

As discussed above, in the Stipulation as to Certain Issues, Aquila's fuel and purchase cost was set at approximately $ 200,000,000. Aquila has experienced an increase of between 13% and 20% annually for each of the last 3 years. Under a 50% pass-through scenario, if Aquila's fuel and purchased power costs continued to increase by 15% annually, Aquila would under recover approximately $15,000,000 in prudently incurred fuel and purchased power expense in the 12 months following the conclusion of this case, and possibly $45,000,000 within 24 months.[122]

When asked how Aquila would recover the millions in prudently incurred costs that would not be recovered by a 50% pass-through fuel adjustment clause, SIEUA, AG-P and FEA witness Donald Johnstone stated "when costs go up you've got manage your business in a way to - - to have earnings. And so you have to control all of your costs to be equal to your revenues." Mr. Johnstone declined to offer any theories on where or how Aquila might be able to reduce other costs to compensate for the $15 to $45 million in

[119] *Id*.

[120] *Id*.

[121] Williams Rebuttal, Ex. 33, pages 11 - 12; and Williams Surrebuttal, Ex. 34, pages 17 -23.

[122] Tr. page 782.

prudently incurred fuel and purchased power cost it would not be allowed to recover under his proposal.

While the Commission believes Aquila should be given the opportunity to recover its prudently incurred fuel costs, it also agrees with Mr. Johnstone and Ms. Brockway that: 1) after-the-fact prudence reviews alone are insufficient to assure Aquila will continue to take reasonable steps to keep its fuel and purchased power costs down; and 2) the easiest way to ensure a utility retains the incentive to keep fuel and purchased power costs down is to allow less than 100% pass through of those costs.[123] Accordingly, it is not appropriate to allow Aquila to pass 100% of its fuel and purchased power costs, above those included in its base rates, through its fuel adjustment clause.

As set out above, without a fuel cost adjustment mechanism, if Aquila's fuel and purchased power costs increase by 15% in each of the next two years, Aquila will under recover $30 million in prudently incurred costs in the first year and $60 million in the second year. Under the 50% pass-through proposal, Aquila would still under-recover $15 million and $30 million in the first and second year respectively. Clearly, any adjustment mechanism that would authorize such under-recovery would be a violation of Section 386.266.4(1), in that, it would not afford Aquila a sufficient opportunity to earn a fair return on equity. In contrast, under a 95% pass-through, again assuming a 15% increase in Aquila's fuel and purchased power costs, Aquila would under recover its prudently incurred costs by only $1.5 million and $3.0 million the first and second year respectively.

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[123] Brockway Surrebuttal, Ex. 601, pages 6–7; Tr. pages 847-849 and 878-885; Johnstone Rebuttal, Ex. 505, page 13, line 10 through page 15, line 10.

Findings of Fact: The Commission finds Mr. Williams' testimony on the issue is more persuasive, and further finds a 50% flow-through would not allow sufficient recovery of prudent fuel and purchased power costs.

The Commission also finds after-the-fact prudence reviews alone are insufficient to assure Aquila will continue to take reasonable steps to keep its fuel and purchased power costs down, and the easiest way to ensure a utility retains the incentive to keep fuel and purchased power costs down is to not allow a 100% pass through of those costs.

The Commission finds allowing Aquila to pass 95% of its prudently incurred fuel and purchased power costs, above those included in its base rates, through its fuel adjustment clause is appropriate. With a 95% pass-through, the Commission finds Aquila will be protected from extreme fluctuations in fuel and purchased power cost, yet retain a significant incentive to take all reasonable actions to keep its fuel and purchased power costs as low as possible, and still have an opportunity to earn a fair return on its investment.

Conclusions of Law: The Commission concludes allowing Aquila to only pass 50% of its prudently incurred fuel and purchased power costs through its fuel adjustment clause is not in keeping with the legislative intent of Section 386.266.4(1), which requires any RAM approved by the Commission be "reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity."

As set out above, without a fuel cost adjustment mechanism, if Aquila's fuel and purchased power costs increase by 15% in each of the next two years, Aquila will under recover $30 million in prudently incurred costs in the first year and $60 million in the second year, totally $90 million over the two-year-period. Under the 50% pass-through proposal, Aquila would still under-recover $15 million and $30 million in the first and second year respectively. Any adjustment mechanism authorizing such under-recovery would be a violation of Section 386.266.4(1).

The Commission concludes that a 95% pass-through would not violate Section 386.266.4(1), in that it would still afford Aquila a sufficient opportunity to earn a fair return on equity.

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

Four financial analysts offered recommendations regarding an appropriate return on equity in this case. Testifying on behalf of Aquila, Samuel C. Hadaway, a consultant from Austin, Texas who holds an economics degree for Southern Methodist University, as well as, a Masters in Business Administration and a Ph.D. from the University of Texas at Austin,[124] recommends Aquila be allowed a return on equity of 11.25%[125] Testifying on behalf of SIEUA, AG-P and FEA, Michael Gorman, a consultant from St. Louis, Missouri who holds a Masters in Business Administration with a concentration in finance from the University of Illinois at Springfield, recommends Aquila be allowed a return on equity of 10.0 %.[126] David C. Parcell, a consultant from Virginia who holds a Masters in Business Administration from Virginia Commonwealth University, testified on behalf of Staff. He recommends Aquila be allowed a return on equity between 9.0% and 10.25%, with the mid-

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[124] Hadaway Direct, Ex. 13, page 1, lines 3-11.

[125] Hadaway Rebuttal, Ex. 14, page 19, lines 13-14.

[126] Gorman Direct, Ex. 507, page 17, and Appendix A.

point of his recommendation being 9.625%.[127] In addition, Russell Trippensee, the Chief Utility Accountant for the Public Counsel, who holds an accounting degree from the University of Missouri at Columbia, testified on behalf of Public Counsel. Mr. Trippensee offered analysis of the recommendations made by the other experts, but did not recommend a specific rate of return on equity.[128]

There is one more source the Commission can use as a guidepost in establishing an appropriate return on equity. 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 2006 was 10.36%, with a median return of 10.25%.[129]

The Commission does not believe it would be appropriate for its return on equity finding to unthinkingly mirror the national average. Obviously, if all commissions took that approach returns on equity would never change, despite changing economic conditions, leading to unreasonable results. However, the national average is a good indicator of the capital market in which Aquila will have to compete for the equity needed to finance its operations. The Commission has an obligation under the law, as well as a matter of practical necessity, to allow Aquila an opportunity to earn a return that will allow it to compete in the capital market. No one, including ratepayers, benefit if Aquila is starved for capital.

In recent rate cases, the Commission has used what has been described as a zone of reasonableness to assist it in evaluating the recommendations offered by return on equity experts. The zone of reasonableness has been described as a range 100 basis

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[127] Parcell Direct, Ex. 221, page 1, lines 14-27, and page 31 line 5-6.

[128] Trippensee Direct, Ex. 403, pages 1-2.

[129] Ex. 241.

points above and 100 basis points below the national average allowed return on equity. If the national average is taken to be 10.36%, then the zone of reasonableness runs from 9.36% to 11.36%.[130]

Aquila, Staff, SIEUA, AG-P, and FEA sponsored financial analysts who recommended a return on equity in this case. Their recommended ROEs are: Aquila – 10.25%, plus a 50 basis point adder; Staff – 9.0-10.25%; SIEUA, AG-P and FEA – 10%, with a 30 basis point reduction if a fuel adjustment clause is authorized. All proposed ROE recommendations fall within of the "zone of reasonableness." The Commission will next analyze the various ROE recommendations proposed by the parties.

The zone of reasonableness is simply a tool to help the Commission to evaluate the recommendations offered by various rate of return experts. It should not be taken as an absolute rule that would preclude consideration of recommendations that fall outside that zone. However, a recommendation that greatly varies from the national norm will be viewed with skepticism.

Each expert witness performed multiple calculations using various methods to justify their recommendations for the return on equity the Commission should use in calculating the rates Aquila will be allowed to charge its customers. Collectively, they devoted hundreds of pages of testimony to discrediting each others' opinions. In the end, despite their best efforts to educate, the experts have managed to create a thicket of conflicting opinions. If the Commission were to attempt to force its way through the tangle it could easily lose its way or even become ensnared.

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[130] Ex. 240, page 7.

To avoid becoming tangled in that thicket, the Commission must study the issue from a greater distance. Rather than attempt to untangle each of the narrow, technical disputes between the parties, the Commission will attempt to step back and examine the problem from a broader perspective.

When the Commission steps back, the first pattern that emerges is the realization that the rate of return advocated by the expert who testified for Aquila is too high. It appears as though Dr. Hadaway designed a methodology to achieve the same return the Commission approved for Kansas City Power & Light Company in Case No. ER-2006-0314.[131]

In large part, the overly high return on equity recommendation put forward by Dr. Hadaway results from his inclusion of a 50 basis point construction risk add-on premium, based on Aquila's allegedly greater construction risk.[132] Dr. Hadaway testified Aquila's six-year construction expenditures as a percentage of net plant is 118.2%, compared to an average of 60.9% for the comparable group.[133] Despite his advocacy of an adjustment to account for Aquila's alleged increased construction risk, Dr. Hadaway admits his entire construction risk adjustment is based upon Aquila's "**projected, estimated"** construction expenditures over the next six years.[134] Further, Dr. Hadaway admitted that in comparing construction risk, he compared more recent Aquila estimates to older estimates for the comparable utilities.[135]

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[131] *Report and Order*, issued December 21, 2006, Case No. ER-2006-0314.

[132] Hadaway Rebuttal, Ex. 14, page 19, lines 6-13.

[133] *Id*.

[134] Tr. pages 322-323.

[135] Tr. pages 416-417.

In addition to the obvious incongruity of a large construction risk adjustment for a company based on projected and estimated construction expenditures, the opposing experts convincingly explained that Dr. Hadaway's return on equity recommendation and proposed construction adjustment are inappropriately inflated for more technical reasons as well. In particular, the Commission accepts as credible the testimony of SIEUA, AG-P, and FEA's witness, Michael Gorman, who explains that Dr. Hadaway's failure to acknowledge offsetting financial risks results in an improper evaluation of the construction and financial risk differential between the proxy groups and Aquila.[136] Dr. Hadaway's proposed adjustment for construction risk is an incomplete assessment of Aquila's overall risk because it ignores other aspects of risk that make Aquila less risky than many of the comparable companies, including: nuclear operations, operations in deregulated states, non-regulated affiliates, and hurricane risk.[137] In sum, the construction risk upward adjustment proposed by Dr. Hadaway appears to be a transparent effort to inflate the company's proposed return on equity.

On the other side of the thicket, the Commission finds the return on equity proposed by Staff Witness Parcell is too low. If the Commission were to adopt the return on equity he advocates, Aquila would have one of the lowest allowed returns on equity in the country. Parcell's group of comparable proxy companies includes several companies owning no generation and are therefore exposed to significantly lower risk.[138] Only Parcell's high point of 10.25% seems reasonable under these circumstances.

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[136] Gorman Rebuttal, Ex. 508, pages 5-6.

[137] Tr. pages 334-364.

[138] Parcell Direct, Ex. 221, pages 20-31, and Tr. pages 496-497.

In setting rates the Commission's obligation is to reasonably balance shareholder and ratepayer interests. This is not an intellectual game designed to fatten or drive down the company's bottom line. Economic theories must be tempered by a realistic appraisal of the effect the numbers derived from those theories will have on the company and on ratepayers. For once, the Commission would like to see a rate case in which the witnesses presented by the parties present a balanced analysis rather than racing to the extremes.

Of the witnesses who testified in this case Michael Gorman, the witness for SIEUA, AG-P and FEA, did the best job of presenting the balanced analysis the Commission seeks, but even his analysis was lacking in certain aspects. His overall recommendation was for a return on equity of 10.0%. Mr. Gorman performed three different analyses to arrive at his overall recommendation. His Constant Growth Discounted Cash Flow (DCF)[139] analysis resulted in a recommended return on equity of 9.4 percent using his comparable group and 9.5% using Dr. Hadaway's comparable group,[140] his Bond Yield Plus Risk Premium Model analysis results in a recommended return on equity of 10.0% for both his proxy group and Dr. Hadaway's proxy group,[141] and his Capital Asset Pricing Model (CAPM)[142] results in a recommended return on equity of 10.2% using his proxy group and 10.6% using Dr. Hadaway's proxy group.[143] Mr. Gorman's overall recommendation of 10.0% is then a blending of these three analyses.

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[139] Gorman explains that "[t]he DCF model posits that a stock price is valued by summing the present value of expected future cash flows discounted at the investor's required rate of return (ROR) or cost of capital." Gorman Direct, Ex. 507, page 20, lines 15-17.

[140] *Id*. at page 23, lines 9-11, and page 34, TABLE 4.

[141] *Id*. at page 19, lines 5-6, and page 34, TABLE 4.

[142] Gorman explains that "[t]he CAPM method of analysis is based upon the theory that the market required ROR for a security is equal to the risk-free ROR, plus a risk premium associated with the specific security." *Id*. at page 29, lines 9-11.

[143] Id. at Page 19, Lines 15-16, and page 34, TABLE 4.

On cross-examination, Mr. Gorman indicated his 10.0% recommendation presumed Aquila would not be granted a fuel adjustment clause, and if the Commission awards Aquila a fuel adjustment clause, his recommendation would drop by thirty basis points to 9.7%.[144] Public Counsel witness Russell Trippensee also stated that any ROE recommendation should be reduced if Aquila is authorized to establish a fuel adjustment clause.[145]

All the experts agree having a cost recovery mechanism, such as a fuel adjustment clause, results in less risk for a company and a company's return on equity should be decreased to compensate. The question then becomes whether that decrease in business risk is already reflected in Mr. Gorman's return on equity recommendation.

Mr. Gorman's testimony is lacking in this area in that there is insufficient evidence in the record to determine whether the companies in Mr. Gorman's proxy group have cost recovery mechanisms. However, 18 of the 24 companies in Dr. Hadaway's proxy group have fuel cost recovery mechanisms.[146] Mr. Gorman performed his three analyses using his proxy group and then again utilizing Dr. Hadaway's proxy group.[147] He obtained very similar results irrespective of which group was used.[148] Accordingly, the Commission finds the decreased risk associated with having a cost recovery mechanism is already accounted for in Mr. Gorman's return on equity calculation and no additional adjustment is necessary.

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[144] Tr. pages 532-533.

[145] Trippensee Direct, Ex. 403, pages 7-8.

[146] Hadaway Rebuttal, Ex. 14, page 18, lines 4-16.

[147] *Id*.

[148] *Id*.

Findings of Fact: The Commission finds that none of the experts' final results appear to be reasonable. The 11.25% rate of return advocated by the expert who testified for Aquila, Dr. Hadaway, is too high. Dr. Hadaway's failure to acknowledge or account for financial risks faced by the comparable companies, that are either not faced by Aquila, or faced to a lessor degree, resulted in an improper inflation of his rate of return recommendation.

Dr. Hadaway's 50 basis point construction risk adjustment based upon "projected" and "estimated" construction expenditures as a percentage of existing plant over the next six years is inappropriately high, especially given that he compared current Aquila estimates to older estimates for the comparable companies. A more modest adjustment of 10 to 15 basis points is appropriate.

Michael Gorman, the witness for SIEUA, AG-P and FEA, did the best job of presenting the balanced analysis the Commission seeks. In examining Mr. Gorman's three analyses, the results of his DCF analysis are somewhat inconsistent with the results of the other two analyses and should be excluded. Utilizing the results of Mr. Gorman's Risk Premium and CAPM, Aquila's return on equity should be in the low 10% area. Next, Aquila's return on equity should be adjusted upwards by 10 to 15 basis points to reflect its increased construction risk compared to the comparable companies, as well as the fact the company is not recovering 100% of its prudently incurred fuel and purchased power costs.

A cost recovery mechanism, such as a fuel adjustment clause, results in a bit less risk for a company and a company's return on equity should be decreased to compensate. However, the Commission finds the decreased risk associated with having a cost recovery mechanism is already accounted for in Mr. Gorman's return on equity calculation and no additional adjustment is necessary.

Based on its analysis of the expert testimony offered by the parties, and on its balancing of the interest of the company's ratepayers and shareholders the Commission finds 10.25% is a fair and reasonable return on equity for Aquila that will allow it to compete in the capital market for the funds needed to maintain its financial health. Based upon a 10.25% return on equity, Aquila's revenue requirement increase will be approximately $13.6 million and $45.1 million for it L&P and MPS Operating Divisions, respectively.

Conclusions of Law: The Commission must draw primary guidance in the evaluation of the expert testimony from the Supreme Court's *Hope* and *Bluefield* decisions. [149] Pursuant to those decisions, returns for Aquila's investors must be commensurate with returns in other enterprises with corresponding risks.[150] Just and reasonable rates must include revenue sufficient to cover operating expenses, service debt and pay a dividend commensurate with the risk involved. The language of *Hope* and *Bluefield* unmistakably requires a *comparative method*, based on a quantification of risk.[151]

Investor expectations of Aquila are not the sole determiners of ROE under *Hope* and *Bluefield*, we must then compare it to the performance of other companies that are similar to Aquila in terms of risk. *Hope* and *Bluefield* also expressly refer to objective measures.[152] The allowed return must be sufficient to ensure confidence in the financial

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[149] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603, 64 S.Ct. 281, 288, 88 L.Ed. 33, 345 (1943); and *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).

[150] *Id*.

[151] *Id*.

[152] *Id*.

integrity of the company in order to maintain its credit and attract necessary capital. By referring to confidence, the Court again emphasized risk.

In its decision in *Missouri Gas Energy*, the Commission stated that it does not believe its return on equity finding should "unthinkingly mirror the national average."[153] However, the national average is an indicator of the capital market in which Aquila will have to compete for necessary capital. One requirement imposed by *Hope* and *Bluefield* is that Aquila's rates be sufficient to permit it to obtain necessary capital.[154]

Based on its analysis of the expert testimony offered by the parties, and on its balancing of the interest of the company's ratepayers and shareholders the Commission finds a ROE of 10.25% satisfies the *Hope* and *Bluefield* standards and is a fair and reasonable return on equity for Aquila.

3. **Accounting Authority Order – Sibley Generating Facility:** Should the unamortized balances of the Sibley AAOs be included in Aquila's rate base in this case?

The Commission has the regulatory authority to grant a form of relief to a utility in the form of an accounting technique, an accounting authority order (AAO).[155] An AAO allows a 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.[156]

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[153] *In the Matter of Missouri Gas Energy*, Case No. GR-2004-0209 (*Report & Order*, issued Sept. 21, 2004) .

[154] *Hope*, 320 U.S. at 603; *Bluefield*, 262 U.S. at 690.

[155] *Missouri Gas Energy v. Public Service Commission State of Missouri*, 978 S.W.2d 434 (Mo. App. 1998).

[156] *Id.*

The Commission granted Aquila two AAOs associated with expenditures involving its Sibley Rebuild and Western Coal Conversion product. [157] These projects were undertaken to extend the useful life of the Sibley Generating Station by 20 years and to comply with the 1990 Federal Clean Air Act.[158] This project avoided building a new generation plant at substantially higher costs and allowed the Sibley unit to burn low sulfur western coal to meet environmental requirements.[159]

To avoid the need to purchase other power resources to meet the peak season demand, work on these projects was only conducted in off-peak periods.[160] This approach provided for a substantial savings for Aquila's customers, but caused recovery problems for the company because it took several years to complete.[161] If the Commission had not granted Aquila an AAO, Aquila would have been unable to recover the cost of system upgrades without filing annual rate cases.

In its December 27, 1989 *Order Concerning Application for Approval of Accounting Procedure and Consolidating Dockets*, Case No. EO-90-114 and *Report and Order* in Case Nos. EO-91-358 and EO-91-360, the Commission concluded these expenses were extraordinary in nature and justified the special accounting treatment.[162] By allowing the deferral of these costs, the Commission allowed Aquila to stage the Sibley projects, thereby saving its customers the expense of purchasing alternate power resources during peak-demand periods, and also avoiding a series of rate cases to capture

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[157] Kolte Surrebuttal, Ex.19, page 4, lines 6-13.

[158] *Id*.

[159] *Id*.

[160] *Id.* at lines 16-22.

[161] *Id*. at page. 4, line 22 to page 5, line 2.

[162] 1 Mo. P.S.C. 3rd 200 (1991).

the staged elements of those projects.[163] In each case, the Commission allowed the amortization of the expense over a 20-year period, plus the inclusion of the unamortized amount in rate base.[164]

Aquila witness Ron Kolte and Staff witness Philip Williams each contend that the unamortized balances of the Sibley AAOs should be included in rate base in this case.[165] In support of that position, Mr. Williams and Mr. Kolte testify the public policy analysis upon which the Commission based its decision to initially authorize the Sibley AAOs is still sound.[166] Mr. Williams further testified that 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.[167] Both Mr. Kolte and Mr. Williams state that the Commission has already granted the AAOs and incorporated them in prior rate cases and should do so again here.[168]

Public Counsel contends the Commission should deny rate base treatment for the unamortized deferred cost balance allowed by the AAOs.[169] Public Counsel argues inclusion of these balances in the rate base would be inconsistent with the purpose of the AAO mechanism as a remedy to mitigate the impact of regulatory lag. Public Counsel appears to object to the AAOs on the basis that their balances include property taxes,

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[163] *Id*.

[164] Tr. page 94, lines 21-23.

[165] P. Williams Rebuttal, Ex 236, pages 3-4; and Kolte Surrebuttal, Ex. 18, pages 2-9.

[166] *Id*.

[167] P. Williams Rebuttal, Ex. 236, page 6, line 19 to page 7, line 5.

[168] P. Williams Rebuttal, Ex. 236, pages 3-4; and Kolte Surrebuttal, Ex. 18, pages 2-9.

[169] Robertson Rebuttal, Ex. 406, pages 9-17.

carrying costs and depreciation expense related to the originally deferred amounts.[170] Public Counsel claims these items are book entries rather than actual capital outlays of real dollars and that Aquila should not be allowed to earn a return on these amounts.[171]

The Commission agrees with Public Counsel that AAOs are to be considered on a case-by-case basis, and that the Commission can revisit the issue and is not bound by its prior determinations. However, the Commission agrees with Mr. Williams and Mr. Kolte that the public policy analysis upon which the Commission based its decision to initially authorize the Sibley AAOs is still sound.[172] The deferred costs included in the Sibley AAOs represent major capital additions to plant in service and should be treated the same way as other capital costs for these projects, and afforded rate base treatment. Further, absent AAO treatment, these amounts would have been lost as a result of booking these costs directly to expense following completion of the projects.[173] The Commission finds the unamortized balances of the Sibley AAOs should be included in Aquila's rate base in this case.

Findings of Fact: The Commission agrees with Staff and Aquila that the public policy analysis upon which the Commission based its decision to initially authorize the Sibley AAOs is still sound. The deferred costs included in the Sibley AAOs represent major capital additions to plant in service and should be treated the same way as other capital costs for these projects, and afforded rate base treatment.

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170 *Id*.

171 *Id.*

172 P. Williams Rebuttal, Ex. 236, pages 3-4; and Kolte Surrebuttal, Ex. 18, pages 2-9

173 Tr. page 96, lines 15-24.

Conclusions of Law: The Commission has the regulatory authority to grant a form of relief to a utility in the form of an accounting technique, an accounting authority order (AAO). An AAO allows a 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. While AAOs are to be considered on a case-by-case basis, and the Commission can revisit the issue and is not bound by its prior determinations, the deferred costs included in the unamortized balances of the Sibley AAOs, represent major capital additions to plant in service, and should be included in Aquila's rate base in this case.

4. Depreciation: What depreciation rates should be used to determine rates in this case?

Staff and Aquila maintain that Aquila's currently approved depreciation rates should be used to set rates in this case. Initially, SIEUA, AG-P and FEA opposed Aquila's use of those depreciation rates. No other party took a position on this issue.

During the evidentiary hearing, counsel for SIEUA, AG-P and FEA advised the Commission they were dropping the depreciation issue and were now agreeing that Aquila's current depreciation rates should be used in this case.[174]

Findings of Fact: The Commission finds Aquila's currently approved depreciation rates are appropriate to use to determine rates in this case. The Commission further finds no party objects to the use of those depreciation rates.

[174] Tr. page 464, lines 4 - 8.

Conclusions of Law: The Commission finds Aquila's currently approved depreciation rates are appropriate and will be used to determine appropriate rates in this case.

G. The Settled Issues

Many issues were resolved by the agreement of the parties. On April 4, 2007, a Stipulation and Agreement as to Certain Issues was filed and served on the parties. Each party that did not sign the stipulation filed an official statement indicating it did not oppose the stipulation. As permitted by its regulations, the Commission treated the unopposed stipulation and agreement as a unanimous partial stipulation and agreement.[175] After considering the stipulation and agreement, the Commission approved it as a resolution of the issues addressed in that agreement.[176] The issues that were resolved by the approved stipulation and agreement will not be further addressed in this report and order.

IT IS ORDERED THAT:

1. Subject to the conditions set out in the body of this order, Aquila is granted a waiver from the following requirements contained in Commission Rule 4 CSR 240-20.090(9): the requirement to include line loss factors in its original fuel adjustment clause filing, and the requirement to include line loss factors in its fuel adjustment clause that are based upon a line loss study completed within twenty-four months of that fuel adjustment clause filing.

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[175] 4 CSR 240-2.115(2).

[176] An *Order Approving Stipulation and Agreement as to Certain Issues* was issued on April 12, 2007.

2. Aquila is granted a waiver of Commission Rule 4 CSR 240-3.161(2)(P), subject to the conditions set out in the body of this order.

3. The proposed electric service tariff sheets submitted under Tariff File No. YE-2007-0001 on July 3, 2007, by Aquila, Inc., d/b/a Aquila Networks MPS and Aquila Networks L&P for the purpose of increasing rates for retail electric service to customers are hereby rejected. The specific sheets rejected are:

P.S.C. Mo. No. 1

3rd Revised Sheet No. 2, Canceling 2nd Revised Sheet No. 2
2nd Revised Sheet No. 18, Canceling 1st Revised Sheet No. 18
2nd Revised Sheet No. 19, Canceling 1st Revised Sheet No. 19
2nd Revised Sheet No. 21, Canceling 1st Revised Sheet No. 21
2nd Revised Sheet No. 22, Canceling 1st Revised Sheet No. 22
2nd Revised Sheet No. 23, Canceling 1st Revised Sheet No. 23
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2nd Revised Sheet No. 28, Canceling 1st Revised Sheet No. 28
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2nd Revised Sheet No. 31, Canceling 1st Revised Sheet No. 31
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2nd Revised Sheet No. 34, Canceling 1st Revised Sheet No. 34
2nd Revised Sheet No. 35, Canceling 1st Revised Sheet No. 35
1st Revised Sheet No. 36, Canceling Original Sheet No. 36
2nd Revised Sheet No. 41, Canceling 1st Revised Sheet No. 41
2nd Revised Sheet No. 42, Canceling 1st Revised Sheet No. 42
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2nd Revised Sheet No. 103 Canceling 1st Revised Sheet No. 103
2nd Revised Sheet No. 104, Canceling 1st Revised Sheet No. 104
Original Sheet No. 124
Original Sheet No. 125
Original Sheet No. 126

4. Aquila Inc., d/b/a Aquila Networks MPS and Aquila Networks L&P shall file proposed electric service tariff sheets in compliance with this Report and Order no later than midnight on May 20, 2007.

5. Aquila, Inc., shall complete the proposed heat rate and/or efficiency schedule and testing plan with written procedures, as described in 4 CSR 240-3.161(2)(P) that is either agreed to by all parties to this case or has been approved by the Commission no less than sixty (60) days before the effective date listed on the tariff for its initial fuel

adjustment clause filing for the purpose of adjusting a fuel adjustment clause rate pursuant to 4 CSR 240-3.161(7) and 4 CSR 240-20.090(4).

6. All pending motions, not otherwise disposed of herein, are hereby denied.

7. This Report and Order shall become effective on May 27, 2007.

BY THE COMMISSION

Colleen M. Dale
Secretary

(S E A L)

Davis, Chm., concurs, with separate
concurring opinion attached;
Murray, C., concurs;
Appling, C., concurs, with separate
concurring opinion attached;
Gaw, C., dissents, with separate
dissenting opinion to follow;
Clayton, C., dissents;
certify compliance with the provisions of
Section 536.080, RSMo.

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