BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

AARP's Post-hearing Brief

COMES NOW AARP, by and through counsel, and pursuant to the Public Service Commission's (Commission's) Order Adopting Procedural Schedule, hereby submits its Post-hearing Brief, primarily addressing the issue of fuel cost recovery.[1] Because the parties have entered into a stipulation regarding the level of base fuel costs in this case[2], this most contentious issue has actually been narrowed to a question of rate design: How exactly should these fuel and purchased power costs be recognized in rates?

Executive Summary

AARP is generally opposed to the adoption of a Fuel Adjustment Clause surcharge (FAC) or any pass-through fuel adjustment mechanism. If however, the Commission believes that an FAC should be adopted, despite all of the legal arguments

[1] With regard to the unresolved issues in this case, AARP supports the revenue requirement position of the Office of the Public Counsel.
[2] See Order Approving Stipulation and Agreement as to Certain Issues, Exhibit A, Paragraph 12, p. 8.

and the policy reasons put forth in testimony, AARP urges the Commission to adopt significant modifications to any such mechanism. Such modifications should be designed to mitigate the harms to consumers of such a mechanism as well as designed to retain, to the maximum extent possible, the current built-in incentive to efficiently manage fuel costs.

Consumer representatives generally prefer the strong incentives inherent in the traditional ratemaking method of treating fuel costs—that is, placing the expected level of fuel cost in base rates, thus simulating the competitive marketplace by aligning the incentive to gain additional earnings through efficient resource planning and fuel procurement practices with the party that has the greatest ability to control those actions. This normal method places all of the risks and rewards of the electric utility's actions on the utility itself.

Since the state legislature has allowed the Public Service Commission (Commission) to consider other options through SB 179, Aquila is now advocating a particular fuel surcharge that virtually eliminates all of that business risk—a tariff version of a Fuel Adjustment Clause (FAC) that is both unlawful and patently unfair. This post-hearing brief summarizes the reasons why AARP believes that such a mechanism would be so detrimental to its members who are served by Aquila, particularly those who are small residential users who are more vulnerable to price volatility and are less able than the utility itself to control and mitigate the utility's fuel cost risk.[3]

Therefore, the essential question before the Commission is whether to place all of the risk on the utility, place all of the risk on the consumer, or to find a middle way

which would allow these risks to be shared. AARP strongly urges the Commission to choose a fuel recovery method that at least somewhat mitigates the volatility and risk between shareholders and ratepayers, as opposed to adopting Aquila's extreme proposal for dumping 100% of all fuel cost risk onto the backs of consumers. In this regard, the Commission should carefully review the testimony of its expert, former public utility commissioner Nancy Brockway. Exhibits 600 and 601; Transcript pp. 844-887.

If the Commission indeed desires to move towards a pass-through regime for fuel cost recovery, AARP believes that the best way to preserve some incentive for the utility to be cost efficient is to ensure that a significant percentage of fuel costs continue to be recovered through base rates. At a minimum, a significant fraction of Aquila's energy costs must remain at risk (e.g., **50%, 25%**), as opposed to Aquila's proposal which would dump **100%** of its fuel cost risk onto the backs of ratepayers. In order to protect ratepayers Aquila must have a significant amount of "skin in the game".

FUEL COST RECOVERY

A. Aquila's FAC proposal is unlawful because it is inconsistent with SB 179 (Section 386.266).

Subsection 386.266.4(1) RSMo. Supp. 2006. requires that any fuel adjustment mechanism approved by the Commission must be designed to provide the opportunity for a "fair rate of return". Because the Commission is tasked with balancing the interests of shareholders and consumers, such a return must be fair to both sides. As

[3] It must also not be forgotten that consumers already compensate the utility for its total business risk through the proper ratemaking calculation of a return on equity.

such, placing 100% of the risk of fuel cost risk onto consumers would be unlawful, removing essential incentives for efficiency which places upward pressure on rates.

Throughout Section 386.266, and specifically in subsection 1, the statute's focus is on "incentives to improve the efficiency and cost-effectiveness of its fuel and purchased-power procurement activities". Aquila's proposal would retain none of the current incentives created by the lag between rate cases that provides a direct monetary incentive towards cost efficiency and put in place no new incentives. Instead Aquila would have the Commission dump 100% of fuel cost variability onto ratepayers. Their proposal is clearly unbalanced in that 100% of the strong built-in incentive to operate efficiently would be eliminated—directly contrary with the overall intent of the new law.

Furthermore, Aquila's 100% pass-through proposal would create the very real possibility that a future FAC rate increase would occur *during the very same time period that the utility's overall cost of service was falling.* Such a danger is inconsistent with Section 386.266 and it renders Aquila's proposal patently unlawful and entirely unreasonable.

B. Aquila's proposed FAC is unreasonable because it is generally unfair to consumers and would encourage inefficiency.

There are several reasons why cost adjustment mechanisms for regulated monopoly electric companies are not generally recommended. While there are valid arguments for and against their use, the balance of policy arguments weighs against

cost adjustment mechanisms in most cases. See Binz/Brockway Direct Testimony, Exhibit 600, pp. 9-11. The most important thing to remember when considering whether to adopt a cost adjustment mechanism is that moving away from traditional regulatory treatment comes with a potentially large cost. Id., p. 10. Cost adjustment mechanisms are often adopted by regulators not because of the incentives they provide, but in spite of them. Id., p. 10.

First, a cost adjustment mechanism tends to dull the incentives to efficiency that cost of service regulation provides to utilities. To see why, the Commission should consider that a firm operating in a competitive market is not able to change prices to accommodate changes in costs, at least not unilaterally – not until the market price changes. Pressure from cost increases requires a competitive firm to become more productive in order to maintain its profitability. Id., p. 9. It has long been recognized that "regulatory lag" in cost of service regulation mimics this process in a competitive market. It can benefit customers and the utility alike by supplying the incentives that competition provides in other industries.

The second argument against cost adjustment mechanisms is that they tend to skew choices the regulated company must make by rearranging its economic incentives. A utility is continuously faced with short-term and long-term decisions about fuel and power purchases, whether to "build or buy," etc. To the extent that an adjustment mechanism is a "thumb on the scale" for some choices in preference to others, it may induce an electric company to make choices it might not otherwise make, to the detriment of its customers. Id., pp 10-11. This concern is particularly important

with regard to Aquila which has chosen through its own resource planning actions to become extremely reliant upon natural gas generation. Tr. 856-857.

Despite Aquila's assurances that the Commission should rely solely on prudence reviews to provide incentives, regulatory experience has shown that after-the-fact prudence reviews are a crude and considerably-less-than-perfect way to catch inefficiency. Brockway Surrebuttal, Exhibit 601, pp. 6-7; Tr. 878-885. The standard for finding imprudence is in practice, if not in law, higher than the standard for identifying inefficiency. Inefficiency itself is often not enough to justify a prudence disallowance. Exhibit 601, p. 6; Tr. 884. Costly after-the-fact reviews of a management's activities are no substitute for before-the-fact alignment of management motives and consumer interests. Exhibit 601, p. 7.

"Imprudence" is often difficult to prove, as the resources of the Commission's Staff and the Office of the Public Counsel are much less than those of the utility when attempting to mount a case requiring extensive expert testimony. Exhibit 601, p. 7; Tr. 879-881. On the witness stand, former public utility commissioner Nancy Brockway explained several examples of how after-the-fact prudence reviews failed to protect consumers in states in which she was employed (Massachusetts, Maine, and New Hampshire). Tr. 847-849, 878-885.

The third argument against the use of cost adjustment mechanisms relates to their fairness. Cost adjustment mechanisms shift the balance of risk between utilities and their customers; more generally, they change the balance of equities embodied in cost of service regulation. Binz/Brockway Direct, Exhibit 600, p.10. It would be a rare utility that would propose a cost mechanism to track decreasing costs. Id., p. 11. By

removing an upward-trending cost and tracking it with a cost adjustment mechanism, the balance of fairness in ratemaking is changed and the probability that a utility will be able to exceed its authorized return is heightened, without any compensating change to benefit consumers. Id., pp. 11-12.

It is a common misconception that utility regulation is a "cost-plus" exercise and that a regulator's duty is to ensure that companies "recover" their costs. This is factually incorrect. Id., p. 14. Under cost of service regulation, past costs are not "recovered;" they are simply used as a guide to the future costs that new rates attempt to match. In fact, "recovering" past costs, absent a specific exception, is retroactive ratemaking. Id., p. 14. An FAC distorts the traditional ratemaking equation and essentially inoculates a future rate request of a utility from a claim of retroactive ratemaking with respect to the subject costs. Id., p. 15. *Adjustment clauses such as the FAC significantly reduce the pressure on a utility to be efficient, in its fuel and purchased power operations, but more generally in all its operations. Simply put, the "cure" offered by an FAC can be worse than the "disease".* Id., p. 17-18.

An FAC should only apply to an electric company that has fuel costs which fluctuate significantly and which are also outside the utility's control. Id., p. 14. Aquila has not offered any convincing evidence in support of the FAC proposal that shows the Company's power costs are expected to change *rapidly* in Missouri. Id., p. 12. While there is some evidence that fuel costs *may* increase over time, this does not necessarily indicate that a pass-through recovery mechanism is justified. To the extent that increases in cost cannot be offset by productivity gains, increased sales, etc., the utility

always has the alternative to request an increase in rates, including emergency rate relief. Tr. 858-859.

The pressure on a utility to become progressively more efficient is actually a *good thing*: good for customers and companies alike. Id., p. 12. An FAC is also an unreasonable option for a utility like Aquila which has significant ability to control variations in fuel and purchased power costs (both in the short term and in the long term). Tr. 844. Here is a partial list of drivers for fuel and purchased power over which Aquila exercises control or significant influence:

- Basic choices in the utility's resource plan
- The ratio of owned generation and purchased power
- Terms of wholesale contracts
- Efficiency of system operations
- Transmission system design and operation
- Degree and type of fuel risk in purchase decisions
- Hedging activities
- Demand side choices

Id., p. 13. Throughout the hearings in this case, none of Aquila's witnesses presented any analysis of these factors, all of which factor significantly to the impact of volatility in indexed input prices on the ultimate cost to consumers. Despite its protestations to the contrary, Aquila is neither passive nor powerless in the face of changing fuel and power costs. Brockway Surrebuttal, Exhibit 601, p. 7-9. In fact, there are innumerable choices, both short-term and long-term, that Aquila can control relating to fuel and purchased power. Tr. 844-845. Aquila shapes its own power cost future by the numerous choices it makes in these

areas. Accordingly, AARP opposes the adoption of any FAC for Aquila because of the damage that it would do to resource planning decision-making, increasing the likelihood that Aquila's operations will become less efficient. Binz/Brockway Direct, Exhibit 600, p. 13.

The Commission should definitely tread carefully when changing the way it regulates these activities and the basic incentives provided to Aquila. Exhibit 601, p. 8. To the extent that a fuel adjustment clause moves the risk of substandard performance in these areas effectively to the customer, away from the utility (i.e. further down the line from 0% reconciliation of fuel costs and rates to 100%, as would be the case in the company's proposed FAC), the company obviously has fewer incentives to manage its operations and its planning in a fuel-prudent way. Only if it were true that Aquila had zero influence over its fuel costs, then it might make sense to grant Aquila a 100% reconciling FAC. That is not the case. Id., 9-10.[4]

The presence of regulation in a market shapes the behavior of the market participants. While utility regulators might want to limit their role to being a substitute for the competition that is missing in these industries, it is rarely possible to limit regulation's effects that way. Exhibit 600, p. 14. Aquila has operated in Missouri without a power cost adjustment mechanism since 1979. This has created a desirable risk/reward proposition for consumers *and* for the Company. Id. Under the current regulatory regime for Aquila, fundamental decisions such as whether to "build or buy,"

[4] If the Commission does move away from traditional ratemaking methods by adopting a pass-through mechanism, then it should do so incrementally, placing some portion of fuel costs in base rates.

whether and how to hedge power costs, choices of fuel acquisition strategies, and even rate design choices are shaped by the fact that differences between projected and actual power costs accrue to the benefit or detriment of shareholders between rate cases. Id. An FAC mechanism would fundamentally alter the risk analysis that Aquila executives consider when making those decisions, seriously damaging the fairness of the regulatory bargain. Id., p. 15-16.

Aquila witness Fetter claims that greater use of *purchased power* is a benefit of FACs. This point simply highlights one of the main problems with such fuel mechanisms. Instead of treating all power options neutrally, an FAC skews the investment/expenditure decisions of the utility in favor of purchased power. Brockway Surrebuttal, Exhibit 601, p. 11.

Without any quantification whatsoever, Aquila continues to chant that "Wall Street" prefers utilities with an FAC because of the way that such mechanisms shift risk away from shareholders and onto ratepayers. But Aquila makes no attempt to (a) isolate the effect of the presence or absence of an FAC on Aquila in Missouri, nor (b) quantify the effect of the presence or absence of an FAC on Aquila in Missouri. The rebuttal testimony of Aquila witness Hadaway does state that only 6 of the 24 utilities in his reference group for purposes of running a DCF model do not have an FAC, arguing that the cost of capital should be raised if Aquila is denied an FAC. See Schedule SCH-15 to Hadaway's Rebuttal. To explore this proposition, AARP witness Brockway recomputed the group average DCF model results, removing the 6 utilities that were identified as having no FAC. See Exhibit 601, p. 13. Only in the case of traditional constant growth DCF model did the removal of non-FAC utilities make any appreciable

difference. Id. In the case of the more up-to-date methods, removal of the non-FAC utilities lowered the average DCF by 4 basis points in one instance and increased the average DCF by 13 basis points in the other. Id. Thus there is no appreciable impact on a utility's cost of capital for the two DCF models that Mr. Hadaway actually prefers. Id., pp. 13-14.

Finally, it should go without saying (and Aquila has admitted as much) that small consumers do not have the ability to control the utility's resource planning decisions and does not have the ability to financially hedge against volatile rate increases. Such obvious equities should clearly weigh against adopting any pass-through surcharge. Or if the Commission feels compelled to adopt some FAC-type mechanism, then this reality of which side has ability to somewhat control fuel cost risk should influence the decision regarding what portion of fuel costs are actually passed through that FAC (50% or some other number) and what portion of these costs remain in base rates.

B. If the Commission chooses to consider an FAC, despite all legal deficiencies and policy arguments to the contrary, modifications should be made to at least mitigate identified harms of such a mechanism.

If in fact the Commission chooses to adopt any FAC mechanism in this case, it should reject the Aquila proposal in lieu of adopting a modified FAC that shares the risk of fuel and purchased power variability fairly between the utility and the consumers. In designing a just and reasonable FAC mechanism, by far the most important element is the percentage of cost variability that will be recognized in the FAC portion of rates.

The Commission is required to determine the cost components of any FAC, including what *"portion of prudently incurred fuel and purchased power costs may be recovered in a RAM and what portion may be recovered in base rates."* Subsection (2)(C) of the Commission's Rule 4 CSR 240-20.090. The remaining portion would be considered to be embedded in the base rates. Thus the main question is whether Aquila will continue to bear 100% of variability of fuel cost risk, as is currently the case. Will 100% of this risk be dumped onto consumers? Or will the Commission find a compromise between these extremes (i.e., 50%/50%; 75%/25%)?

Current regulation incorporates an estimate of fuel and purchased power costs in base rates. If actual costs are lower, the utility earns more money; if actual costs are higher than the base rate increment, the utility earns less. None of the variation from the base is added to or subtracted from base rates. Thus, current regulation is the ***0% Pass-Through Case***, retaining a strong incentive for Aquila to act prudently. Binz/Brockway Direct Testimony, Exhibit 600, p. 19. In contrast, the FAC proposed by Aquila would track every penny of differences between base rates and actual power costs. Whether over or under, the entire variation and risk would be passed through to customers in the form of an increment on the monthly bill. The Aquila proposal is the ***100% Pass-Through Case***. Id., p. 19.

Between these extremes are infinitely many middle-ground cases. If the Commission chooses to adopt some version of an FAC for this utility, against all of the serious objections raised, it is perfectly reasonable for the Commission to apply the FAC to 50% of the over/under deviation from base rates. Id., p. 19. If the Commission approves a ***50% Pass-Through FAC***, the vast majority of Aquila's power costs will still

be collected in base rates. It is important to understand that the 50% fraction applies only to the variation from that base amount. And since the fraction applies symmetrically to cost differences, the utility will sometimes over recover, sometimes under recover, at half the rate that happens today. Id., p. 19.

By using the 50% rule, the Commission would strike an exact middle ground between the type of regulation that has existed since 1979 in Missouri and the type of regulation proposed by Aquila in this case. Id., p. 20. This is what the Missouri Legislature had in mind when it passed SB 179, granting the Commission the ability to "approve, *modify* or reject" any FAC proposal. Subsection 386.266.4 RSMo. Supp. 2006. (Emphasis added). This 50% approach would retain half of the incentives for efficiency that traditional cost of service regulation provides to utilities. When faced with the choice of acting to lower its expenses, Aquila would know that it will be allowed to "keep" half of the costs savings in this approach. In contrast, under Aquila's proposed 100% pass-through FAC, any efficiency gains are taken away from Aquila at its next FAC filing. Id., p. 20.

The same logic applies in reverse. Unless a utility's bad behavior is found to be imprudent (a very high standard) it faces *no consequence for incurring excess costs* under the FAC. Excess costs will simply be passed through in the next FAC filing. Id., p. 20. On the other hand, if the utility is sharing its over/under power cost results, the utility faces a disincentive for bad behavior that results in higher costs because only half of such higher costs are passed through the FAC, with the balance absorbed by the Company. Id., p. 20. A 50/50 sharing of risks is a fair way to graduate the risks and benefits of an FAC between ratepayers and shareholders. Brockway Surrebuttal,

Exhibit 601, p. 11. Aquila itself promoted a graduated or shared-risk/reward type mechanism, although it did not explain why sharing in this way is appropriate but not for other components of an FAC.

There are other examples of fuel adjustment mechanisms in other states that are more sophisticated than Aquila's proposal, such as the Wyoming tariff of Rocky Mountain Power, approved by the Wyoming PSC in May 2006. See Exhibit 600, pp. 21-25; Attachment RJB-7. Given the weak incentive that prudence reviews provide, the Commission should retain some at least some of the strong incentive that current regulation provides, in any FAC that is adopted. Tr. 885-887.

The alternative proposals of witnesses Donald Johnstone and Cary Featherstone are also appropriate methods for balancing the interests of the utility and its consumers with regard to fuel risk. Tr. 863. In fact, the sharing mechanism advanced by Mr. Johnstone contains many features that are consistent with AARP's proposed alternatives and addresses the most of the important policy questions with regard to FAC mechanisms.

AARP is not interested in the "soft cap" modifications to an FAC offered by some parties, which would simply defer certain increases to future periods with interest, and likely result in greater rate shock. Tr. 864. However, AARP would favor a reasonably designed "hard cap"—that is, a modification that actually limits FAC increases in any given period, as opposed to a "soft cap" that defers increases, accumulating them for later imposition on consumers.

WHEREFORE, AARP respectfully requests that the Commission reject Aquila's proposed FAC, or if it chooses to adopt any pass-through FAC mechanism despite the legal arguments and policy concerns to the contrary, then such a mechanism should be designed consistent with AARP's alternative recommendations. Most importantly, the Commission should stop short of dumping 100% of fuel cost risk onto the backs of ratepayers. A significant portion of Aquila's energy costs must remain at risk (e.g., **50%, 25%**). In other words, Aquila should at least have some significant amount of "skin in the game".

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been emailed to counsel for each of the parties on the service list for this matter on this 27th day of April 2007.

/s/ John B. Coffman