BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its MPS and L&P Missouri Service Areas.	)	Case No. ER-2005-0436
In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail Steam Heat Service Provided to Customers in its L&P Missouri Service Area.	)	Case No. HR-2005-0450

PREHEARING BRIEF OF STAFF

Nathan Williams
Senior Counsel
Missouri Bar No. 35512

Attorney for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-8702 (Telephone)
(573) 751-9285 (Fax)
nathan.williams@psc.mo.gov

January 10, 2006

NP

TABLE OF CONTENTS

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its MPS and L&P Missouri Service Areas.	))))	Case No. ER-2005-0436
In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail Steam Heat Service Provided to Customers in its L&P Missouri Service Area.	))))	Case No. HR-2005-0450

STAFF'S PREHEARING BRIEF

On May 24, 2005 Aquila, Inc. filed tariff sheets to implement a general electric rate increase for service it provides to its Missouri customers in and about Kansas City and St. Joseph, Missouri under the names Aquila Networks—MPS and Aquila Networks—L&P, respectively. Three days later on May 27, 2005 Aquila, Inc. filed tariff sheets to implement a general steam heat rate increase for service it provide to its Missouri customers in and about St. Joseph, Missouri under the name Aquila Networks—L&P. The Commission opened Case Nos. ER-2005-0436 and HR-2005-0450, respectively, to address the tariffs. Because many of the issues are common, the Staff addresses both cases in this brief.

The Staff has organized this brief to follow the list of issues filed December 22, 2005; however, the Staff believes the most significant issues are those pertaining to Aquila's generation capacity resources (Issues 4, 5, 5a-f, 13, 24), fuel cost recovery (Issues 32, 32a-f, 33, 33a-e), fuel costs (Issues 11, 12, 14, 15, 16, 17, 18) and rate of return (Issues 1, 2, & 3). Although ordered to include an executive summary, because the position statements filed by the Staff serves that purpose and it would unduly lengthen this brief to do so, the Staff has not restated its position statements as an executive summary.

STATUTORY REQUIREMENTS AND APPLICABLE STANDARDS

Purpose

Missouri courts have long recognized the purpose of the Public Service Commission Law is to protect consumers against the natural monopolies of the public utilities while permitting the utilities to recover just and reasonable returns.[1] In doing so the courts have stated the legislative purpose of the Public Service Commission Law is to replace competition inadequate to protect the public and avoid economic waste of competition between public utilities.[2] Further, the courts have said, ". . . such regulation, to command respect from patron or utility owner, must be in the name of the overlord, the state, and to be effective must possess the power of intelligent visitation and the plenary supervision of every business feature to be finally (however invisibly) reflected in rates and quality of service."[3]

All relevant factors

In addressing the propriety of a fuel adjustment clause in 1979, the Missouri Supreme Court, *en banc*, stated,

> Even under the file and suspend method, by which a utility's rates may be increased without requirement of a public hearing, the commission must of course consider all relevant factors including all operating expenses and the utility's rate of return, in determining that no hearing is required and that the filed rate should not be suspended.[4]

---

[1] See *State ex rel. Utility Consumers Council of Missouri, Inc. v. Public Serv.* Comm'n, 585 S.W.2d 41, 47 (Mo. banc 1979).
[2] *Id.*
[3] Id. (quoting *May Dept' Stores v. Union Electric Power and Light Co.*, 341 Mo. 299, 107 S.W.2d 41, 48, quoting *State ex rel. City of Sedalia v. Public Service Comm'n*, 275 Mo. 291, 204 S.W.497, 498 (Mo. 1918) appeal dismissed 251 U.S. 547, S.Ct. 342, 64 L.Ed. 408 (1920)).
[4] Id. at 56.

In support of its statement, the Court cited a 1957 divisional decision of the Court.[5]

In its 1957 decision the Missouri Supreme Court held, for utility property used and useful for public service, the value of the property determined under section 393.230.1, RSMo 2000, is a relevant factor that must be considered with all other facts in determining just and reasonable rates, and reversed the Commission for excluding from consideration the present value of the utility's property on the grounds of expediency, economy and difficulty of ascertaining present value. The Commission had relied on the original cost of the utility's property for its value, a fact the court stated was a relevant factor.[6]

The Western District Court of Appeals has characterized the requirement of setting rates based on all relevant factors as a prohibition against single-issue ratemaking and stated the rationale behind the "prohibition is to prevent the Commission from allowing a utility to 'raise rates to cover increased costs in one area without realizing there were counterbalancing savings in another area.'"[7]

In these cases Aquila has filed its general rate increase requests under the file-and-suspend method of section 393.150, RSMo 2000. While much of the case law has focused on the factors to be considered in determining the overall amount a utility should be entitled to recover from its customer through rates, with regard to a rate change, the statute is clear that it is the "***propriety***" of the rate that is to be examined and, in the case of a rate increase, to be allowed to become effective, the utility must show the rate is "just and reasonable." In a 1986 decision

---

[5] *State ex rel. Missouri Water Company v. Public Service Commission*, 308 S.W.2d 704, 22 P.U.R.3d 254 (Mo. 1957) (transfer to court en banc denied January 13, 1958).
[6] *State ex rel. Missouri Water Company v. Public Service Commission*, 308 S.W.2d 704, 22 P.U.R.3d 254 (Mo. 1957) (transfer to court en banc denied January 13, 1958).
[7] *State ex rel. Sprint Spectrum, L.P. v. Missouri Public Service Commission*, 112 S.W.3d 20, 28 (Mo. App. 2003) (quoting *State ex rel. Midwest Gas Users' Assoc. v. Pub. Serv. Comm'n of Mo.*. 976 S.W.2d 470, 480 (Mo. App. 1998).

the Missouri Supreme Court, *en banc*, held Commission approval of different rates for different customers, "rate design," requires sufficient findings of fact to support the rates.[8]

"Used and Useful" and "Fully Operational and Used for Service"

In 1984 the Missouri Court of Appeals for the Western District, in an electric utility rate case, in considering the Commission's exclusion of the costs of a distribution line extension from rate base, stated the following regarding "used and useful":

> In the field of utility rate making, two historic approaches have been taken to including or excluding property in the rate base where the property is not currently used to provide the service paid for by the rate, the used and useful theory and the prudent management theory. **Colton, Excess Capacity: Who Gets The Charge From The Power Plant?** 34 Hastings Law Journal, 1133 (1983). Under the used and useful theory, the company is allowed to charge customers only for the cost of plant and equipment actually in use to provide service for current customers. . . .[9]

"Fully operational and used for service" is a statutory requirement imposed by voters in the state of Missouri in 1976. The language of the statute follows:

> Any charge made or demanded by an electrical corporation for service, or in connection therewith, which is based on the costs of construction in progress upon any existing or new facility of the electrical corporation, or any other cost associated with owning, operating, maintaining, or financing any property before it is fully operational and used for service, is unjust and unreasonable, and is prohibited.[10]

In 1985 the Missouri Supreme Court, *en banc*, construed the purpose of the foregoing statute when the Commission denied Union Electric Company recovery in rates of costs it had incurred for the construction of a second nuclear reactor power unit at its Callaway site after Union Electric Company abandoned construction of that unit. With regard to the statutory language, the Court said:

---

[8] *State ex rel. Monsanto Company v. Public Service Commission*, 716 S.W.2d 791 (Mo. banc 1986).
[9] *State ex rel. Missouri Power and Light Co. v. Public Service Commission*, 669 S.W.2d 941, 946 (Mo. App. 1984).
[10] Section 393.135 RSMo 2000.

> The manifest purpose of Proposition One was to make the utility wait until completion of new construction before including the cost in its rate base, or otherwise recovering its expenditures. Charges for construction work in progress had been expressly authorized by the Commission just a few months earlier. The language contains no express reference to cancellation. There are substantial indications that Proposition One was primarily concerned with timing, and that the possibility of abandonment was not present in the thoughts of the sponsors or of the voters. There was then much discussion in reports of regulatory commission decisions about the treatment of construction work in progress but little case law, judicial or administrative, about allowances for abandoned projects.
>
> Reasons for requiring deferral can be easily perceived. (1) If construction charges are assessed in advance persons who will never have the benefit of the completed facilities such as those who die or move before the facility goes on line, will have to bear a part of the cost. (2) It has been demonstrated that the costs of both Callaway projects were substantially underestimated. If reimbursement is deferred until the facility is on line the Commission may have more effective continuing control. (3) If the utility must wait until construction is completed to obtain reimbursement or return, it may be impelled to complete necessary construction more expeditiously. This enumeration may be far from complete, but it serves to highlight some of the arguments which might be made in favor of legislation such as Proposition One.[11]

Thus, while "used and useful" and "fully operational and used for service" have similarities, they are different. According to the Supreme Court, the statute is directed to determining the point after which plant may be included in rate base, while the definition provided for "used and useful" addresses both the point after which plant may be included in rate base and the point after which it may not be included in rate base. Neither expressly addresses the situation where the plant is unlawfully actually in use to provide service for current customers.

Prudence

The Staff takes issue with the prudence of certain acts taken by Aquila. First, the Staff asserts it was imprudent for Aquila's regulated division Aquila Networks—MPS not to have

[11] *State ex rel. Union Electric Company v. Public Service Commission*, 687 S.W.2d 162, 166 (Mo. banc 1985).

constructed, held the incidents of ownership to, and had fully operational and used for service, a generation facility with sufficient combustion turbine units to generate 500 MW of electricity when Aquila's five-year purchased power agreement with Calpine for power from its Aries facility ended May 31, 2005.

Second, Staff asserts prudent financing of the foregoing generation facility is through a Chapter 100 financing. For both the site of 500 MW and for 315 MW of the 500 MW the Staff asserts Aquila should have built, the Staff has used Aquila's costs from its construction of its South Harper facility as a proxy. As built, additional combustion turbine units capable of generating about 200 MW of power could readily be added to the South Harper facility. It is the Staff's position that any failure of Aquila to effectuate such a Chapter 100 financing would be due to Aquila's imprudence.

In 1993 the Missouri Court of Appeals for the Western District upheld the Commission's rejection of a water supply contract and imputation of a utility-owned water storage facility for purposes of the value of utility property to be considered in setting rates.[12] In reaching its holding the Court cited with apparent approval the Commission's employment of the Commission's "reasonable care standard" as follows:

> "The Commission will assess management decisions at the time they are made and ask the question, 'Given all the surrounding circumstances existing at the time, did management use due diligence to address all relevant factors and information known or available to it when it assessed the situation?'"[13] In that case the Commission determined the utility had been imprudent in entering into a water supply contract with a water supply district where, in exchange for limited storage capacity, the utility obligated itself to provide a potentially unlimited quantity of water to the district, pay the district $2,000 per month and assume operation and maintenance of the district's facilities for a period of twenty years commencing in 1977.[14] The utility's own study comparing the options of

[12] *State ex rel. Capital City Water Company v. Missouri Public Service Commission*, 850 S.W.2d 903 (Mo. App. 1993).
[13] Id. at 911-12.
[14] Id. at 912-13.

> building or contracting for storage made at the time it entered into the contract recommended a limit on the quantity of water the utility would provide the district without charge.[15]

In an earlier case, decided in 1984, the Western District Court of Appeals, in overturning the Commission's disallowance of the costs of a distribution line extension in a rate case, the Court stated the following regarding prudency reviews:

> Where the Public Service Commission in setting rates reviews management decisions by the utility in operating its business, the prudent management theory focuses on the decision making process by management and not on the results of the decision. This follows for the reason that prediction of consumer demand is uncertain, the utility is obligated to furnish service to the public within reasonable limits and results are available only after the decision in question has been made. If the company has exercised prudence in reaching a decision, the fact that external factors outside the company's control later produce an adverse result do not make the decision extravagant or imprudent. In the landmark case of Wisconsin Telephone Company v. Public Service Commission, 232 Wis. 274, 287 N.W. 122 (1939), a case which dealt with the consequences upon the company's plant of the 1930's depression, the court stated the limits upon commission re-management of the utility in the following language applicable to the present case:
>
> > "In making its determination in this case the Commission substituted the discretion of the witness (commission staff) for that of the managers of the property without in any way impeaching the discretion of the managers. It is much easier to point out past errors in management than it is to avoid future mistakes. A reasonable rate is one based on reason as applied to the property of the utility. While the Company must bear the burden of an unreasonable extension of its plant and the risk that portions of it prudently acquired may become obsolete or not useful, it should not be penalized for failure exactly to anticipate future demands for service in a period of depression."
>
> *Wisconsin Telephone Co. v. Public Service Commission*, supra, 287 N.W. at page 158.[16]

---

[15] Id. at 913.

[16] *State ex rel. Missouri Power and Light Company v. Public Service Commission*, 669 S.W.2d 941, 947-48 (Mo. App. 1984).

Thus, a proper analysis of prudency is based on whether the utility's decision was informed and sensible when it was made.[17]

Burden of Proof

Under the file-and-suspend method for seeking a rate increase, before the Commission, "the burden of proof to show that the increased rate or proposed increased rate is just and reasonable [is] upon the . . . electrical corporation . . .".[18] Burden of proof is comprised of two components, the burden of production and the burden of persuasion. The burden of production means that a party must adduce evidence on an issue sufficient to have it decided and the burden of persuasion means a party has the onus of convincing the fact-finder in that party's favor.[19]

REVENUE REQUIREMENT

Rate of Return

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

Staff Position: A cost of common equity of 8.50 percent to 9.50 percent would produce a fair and reasonable rate of return of 7.90 percent to 8.32 percent for the Missouri jurisdictional electric utility rate base for Aquila Networks—MPS and Aquila Networks—L&P and steam utility rate base for Aquila Networks—L&P.

The cost of capital, or the amount a utility must pay to secure financing from debt and equity investors (shareholders), "is essentially the equivalent of fair rate of return."[20] Rate of

---

[17] But prudence is not the end of the analysis. The expenditures must benefit ratepayers, the Commission has some discretion in making its determinations, and its orders and decisions are subject to revision to meet changing conditions or changes in its understanding of those conditions. *State ex rel. Laclede Gas Co. v. Public Service Commission*, 600 S.W.2d. 222, 228-29 (Mo.App. W.D. 1980), *appeal dismissed*, 449 U.S. 1072, 101 S.Ct. 848, 66 L.Ed.2d 795 (1981); *State ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 645 S.W.2d 44, 55-56 (Mo.App. W.D. 1982); *State ex rel. Union Electric Co. v. Public Service Commission*, 765 S.W.2d 618, 621-26 (Mo.App. W.D. 1988); *State ex rel. General Telephone Company v. Public Service Commission*, 537 S.W.2d 655, 661-62 (Mo.App. W.D. 1976).

[18] Section 393.150.2 RSMo 2000, *State ex rel. City of St. Louis v. Public Service Comm'n of Missouri*, 329 Mo. 918, 47 S.W. 2d 102, 104 (banc 1931).

[19] *Byous v. Missouri Local Government Employees Retirement System Board of Trustees*, 157 S.W.3d 740, 744 (Mo. App. 2005).

[20] *Assoc. Nat. Gas Co. v. Pub. Serv. Comm'n*, 706 S.W.2d 870, 875 (Mo. App. W.D. 1985).

return is determined by a calculation that factors in (i) the ratio of debt and equity to total capital, and (ii) the cost and (iii) weighted cost for each of these capital components.[21] The Western District Court of Appeals recently succinctly summarized the well-established standards that govern a Commission's procedures in this area:

> In [*Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923)] the [United States Supreme] Court established a standard for "just and reasonable" public-utility rates as follows:
>
>> What annual rate will constitute just compensation depends upon many circumstances, and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.
>
> 262 U.S. at 692-93. The Court refined this standard further in *Hope*, noting that public-utility commissions are "not bound to the use of any single formula or combination of formulae in determining rates," and that ratemaking "involves the making of 'pragmatic adjustments.'" 320 U.S. at 602 (citation omitted). According to the Supreme Court, under the "just and reasonable" standard "it is the result reached not the method employed which is controlling."[22]

A cost of common equity of 8.50 percent to 9.50 percent would produce a fair and reasonable rate of return of 7.90 percent to 8.32 percent for the Missouri jurisdictional electric

[21] *Id.*

[22] *Missouri Gas Energy v. Pub. Serv. Comm'n,* WD65366 (Slip. Op., Dec. 27, 2005; not yet final).

utility rate base for Aquila Networks—MPS and Aquila Networks—L&P and steam utility rate base for Aquila Networks—L&P.[23] The Staff arrived at this conclusion using the discounted cash flow (DCF) method, the method the Staff considers to be the most reliable in estimating a utility company's current cost of common equity. The Staff checked the reasonableness of its conclusion by comparing it to results it reached under several scenarios using the Capital Asset Pricing Model, and those results were within or below Staff's recommended range.[24]

The Staff also verified the reasonableness of its conclusion in several other ways (discussed below), and Aquila has failed to respond to the Staff's points. Instead, Aquila chose to use the KCPL Experimental Regulatory Plan approved by this Commission in Case No. EO-2005-0329 to support its position that Aquila needs a higher rate of return to provide more cash flow during its "heavy construction program over the course of the upcoming five year period."[25] This attempt is misguided, considering that nothing precluded Aquila from pursuing this relief from the Commission in its own filing for approval of a regulatory plan, which the Commission docketed as Case No. EO-2005-0293. If Aquila had pursued this form of relief in that case, as a matter of balance, a future rate base offset would have been likely.

Aquila's position in this case is undermined by one of Aquila's own retained expert, The Blackstone Group, who recently performed a discounted cash flow analysis where it used a discount rate in the range of **HC ____________ HC**.[26] This discount rate is below the discount rate recommended by Staff (7.90% to 8.32%).[27] However, Aquila did not retain *this* expert for the purpose of justifying a rate increase. Rather, Aquila retained this expert to provide

[23] Staff witness Murray Direct, p 28, l. 11 (electric); p. 28, 23 (steam) and Schedule 16.
[24] Staff witness Murray Direct, p. 28, ll. 16 - p. 32, l. 15 (electric); p. 29, l. 5 - p. 32, l. 6 (steam).
[25] Aquila witness Hadaway Rebuttal, p. 9, ll. 17-18 (electric); p. 10, ll. 19-20 (steam).
[26] Staff witness Murray Direct, p. 37, l. 8 (electric); p. 37, l. 23 (steam).
[27] Staff witness Murray Surrebuttal Schedule 3.

HC

an opinion of both what utility assets Aquila should market for sale and to estimate a fair sale price for each of those utility assets.

The Blackstone Group's audience was Aquila's board of directors, who are presumed to act in the best interest of Aquila's shareholders through creating shareholder value by maximizing the sale price of certain regulated utility properties. [28] Its audience was not a utility regulator. But the Blackstone Group and Dr. Hadaway, as financial analysts, both estimate the cost of capital, *i.e.* discount rate, appropriate for the risk (both business risk and financial risk) inherent in Aquila's regulated electric utility properties, **HC _________________________ ____ HC**. Most importantly, embedded in these discount rates is an estimated cost of common equity. Dr. Hadaway's estimated cost of common equity is part of the record in this case, but Staff was unable to ascertain The Blackstone Group's estimated cost of common equity.[29]

The difference between the discount rates used by Aquila's rate case expert, Dr. Hadaway, and those used by its asset sale consultant expert, The Blackstone Group, cannot be reconciled. The latter uses a discount rate of **HC ___________ HC ** (this figure essentially indicates its estimation of investors required rate of return) in valuing ** HC ________________ ____ HC** for sale—where the target interests are those of Aquila's shareholders and those who may buy **HC___________________ HC** or its assets.[30] By using a lower discount rate, The Blackstone Group has determined that a relatively low degree of risk applies to Aquila's electric utility properties.

---

[28] Staff witness Murray Direct, p. 36, l. 9 - p. 37, l. 5 (electric); p. 37, ll. 1-20 (steam).
[29] Staff requested The Blackstone Group's estimated cost of common equity but has been informed that that information is proprietary to The Blackstone Group and cannot be released by Aquila.
[30] Staff witness Murray Direct, p. 37, l. 8 (electric); p. 37, l. 23 (steam).

HC

Then, in the ratemaking context, where the objective is to justify an allowed return on common equity from the Commission, Aquila's other expert, Dr. Hadaway, determined that the same assets—**HC ____________________ HC**—are inherently riskier. Dr. Hadaway indicates investors require a return of 9.01% for Aquila Networks—MPS and 9.67% for Aquila Networks—L&P.[31] The amount of risk the company's retained experts assign to the required rate of return differs widely based on the company's intended audience, yet the business being evaluated is the same. The Staff requested supporting work papers for the analysis that The Blackstone Group performed on Aquila's behalf (Staff Data Request No. 253), but Aquila responded that this information was proprietary to The Blackstone Group and, therefore, Aquila was prohibited from providing it to the Commission's Staff. The Staff recognizes there may be some rationale for slight differences in The Blackstone Group's and Dr. Hadaway's discount rates, such as a current cost of debt versus an embedded cost of debt; but the failure of Aquila and Dr. Hadaway to even attempt to explain these differences should be noted by the Commission. If Staff had received this information, the Staff would have evaluated it and explained to the Commission in this case its views on the relationship between the differences and the differing discount rates of Aquila's experts. Although the Staff was unable to obtain information that might explain the differences in the discount rates of Aquila's experts, the Staff strongly urges the Commission to explore this classic instance of "double-speak" with Aquila during the hearing in this case. A very significant piece of information available to test the reasonableness of returns on common equity the parties have recommended in this case is the required return on common equity embedded in The Blackstone Group's discount rate of **HC ___________ HC**.

[31] Aquila witness Hadaway Direct, p. 8, ll. 14-23 (electric), p. 9, ll. 9-18 (steam).

HC

Aquila's witness has not contradicted the Staff's discussion of the expected return on Aquila's pension assets. Aquila also has not responded to the Staff's discussion of the yield on Empire's trust preferred securities. Both of these tests of reasonableness are a reflection of the current capital market environment.[32] Likewise, Dr. Hadaway did not refute the estimated returns and equity risk premiums considered reasonable by a host of industry experts such as Dr. Jeremy Siegel, Dr. Kenneth French, Mr. Warren Buffett and Mr. Alan Greenspan.[33] Because recommended returns on common equity are based on the capital markets' indication of the required return on common equity (in fact, this is why Staff still strongly endorses relying on the DCF model), the Staff believes that these tests of reasonableness are the most relevant in determining a just and reasonable allowed return on common equity. This is the type of information that provides insight into investors' required returns and hence, a reasonable return on common equity.

Dr. Hadaway used an April 2003 *Journal of Finance* article in his rebuttal testimony to justify using an estimated gross domestic product growth rate as a proxy growth rate for his comparable group when using the constant growth discounted cash flow model (also known as the dividend discount model).[34] In that article, the paragraph immediately following the language quoted in Dr. Hadaway's testimony indicates that, based on the same model, the expected return is 7.5% for the entire market.[35] The authors of the article cited by Dr. Hadaway use the very same model used by witnesses in rate case proceedings, including this case. However, in the present case, this dividend discount model estimate is published in a professional publication.

---

[32] Staff witness Murray Direct, p. 38, l. 1 - p. 39, l. 10 (electric); p. 39, l. 17 - p. 40, l. 3 (steam).
[33] Staff witness Murray Direct, p. 33, l. 1 - p. 36, l. 2 (electric); p. 33, l. 15 - p. 36, l. 24 (steam).
[34] Aquila witness Hadaway Rebuttal, p. 15, l. 5 - page 16, l. 4 (electric and steam).
[35] Staff witness Murray Surrebuttal, p. 16, ll. 12-23 (electric); p. 16, ll. 9-20 (steam).

Finally, Aquila did not respond to Staff witness Murray's reference to a *Wall Street Journal* article in his rebuttal testimony. The authors of the article drew parallels between bonds and utility stocks and noted that "[d]espite 11 consecutive rate raises by the Federal Reserve, however, long-term bond yields remain low, allowing dividend-paying utilities to retain their edge."[36] As Staff witness Murray concludes, "[i]f investors perceive utility stocks as bond substitutes, then they are not going to require as much of an equity risk premium to invest in these stocks versus the rest of the market."[37] Articles of this nature are what investors read and rely upon when making investment decisions. Aquila, has ignored the environment in which investors make their decisions and disregarded of some of its own retained experts' conclusions and objective checks on rates of return, indicate that ; as a result, Aquila's conclusion that an appropriate and reasonable rate of return of 11.50% is increasingly detached from reality.

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

Staff Position: The capital structure should reflect Aquila's actual capital structure on October 31, 2005 (the true-up date). Aquila's common equity ratio is 42.43 percent and its long-term debt ratio is 57.57 percent.

The capital structure the Commission employs should be Aquila's actual capital structure on October 31, 2005 (the true-up date). On that date Aquila's common equity ratio was 42.43 percent and its long-term debt ratio was 57.57 percent.[38] The Commission should determine Aquila's revenue requirement using its actual capital structure as of the true-up date, rather than using a hypothetical capital structure for Aquila Networks—MPS and Aquila Networks—L&P. Aquila's actual capital structure is the most appropriate for determining rate of return because it is verifiable and represents how the divisions of Aquila, such as Aquila Networks—MPS and

[36] Staff witness Murray Rebuttal, Schedule 1-1.
[37] Staff witness Murray Rebuttal, p. 7, ll. 22-24 (electric); p. 7, ll. 18-20 (steam).
[38] Staff witness Murray Surrebuttal, Schedule 3.

Aquila Networks—L&P (who do not issue their own debt or equity), are capitalized.[39] Aquila's operating divisions receive capital from Aquila's corporate treasury. At any given time, the corporate treasury may have a mix of capital that includes debt proceeds from a variety of issuances. Moreover, Aquila's credit rating is a function of its consolidated capital structure. Credit rating agencies do not evaluate the creditworthiness of Aquila's operations on some hypothetical stand-alone basis because those operations are not ring-fenced subsidiaries that issue their own debt; further, investors are only interested in Aquila's consolidated operations because that is the vehicle for their investment. [40]

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

Staff Position: Aquila's embedded cost of long-term debt should be 7.445 percent.

For ratemaking purposes Aquila's embedded cost of long-term debt is 7.445 percent.[41] The Staff made a number of adjustments to Aquila's actual embedded cost of long-term debt because it includes a number of debt issuances that were made at a time when Aquila's creditworthiness was highly uncertain. As Staff witness Murray states, "[i]t would not be fair to ask Missouri ratepayers to pay the increased costs that Aquila is incurring due to [its] failed investments. These increased costs should be incurred by investors because they would have incurred the benefits of these investments had they succeeded[,]" not the ratepayers.[42] The Staff checked the reasonableness of its adjustments by comparing the results it obtained to the cost of long-term debt the Commission used for The Empire District Electric Company in its most recent rate case—Case No. ER-2004-0570. Although Aquila's adjusted embedded cost of debt has increased by approximately 16 basis points (.16 percent) between the time when the Staff

[39] Staff witness Murray Direct, p. 19, ll. 13-18 (electric); p. 20, ll. 1-6 (steam); Staff witness Murray Rebuttal , p. 26, l. 14 - p. 28, l. 2 (electric); p. 26, l. 3 - p. 27, l. 14 (steam).
[40] Staff witness Murray Rebuttal, p. 26, l. 14 - p. 27, l. 3 (electric); p. 26, ll. 3-21 (steam).
[41] Staff witness Murray Surrebuttal, p. 3, l. 21 (electric); p. 3, l. 20 (steam).
[42] Staff witness Murray Direct, p. 21, ll. 9-12 (electric); p. 21, ll. 12-14 (steam).

performed its initial analysis and the true-up date in this case, this is the result of changes in the market and not changes in Aquila's risk profile.[43] Consequently, the Staff's embedded cost of debt is reasonable and should be used by the Commission for setting rates in these cases.

The embedded cost of debt of 7.445 percent should be applied to Aquila Networks-MPS and Aquila Networks-L&P. The Staff advises against the Commission accepting Aquila's debt assignment process because of the ease with which it may be manipulated. There is no way to determine if debt capital at higher or lower cost than that currently assigned to the divisions has been used to fund capital investments in the divisions.[44]

Rate Base Issues

4. Generation Resources (Electric): What are the prudent types and amounts of generation resources to include in Aquila Networks-MPS's rate base?

Staff Position: Five combustion turbines capable of generating at least 500 MW of electricity should be included in Aquila Networks-MPS's rate base in place of the 500 MW which Aquila has included through its South Harper facility (about 315 MW) and a purchased power agreement with Calpine.

The Staff has no quarrel with Aquila's capacity mix, except for its reliance on three combustion turbines capable of generating about 300 MW plus purchased power of about 200 MW to replace the capacity it had from Calpine under a purchased power agreement that ended May 31, 2005 rather than building and owning five combustion turbines for that capacity.

As indicated in the prudence subpart of the statutory requirement and applicable standards section of this brief, the standard under which this issue is evaluated is whether Aquila made an informed and sensible decision (acted prudently) when it chose in 2004 to build three utility-owned combustion turbine generation units capable of generating a total of 315 MW and rely on an additional approximately 200 MW of purchased power to meet its load requirements,

[43] Staff witness Murray Surrebuttal, p. 4, ll. 20-22 (electric); p. 4, ll. 19-21 (steam).
[44] Staff witness Murray Rebuttal, p. 30, ll. 13-16 (electric); p. 29, l. 23 - p. 30, l. 2 (steam).

rather than building five combustion turbine units capable of generating at least 500 MW. In the Staff's view, despite the more immediately favorable impact on rates Aquila's choice would have, the answer is, "No."

The evidence the Staff anticipates will be adduced in this case that supports its position that from the perspective of Aquila Networks—MPS, part of the Missouri utility operations of Aquila, Aquila's decision not to build and own a total of about 500 MW of combustion turbine capacity between February, 2004 and May 31, 2005 was imprudent follows.

Aquila entered into a purchased power agreement with Calpine for capacity of 320 MW during the summer of 2001, 200 MW per month from January, 2002 through May, 2005, and for an additional 300 MW per month during the months April through September in each year 2002 through 2004. The agreement expired on May 31, 2005.[45] To serve its Aquila Networks—MPS customers, Aquila needed to have a new source of capacity in place by the time the foregoing purchased power agreement expired.[46] In 2001 Aquila solicited proposals for replacement capacity. Because of changing market conditions, Aquila did not act on any of those proposals and solicited proposals for capacity again in 2003. In January of 2004 Aquila advised the Staff Aquila's preferred short-term resource plan was to build and own three combustion turbines in 2005 and enter into three-to-five year purchased power agreements for the balance of Aquila Network—MPS's capacity needs. In response to a letter from the Staff questioning, among other things, the short planning horizon of Aquila's resource plan, Aquila provided to the Staff in February 2004 a resource plan designed on a twenty-year horizon where ** HC ___________

____

____

[45] Staff witness Featherstone Direct p. 49, l. 19 - p. 50, l. 12; Staff witness Featherstone Rebuttal. p. 17, ll. 5-11.
[46] Staff witness Mantle Direct, p. 4, ll. 1-8; Staff witness Featherstone Direct, p. 49, ll. 18-24.

HC

__________ HC** In July 2004 and subsequently, Aquila's least cost and preferred plans remained the same as they were in February 2004. Aquila ultimately acquired its South Harper facility site and finished building three combustion units with a total capacity of 315 MW on it in 2005. Aquila was unable to enter into a suitable long-term capacity contract for Aquila Networks—MPS's remaining needs and for part of 2005 Aquila met the shortfall by a short-term contract with an affiliate for 325 MW.[47]

The Staff does not quarrel with the process Aquila employed for evaluating its capacity needs for Aquila Networks—MPS; however, the Staff does quarrel with how Aquila exercised its discretion. Until recently Aquila had a policy of not acquiring generation capacity held by its regulated divisions and enforced that policy even if its regulated division determined building and owning capacity was its best option.[48] Utilities should carefully perform risk and contingencies analyses of their resource options and select a plan that is robust in many different scenarios of possible future events.[49] When the need for the capacity is anticipated to continue into the distant future, the case here for approximately 500 MW, the primary basis of the decision should be on the long-term impacts on rate base, not the short-term impacts.[50] Among the long-term impacts of owning generation are (1) an overall lowest cost approach to meeting capacity needs, (2) stability to the utility's cost structure not present when the utility is

[47] Staff witness Mantle Direct, p. 4, l. 1 - p. 6, l. 7.
[48] Staff witness Featherstone Surrebuttal, p. 66, l. 1 - p. 87, l. 7.
[49] Staff witness Mantle Direct, p. 6, ll. 13-15.
[50] Staff witness Schallenberg Direct, p. 7, ll. 3-10; Staff witness Mantle Surrebuttal, p. 3, ll. 7-19; Aquila witness Korte Rebuttal, p. 4, ll. 2-4; Aquila witness Korte Surrebuttal, p. 3, ll. 4-7.

HC

continually pursuing the purchase of capacity to meet its loads, (3) a stronger negotiating position in purchasing power since it has demonstrated a willingness to build capacity, and (4) decreased vulnerability to the purchased power market.[51]

When Aquila was planning how to meet its capacity needs at Aquila Networks—MPS for 2005 and beyond, it was imprudent for Aquila to rely on capacity contracts to meet those needs without even having a firm long-term capacity contract in hand. Further, the Staff believes Missouri consumers obtain stability when a utility meets its capacity needs by building and owning its own generation units. It is the Staff's view that the prudent course for Aquila was to own its generation and not to rely on purchased power agreements to satisfy significant portions of Aquila Networks—MPS's ongoing long-term capacity needs.[52]

Here, Aquila should have owned and had operating for its Aquila Networks—MPS division in 2005 a total of five combustion turbine units capable of generating a total of 500 MW.[53] Instead, Aquila built three combustion turbine units at its South Harper site capable of generating a total of 315 MW and entered into a one-year purchased power agreement with **HC ________________________________ HC**.[54] The Commission should disregard what Aquila actually did to replace the variable capacity (200-500 MW per month) Aquila Networks—MPS lost when Aquila's contract with Calpine expired in May 2005 and, instead, treat Aquila Networks—MPS as owning five combustion turbine units capable of generating 500 MW.

---

[51] Staff witness Schallenberg Direct, p. 6, l. 10 - p. 7, l. 1; Staff witness Schallenberg Surrebuttal, p. 6, l. 14 - p. 7, l. 3; Staff witness Featherstone Rebuttal, p. 11, ll. 4-7 and p. 13, ll. 11-17.
[52] Staff witness Mantle Direct, p. 6, l. 8 - p. 7, l. 2.
[53] Staff witness Mantle Direct, p. 2, ll. 15-18.
[54] Staff witness Schallenberg Surrebuttal, p. 6, ll. 14-19.

The Staff has relies on Aquila's costs in acquiring and installing on the site three combustion turbines capable of generating a total of about 300 MW as a proxy for about 300 MW of the 500 MW. For the remaining 200 MW the Staff has used an estimate of ** HC ________ HC** for the cost of the combustion turbines.[55]

5. South Harper (Electric): What costs related to the South Harper facility, if any, should be included in Aquila Networks-MPS's rate base?

Staff Position: None. However, in lieu of including the South Harper facility costs in rate base, costs based on the actual costs of the South Harper facility should be included in rate base.

As indicated in the "Used and Useful" and "Fully Operational and Used for Service" subpart of the statutory requirement and applicable standards section of this brief, the standard under which this issue would typically be evaluated is whether the South Harper facility was completed to the point where it may be included in rate base. Because construction of the South Harper facility is complete and Aquila is using the facility to provide electricity to current customers, under the foregoing standards, the costs of the plant would qualify for inclusion in Aquila Network—MPS's rate base. However, here, as discussed below, Aquila unlawfully built the South Harper facility.

On December 20, 2005 the Western District of the Missouri Court of Appeals issued its opinion affirming the January 11, 2005 judgment of the Cass County Circuit Court permanently enjoining Aquila from constructing and operating Aquila's South Harper facility in Cass County, Missouri.[56] By posting an appeal bond, Aquila was able to avoid the effects of that judgment until it became final and unappealable. Aquila publicly announced January 4, 2006 it will not seek review of the Court of Appeal's opinion and, therefore, the opinion became final fifteen

---

[55] Staff witness Schallenberg Direct, p. 7, ll. 12-14; Staff witness Schallenberg Surrebuttal, p. 2, l. 6 - p. 6, l. 7.
[56] *StopAquila, org. v. Aquila, Inc.*, No. WD64985 (Mo. App. December 20, 2005

HC

days after it was entered—on January 5, 2006. As a result, there is now a final unappealable judgment that Aquila's South Harper facility is unlawful.

In the Staff's view, the unlawful facility is not properly includable in rate base; however, the Staff believes the Commission should recognize the benefit to ratepayers of the electricity Aquila Networks—MPS is obtaining from the unlawful South Harper facility. The Staff has used the costs of acquiring a site and building three combustion turbine units having a total capacity of 315 MW as a substitute for the unlawful South Harper facility. For the costs of that site and acquiring and installing those combustion turbine units, the Staff has used the actual costs, from the standpoint of its regulated division Aquila Networks—MPA, Aquila prudently incurred in building its South Harper facility.[57]

a. When should allowances for funds used during construction be treated as beginning and ending, and what is the appropriate AFUDC rate?

Staff Position: South Harper began generating electricity to meet system load requirements for Unit 1 on July 12, 2005, Unit 2 July 1, 2005 and Unit 3 on June 30, 2005. The units where considered for commercial operation on these dates and these should be the dates Aquila transfers the units to plant-in-service and discontinues calculating allowance for funds used during construction.

The Staff has included in its case costs for about 300 MW of 500 MW of generation it asserts Aquila should have met with five combustion turbine units by using Aquila's South Harper facility as a proxy. This issue affects costs the Staff has included in its case.

The issue of when allowances for funds used during construction should end is one of timing. Aquila takes the position they, for each combustion turbine unit, should extend until the Staff's in-service criteria—criteria the Staff relies on for recommending to the Commission a new generating unit meets the statutory requirement of being "fully operational and used for service"—are met, and therefore the costs of the unit may be included in rate base. In contrast,

[57] Staff witness Featherstone Direct, p. 6, l. 21 - p. 7, l. 3, p. 51, ll. 20-23; Staff witness Williams Direct, p. 4, ll. 17-21, p. 14, l. 8 - p. 18, l.14; Staff witness Williams Surrebuttal, p. 20, l. 13 - p. 21, l. 13.

the Staff asserts that the point in time at which allowances for funds used during construction should end is when the combustion turbine unit is actually in use to provide service for current customers, i.e., when it is "used and useful." The Staff asserts, for each unit, that point is time is when the unit was declared "commercial." That point is when control of both when that unit runs and at its output is controlled by the dispatchers who actually oversee at all times the loads on Aquila's Missouri systems and arrange the power needed to serve that load.[58] Therefore, for the 315 MW of generation the Staff included in its case based on using Aquila's South Harper facility as a proxy, the Staff has used the dates each South Harper combustion turbine unit was declared "commercial" as the date when AFUDC for that unit ends. Missouri court explanations of the terms "fully operational and used for service" and "used and useful" are set out in the "used and useful" and "fully operational and used for service" subpart of the statutory requirement and applicable standards section of this brief above.

b. What cost for test power should be treated as being included in Aquila Networks-MPS's rate base?

Staff Position: The test power costs should coincide with the commercial operation date. All power generated by Unit 1 before July 12, 2005, for Unit 2 before July 1, 2005 and Unit 3 before June 30, 2005 should be test power and treated as part of the construction costs of South Harper. Test power values will be determined in the true-up audit of this case.

For each combustion turbine unit, the date for which test power costs allowed in rate base should end coincides with the date allowances for funds used during construction ends. Therefore, for the 315 MW of generation the Staff included in its case based on using Aquila's South Harper facility as a proxy, the Staff has used the dates each South Harper combustion turbine unit was declared "commercial" as the date when test power costs end. Using that cutoff point, unit 1 generated 785 MWh of test power, unit 2 generated 967 MWh of test power and

[58] Staff witness Featherstone Direct, p. 52, l. 10 - p. 54, l. 3; Staff witness Featherstone Surrebuttal, p. 2, ll. 9-16, p. 3, l. 9 - p. 16, l. 19.

unit 3 generated 1,738 MWh of test power.[59] The costs of that power should be included in construction costs. In its Report and Order issued December 19, 2005 the Commission specifically found "Aquila began generating electricity at the South Harper Station on June 30, 2005."[60]

c. Should the costs of fee and professional services payments Aquila made to or for the benefit of the City of Peculiar for Aquila to enter into a Chapter 100 financing arrangement with the City of Peculiar be included in Aquila Networks-MPS's rate base?

Staff Position: Reasonable and prudent fees and professional services payments relating to the Chapter 100 financing should be included in Aquila's Networks-MPS rate structure.

The Staff has included both upfront costs of the City of Peculiar ($927 thousand as of June 30, 2005) and payments in lieu of taxes to the City of Peculiar related to the Chapter 100 financing in the 315 MW of combustion turbine capacity for which the Staff is using actual South Harper costs as a proxy.[61]

d. South Harper Exclusions – should various legal, consulting and other costs included by Aquila as costs of construction be allowed rate base treatment?

Staff Position: Aquila and Staff have reached an agreement on removing from South Harper construction costs amounts incurred in the legal, consulting and other costs relating to the court and Commission cases on permitting and zoning matters.

Because Aquila is not contending these costs should be recovered from ratepayers, this issue is no longer contested.

e. If the costs related to the South Harper facility are not included in Aquila's rate base, should the cost of service reflect an alternative amount?

Staff Position: The Staff used the construction costs of the three combustion turbines at South Harper as a surrogate for capacity to replace approximately 315 megawatts of

---

[59] Staff witness Featherstone Surrebuttal, p. 6, l. 21 - p. 7, l. 9.

[60] *In the Matter of the Application of Aquila, Inc. for Authority to Acquire, Sell and Lease Back Three Natural Gas-Fired Combustion Turbine Power Generation Units and Related Improvements to be Installed and Operated in the City of Peculiar, Missouri*, Case No. EO-2005-0156 (Report and Order issued December 19, 2005,p. 7).

[61] Staff witness Williams Surrebuttal, p. 16, l. 21 - p. 17, l. 13.

capacity of the Aries purchased power agreement. If costs for South Harper are excluded from rate base, then alternative replacement capacity would have to be determined and valued in this case. Staff maintains that the recently completed South Harper unit is the best value for the costs of this capacity and should be used for the three combustion turbines, regardless of the site location or existence of the generating facility.

As discussed under Issue 5 above, the Staff believes the Commission should recognize the benefit to ratepayers of the electricity Aquila Networks—MPS is obtaining from the unlawful South Harper facility. The Staff has used the costs of acquiring a site and building three combustion turbine units having a total capacity of 315 MW as a substitute for the unlawful South Harper facility. For the costs of that site and acquiring and installing those combustion turbine units, the Staff has used the actual costs, from the standpoint of its regulated division Aquila Networks—MPA, Aquila prudently incurred in building its South Harper facility.[62]

f. What total cost for the combustion turbines and related equipment transferred to Aquila, Inc. from Aquila Equipment, LLC and installed at Aquila's South Harper facility should be included in Aquila-Networks-MPS's rate base?

Staff Position: Based on the Commission's rejection of the Stipulation and Agreement filed in Case No. EO-2005-0156, the lower of cost or market.

Commission Rule 4 CSR 240-20.015 requires electric utilities to record on their books the lower of the cost or market value of an asset acquired from an affiliate. Here Aquila acquired the combustion turbines from its affiliate Aquila Equipment, LLC. The original acquisition cost of the combustion turbines, and some ancillary equipment, was $78,716,233.[63] Relying primarily, but not exclusively, on an actual offer made by one of Aquila's affiliates to sell these turbines and ancillary equipment to Kansas City Power & Light Company in 2002, the Staff asserts the fair market value of the combustion turbines and ancillary equipment is $66.7 million.

[62] Staff witness Featherstone Direct, p. 6, l. 21 - p. 7, l. 3, p. 51, ll. 20-23; Staff witness Williams Direct, p. 4, ll. 17-21, p. 14, l. 8 - p. 18, l.14; Staff witness Williams Surrebuttal, p. 20, l. 13 - p. 21, l. 13.
[63] Aquila witness Williams Surrebuttal, p. 17, ll. 4-5.

In addition to the offer to Kansas City Power & Light Company, the Staff considered sales by Aquila to non-affiliates of combustion turbines in 2003, Aquila's pending sale of combustion turbine generating facilities to AmerenUE, an offer from Rolls-Royce Power Company to sell combustion turbines to Aquila made in September 2004, sales information contained in the publication *Gas Turbine World* and information regarding combustion turbine costs obtained in integrated resource planning meetings held with utilities regulated by this Commission.[64]

> 6. AAO's (Electric): Should the unamortized balance of the accounting authority orders the Commission issued for the Rebuild and Western Coal Conversion of Aquila's Sibley generating facility be included in Aquila Networks-MPS's rate base?
>
> **Staff Position**: Yes. The Commission authorized these accounting authority orders in Case Nos. ER-90-101, EO-91-247 and ER-93-37. The unamortized balances the Commission authorized in those cases should continue to be included in the rate base calculations until such time as the amortization period is complete.

There are two accounting authority orders at issue in this case. The Commission granted them to authorize Aquila Networks—MPS to defer depreciation expenses, property taxes and carrying costs associated with the Capacity Life Extension (Sibley Rebuild Project) and Western Coal Conversion projects at its Sibley generating station. The Commission granted these authorizations in Case Nos. EO-90-114 and EO-91-358 and reauthorized them in Case Nos. ER-90-101 and ER-93-37. The Commission also granted Aquila an AAO associated with the January 2002 ice storm, but that AAO is not at issue in this case. There is also no issue regarding expense amortization of the AAOs in this case.[65]

The issue in this case regarding AAOs, raised by Public Counsel witness Ted Robertson, is whether the unamortized balance of the AAOs associated with the Sibley Rebuild Program and

---

[64] Staff witness Featherstone Direct, p. 46, l. 6 - p. 48, l. 5; Staff witness Featherstone Surrebuttal, p. 46, l. 18 - p. 60, l.2, Schedule 11-1 HC.
[65] Staff witness Williams Rebuttal, p. 2, ll. 4-19.

the Western Coal Conversion Program should be included in rate base.[66] The Staff believes the unamortized deferred balances of the AAOs for the Sibley Rebuild Program and the Western Coal conversion Program authorized in Case Nos. ER-90-101 and ER-93-37 should be included in the determination of rate base.[67]

Staff has consistently applied this methodology in each Aquila rate case and the rate cases of its predecessor company since Case No. ER-90-101. The Commission ordered the Sibley Rebuild Program AAO and the Sibley Western Coal Conversion AAO to be amortized over a 20-year period consistent with the life extension of the generating units. The capital expenditures and the related AAO authorized by the Commission are just like any other capital expenditure in that they are given rate base treatment (return on the investment) as well as a recovery of the related costs through depreciation/amortization expense recovery.[68]

The Sibley Rebuild Program and The Sibley Western Coal Conversion Project were extraordinary construction projects undertaken by the Company to provide a continuation of adequate service. These projects represent major capital additions to plant in service as opposed to extraordinary maintenance expenditures resulting from an extraordinary occurrence like the ice storm. The deferred costs included in the AAO authorized by the Commission for the life extension of Sibley should be treated the same way as the other capital costs for these projects, and afforded rate base treatment. 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.[69] As Mr. Williams correctly states:

---

[66] Staff witness Williams Rebuttal, p. 2, ll. 15-17.
[67] Staff witness Williams Rebuttal, p. 3, ll. 3-9.
[68] Staff witness Williams Rebuttal, p. 3, ll. 3-19.
[69] Staff witness Williams Rebuttal, p. 5, l. 16 - p. 6 l. 2.

> The Commission has already determined this issue. To now accept the Public Counsel's arguments would negate the Commission's orders from Case Nos. ER-90-101 and ER-93-37. The AAOs granted in those cases were the result of life extension projects and, as such, should be treated the same way as normal capital expenditures (which are classified as plant in service and not as routine maintenance costs). These amounts were included in the AAOs to provide the Company an opportunity to recover the depreciation, property taxes and carrying costs associated with the rebuilds that occurred between the completion of the projects and the Company's next rate case. Absent AAO treatment, these amounts would have been lost as a result of booking these costs directly to expense following completion of the projects.[70]

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.[71] An AAO allows the utility to defer and capitalize certain expenses until the time it files its next rate case, and it protects the utility from earnings shortfalls and softens the blow which results from extraordinary construction programs.[72]

The Commission has performed this function and should proceed accordingly.

7. Deferred Taxes – AAO (Electric): Should deferred income taxes associated with the Sibley and Ice Storm accounting authority orders be determined and applied as an offset to Aquila Network-MPS's rate base?

Staff Position: Accumulated Deferred Taxes should be included in Rate Base if the IRS tax timing difference has been normalized for ratemaking purposes. Reflecting Accumulated Deferred Taxes in Rate Base need not be consistent with the Rate Base treatment afforded any related balance sheet amounts.

8. Deferred Tax Balances (Electric and Steam): The Staff did not file testimony on this issue since the issue is primarily between The Office of the Public Counsel and Aquila. At the hearing Staff Witness Traxler will be available to answer questions on this issue. Deferred Tax Balances: (Electric and Steam) Should deferred tax debit balances related to non-rate base accruals and reserves be included in the accumulated deferred income tax balances deducted from plant in service in the determination of Aquila Networks-MPS's and Aquila Networks-L&P's rate bases?

[70] Staff witness Williams Rebuttal, p. 4, ll. 7-17.
[71] *Missouri Gas Energy v. Public Service Commission State of Missouri,* 978 S.W.2d 434, 436 (Mo. App. 1998).
[72] Id. at 436.

Staff Position: Accumulated Deferred Taxes should be included in Rate Base if the IRS tax timing difference has been normalized for ratemaking purposes. Reflecting Accumulated Deferred Taxes in Rate Base need not be consistent with the Rate Base treatment afforded any related balance sheet amounts.

Like the prior issue, the Staff did not file testimony on this issue since the issue is primarily between The Office of the Public Counsel and Aquila. At the hearing Staff Witness Traxler will be available to answer questions on this issue.

9. Accounts Receivable Program (Electric): Should customer accounts receivable be treated as being sold for purposes of determining Aquila Network-MPS's and Aquila Networks-L&P's cash working capital included in rate base?

Staff Position: Yes. Aquila should be held to the commitment made by its senior executives in prior Commission cases that the Company would insulate its customers from any adverse affects of the Company's financial problems. Therefore, the Staff's treatment of customer accounts receivable as being sold insulates customers from the negative effects of Aquila's financial problems that resulted in the cancellation of the accounts receivable sales program.

Keith Stamm, Aquila vice-president and chief operating officer, in Aquila's last general electric rate increase case before this Commission stated: "…This request for rate relief stand[s] on the merits of the need of Missouri-regulated operations alone, isolated and insulated from the impacts of our non-regulated activities."[73]

At issue concerning Cash Working Capital here is whether the Commission should use a collection lag of 4.38 days associated with accounts receivable of Aquila Networks—MPS and Aquila Networks—L&P, which is the collection lag Aquila experienced with its former accounts receivable sales program.[74] Staff used the 4.38 day lag to insulate the customers of Aquila Networks—MPS and Aquila Networks—L&P from the negative impact to Cash Working Capital caused by Aquila's financial problems resulting from its non-regulated operations. The Company participated in the accounts receivable sales program from the mid-1980's through

---

[73] Staff witness Williams Surrebuttal, p. 10, ll. 3-15 (quoting Aquila witness Stamm Direct, p. 2, l. 19 filed in Case No. ER-2004-0034).
[74] Staff witness Williams Surrebuttal, p. 13, ll. 2- 15.

2002, when the bank buying the receivables ended the program due to Aquila's lack of creditworthiness that resulted from its non-regulated activities.[75]

Aquila does not dispute that the bank ended the program because of Aquila's financial problems that resulted from the failure of Aquila's unregulated activities, but asserts the former program is not available to anyone now.[76] The Staff believes Aquila has the burden of proving that, if Aquila were creditworthy, the former accounts receivable sales program, or one equivalent to it, would not be available to Aquila. The only testimony Aquila has filed on the unavailability of the program is that of its employee Dennis Williams. The Commission should not allow such self-serving hearsay to persuade it the former accounts receivable program would not be available to a creditworthy Aquila.

If the former accounts receivable sales program is not imputed to Aquila then added accounts receivable carrying costs would be passed on to ratepayers by means of a collection lag of 20.51 days, instead of the 4.38 days with the former accounts receivable sales program. An increase in collection lag, from 4.38 to 20.51 days, would raise the revenue requirement associated with the sale of customer accounts receivable by nearly $1.373 million to Aquila Networks—MPS ratepayers and $417,000 to Aquila Networks—L&P ratepayers.[77]

To insulate ratepayers from the adverse impacts of Aquila's non-regulated activities, the Commission should impute an accounts receivable collection lag of 4.38 to Aquila Networks—MPS and Aquila Networks—L&P for rate setting purposes in these cases.

10. 20 West 9th (Electric and Steam): What cost should be included in Aquila Networks-MPS's and Aquila Networks-L&P's rate bases for Aquila's 20 West 9th headquarters/annex?

[75] Staff witness Williams Surrebuttal, p. 12, ll. 3-8.
[76] Aquila witness Williams Rebuttal, p. 5 ll. 10-14.
[77] Staff witness Williams Surrebuttal, p. 9, ll. 3-6.

Staff Position: The Staff has accepted Aquila's proposal to eliminate the costs of the downtown Kansas City headquarters building that is associated with excess office space. The amount of excess office space was determined in accordance with industry standards.

Aquila maintains its office space at 20 W. 9th in downtown Kansas City, Missouri, despite a significant decline in its use of the building. This decline in use has resulted in availability of office space that could be rented to generate additional income.

Aquila commissioned Deloitte & Touche USA LLP (Deloitte) to help with implementation of a cost savings and efficiency program. Deloitte's analysis showed, among other things, that Aquila could receive as much as $1.2 million is lease revenue from the available office space in 2005 and into the future.[78]

Members of the Staff toured this facility during the audit performed for this case and noted a significant amount of unoccupied office space. Based on this visual inspection, combined with the recommendations from Deloitte, the Staff recommends imputing $1 million in annual lease revenue to Aquila. The reduction from $1.2 million is due to costs associated with renting property.

In light of the foregoing, the Staff and Aquila agree the costs of this office building associated with the excess office space, based on industry standards for office space costs, should be eliminated from inclusion in rate base.[79] Likewise, the Commission should eliminate from the rate bases of both Aquila Networks—MPS and Aquila Networks—L&P all costs associated with excess office space at Aquila's office space at 20 W. 9th in downtown Kansas City, Missouri.

11. SO2 Emissions Costs (Electric): What level of SO_2 emissions costs should be included in rate base?

Staff Position: The level the Staff included in its direct testimony. Although it included a greater amount in its direct testimony, Aquila now agrees with the Staff's level.
The Staff included the unused level of SO_2 emission allowances that Aquila carried on its

[78] Staff witness Hyneman Direct, p. 31, ll. 15-23.
[79] Staff witness Hyneman Direct, p. 22 l. 5 p. 24, l. 5.

books, on a 13-month average basis, in rate base.[80] Public Counsel witness Ted Robertson filed rebuttal testimony claiming that the Staff's recommended rate base amount of inventory is too high. It appears Mr. Robertson's contention is based largely on his conclusion that, since more emission allowances are being used because of the CW Mining coal supply contract breach, more allowances are being held in inventory to support the higher usage rate. In addition, Mr. Robertson states Aquila's financial books of record also contain costs associated with other trading activities of SO_2 emission allowances, such as purchases, sales, swaps, etc.[81] Public Counsel witness Robertson offers no analysis to support his claim that the Staff's recommended rate base amount of emission allowance inventory is excessive. The Staff regards his concern as immaterial. Staff's position is that the inventory amounts—Aquila Networks—MPS has about \$1 million and Aquila Networks—L&P has less than \$0.6 million in rate base—constitute only a few months' worth of usage, so it does not appear to be a case where Aquila could have opportunity to reap any significant return from ratepayers. Public Counsel offers no value for SO_2 emissions costs in rate base for either Aquila Networks—MPS or Aquila Networks—L&P. Therefore, the Commission should adopt the SO_2 emissions costs proposed by Staff inclusion in rate base.

Expense Issues

12. SO2 Emissions Costs (Electric): What level of SO_2 emissions costs should be included in expense?

Staff Position: The level the Staff included in its direct testimony. Although it included a greater amount in its direct testimony, Aquila now agrees with the Staff's level.

This is an issue between the Staff and Aquila on one side, and The Office of the Public Counsel on the other. The issue arises as result of Aquila's loss of a coal supply contract of high

[80] Staff witness Vesely Direct, p. 17, ll. 22-23.
[81] Public Counsel witness Robertson Rebuttal, p 24, line 6.

Btu coal for its Sibley and Lake Road power plants. This coal is blended with lower Btu coal and the blend used as a fuel source at both plants. Aquila had an agreement to purchase low sulfur coal from CW Mining. In 2005, CW Mining breached the coal supply agreement, forcing Aquila to acquire replacement coal at a much greater cost.[82] Because the replacement coal has a higher sulfur content, Aquila must purchase a greater number of SO_2 emission allowances, and consequently incur higher costs, than if the Company was continuing to receive CW Mining coal.[83]

In its direct case, Aquila assumed replacement coal from Illinois, with its much higher sulfur content. However, Aquila eventually succeeded in contracting for replacement coal with Consolidation Coal. The sulfur content of this replacement western coal, although higher than the coal supplied by CW Mining, is much lower than that of the Illinois coal.[84] As a result, Aquila will no longer be using the Illinois coal.[85]

The Staff, in its direct case, was able to reflect Aquila's switch to the lower sulfur coal. The difference between the respective SO_2 emission allowance levels proposed by Staff and Aquila in their direct cases is primarily attributable to the Staff's reduction of Aquila's projection by 10%, in recognition of the fact that Aquila determined it would not continue to purchase the Illinois coal.

Overall, in its direct case, the Staff both reflected higher costs for SO_2 allowances from increases in the SO_2 market and removed the increase in SO_2 emission costs that resulted from CW Mining's breach of its coal supply contract with Aquila.

Public Counsel witness Ted Robertson contends the SO_2 emission allowance expenditures

[82] Featherstone Direct, p. 36, l. 4 – p. 37 l. 4.
[83] Vesely Surrebuttal, p. 2, ll. 9-11.
[84] Staff witness Vesely Surrebuttal, p. 14, ll. 1-2.
[85] Staff witness Vesely Surrebuttal, p. 12, ll. 11-13.

amount for the Sibley power plant the Staff and Aquila agreed-upon is too high; and that the Staff's recommended allowance purchase level of 5,939 should be reduced by almost 50% to 3,068.[86] Public Counsel witness Robertson attributes the difference to the breach of the coal supply contract by CW Mining. The substitution of somewhat higher sulfur coal from Consolidation Coal for the coal formerly supplied by CW Mining results in a higher cost of SO_2 emission allowances. The Office of the Public Counsel argues ratepayer should not have to bear the burden of higher SO_2 allowance costs when there remains a prospect for recovery through the courts. A judgment for damages would, to the extent of the judgment, amount to a double charge on Aquila's customers.[87]

In response to Public Counsel witness Robertson's rebuttal testimony on this issue, Staff witness Graham Vesely, in his surrebuttal testimony, describes how he took a second look at estimating the appropriate level of SO_2 allowance purchases.[88] Staff witness Vesely agrees. if it is assumed Aquila is still using coal from CW Mining, which it is not, the estimated emission allowance requirement at Sibley would be lower than the amount to which to the Staff and Aquila have agreed, although not as low as that proposed by Public Counsel witness Robertson. As stated above, with the default of CW Mining, the replacement coal supplier with which Aquila has signed a two-year contract (Consolidation Coal Company) is providing a coal that is much lower in sulfur than the Illinois coal, but still higher in sulfur than the CW Mining coal.

Prior to the filing of rebuttal testimony, the Staff and Aquila agreed to settle a number of Staff adjustments, among those Aquila adopted the Staff's adjustment for SO_2 allowances as proposed in the Staff's direct filing. As Staff witness Vesely indicates in his surrebuttal testimony, notwithstanding the fact that using a revised approach produced a result closer to that

[86] Public Counsel witness Robertson Rebuttal, p. 22, ll. 20-21.
[87] Public Counsel witness Robertson Rebuttal, p. 23, ll. 10-22.
[88] Staff witness Vesely Surrebuttal, pp. 12-13.

of Public Counsel, the Staff continues to support the adjustment it sponsored in its direct case.[89]

13. Generation Resources (Electric): What are the prudent types and amounts of generation resources for determining fuel and purchased power expense for Aquila Networks-MPS and Aquila Networks-L&P?

Staff Position: The prudent type of generation resource to use is five combustion turbines.

The Staff has no quarrel with Aquila's generation resources, except its reliance on three combustions turbines capable of generating about 315 MW plus 200 MW of purchased power to replace the capacity Aquila lost when its purchased power agreement with Calpine ended May 31, 2005. As set out under issues 4, 5, 5a, 5b, 5c, 5d, 5e and 5f above, the Staff has used five combustion turbines for the approximately 500 MW, not three combustion turbines plus 200 MW of purchased power. Therefore, the real difference in their positions is Aquila's reliance on purchased power for about 200 MW and the Staff's use of two combustion turbines to supply that capacity. In the prudence subpart of the statutory requirement and applicable standards section of this brief the Staff cited a case where the Commission had imputed a water storage facility to Capital City Water Company in lieu of a water supply contract it had entered into because the contract was imprudent and on review the Western District Court of Appeals affirmed the Commission.[90] For the reasons set out in its argument under Issue 4 above, like it did when it imputed a water storage facility to Capital City Water Company in lieu of a water supply contract, the Commission should impute two combustion turbines capable of generating about 200 MW in lieu of the costs of purchased power agreements for that capacity.

14. Spot Market (Electric and Steam): How should prices for power Aquila purchases on the spot market be determined?

---

[89] Vesely Surrebuttal, p. 13, ll. 14-16

[90] *State ex rel. Capital City Water Company v. Missouri Public Service Commission*, 850 S.W.2d 903 (Mo. App. 1993).

The Staff's methodology, as set out in the direct testimony of Staff witness David Elliott, is the appropriate methodology to use for determining spot purchased power prices. Spot purchases, or "spot energy," is energy purchased on an hourly basis, rather than a relatively long-term contract. In general, utilities will make spot purchases for economic reasons; *i.e.*, when the cost to purchase energy is lower than either the marginal cost to generate the needed electricity or the cost to purchase under a long-term contract.[91]

In his Rebuttal testimony, Mr. Korte expressed concern that there has been a "change in staff methodology" because Staff used "different programming software" than described in its policy paper.[92] Mr. Korte was referring to the fact that the Staff at one time used Lotus 1-2-3 software to calculate the averages, and that it currently uses Microsoft Excel to perform the calculations.[93] As Staff witness Elliott points out in his surrebuttal testimony, the Staff tested the Excel program before switching from the Lotus program, and the calculation results were the same.[94] Aquila is simply wrong in raising the software used to perform the calculations as a concern.

Staff witness Elliott calculated spot purchased power prices in the same manner the Staff has used for nearly a decade. In order to develop a price for each hour of the year, the methodology applies a statistical calculation, using a truncated normal distribution,[95] to the <u>actual</u> price data for the period July 2004 through June 2005, which data were provided by Aquila to the Staff pursuant to Commission Rule 4 CSR-240-3.190.[96]

By contrast, according to Aquila witness James W. Okenfuss, Aquila uses the Global Energy Decisions ("GED") MIDAS GOLD™ software in combination with the GED database to model multi-area markets in order to determine forecasted hourly spot purchased prices for the

---

[91] Staff witness Elliott Direct, p 7, ll. 1-6.
[92] Aquila witness Korte Rebuttal, p. 9, ll. 1-4; [steam] p. 2, l. 22 - p. 3, l. 2.
[93] Aquila witness Korte Rebuttal, p. 9, ll. 2-4; [steam] p. 2, l. 23 - p. 3, l. 2.
[94] Staff witness Elliott Surrebuttal, p. 4, ll. 7-9; [steam] p. 4, ll. 11-13.
[95] Staff witness Elliott Direct, p 7, ll. 12-14.
[96] Staff witness Elliott Direct, p. 5, ll. 18-20, p. 7, ll. 14-17.

Southwest Power Pool NERC region.[97] These prices are then used as inputs to the Company's RealTime© model, which is the same software used by the Staff. A key Staff concern is the fact that Aquila's approach assumes that a primary driver of purchased power prices is the price of natural gas. Aquila witness Korte asserts that there is a strong correlation between the prices of purchased power and natural gas.[98] However, his testimony contains no analysis to support such an assertion. The Staff believes that, while there is some degree of correlation between these two variables, the price of spot energy is also dependent upon a host of other variables, "such as the generating units available, the transmission system availability, and the generation costs for not only neighboring utilities but also utilities in the region." While these variables are included in Aquila's modeling, the Company varies only the prices of natural gas in developing its forecasted purchase power prices.[99]

Aquila witness Korte alleges that the Staff's methodology is biased. In rebuttal testimony, he states, "The most glaring source of bias comes from the appearance that the method over-estimates the number of high outlier data points, discarding valid information while under-estimating low outliers."[100] The allegation is incorrect. The Staff applies the same methodology for identifying outliers at both ends of the distribution of purchase prices; *i.e.*, any value not within the range bounded by plus or minus 2.39 standard deviations of the mean, or average, is considered an outlier.[101] Also, it should be pointed out that identified outliers are not simply discarded; rather, they are set equal to the maximum (for high outliers) or minimum (for low outliers) values falling within the aforementioned range.[102]

In looking at the Staff's purchased power prices, Aquila witness Korte also observed "the

[97] Aquila witness Okenfuss Direct
[98] Aquila witness Korte Rebuttal, p. 9, ll. 20-23; [steam] p. 3, ll. 20-23.
[99] Staff witness Elliott Surrebuttal, p. 5, ll. 1-12; [steam] p. 4, l. 20 - p. 5, l. 7.
[100] Aquila witness Korte Rebuttal, p. 10, ll. 21-23; [steam] p. 4, ll. 20-22.
[101] Staff witness Elliott Surrebuttal, p. 5, ll. 13-15; [steam] p. 5, ll. 18-20.
[102] Elliott Surrebuttal, p. 5, ll. 16-18; [steam] ll. 21-23.

peak power price for power in December is 5.9% higher than the peak price in July." He goes on to say: "Most market observers would assume that for the Midwest, July prices should be higher than December prices."[103] However, in his Surrebuttal testimony, Staff witness Elliott points out that, in fact, this was Aquila's actual experience in the test year. On December 22, 2004, Aquila's actual peak purchase price for the month was $131 per MWH, while the peak July purchase price, which occurred on July 16, 2004, was only $100 per MWh. Thus, the December 22, 2004 price was 31% higher than the July 16, 2004 price.[104] Moreover, a similar observation is found even when one looks at Aquila's own spot purchased power price inputs to its fuel model. In this case, the comparison is between the peak monthly prices in February 2005 and July 2004. Mr. Elliott noted that the February peak price was about 3.6% higher than the July peak, and that in addition, there were actually three other February prices that exceeded the July peak price.[105]

It is a first principle of the Staff's approach to ratemaking that permanent rates ought to be established on the basis of actual historical experience rather than projections into the future. This approach seems eminently appropriate in the case of purchased power prices, which, particularly in the current market environment, are especially volatile and hence extremely difficult to predict, since the pricing is done on market based levels. By contrast, the Staff's approach is based on what actually occurred. As Staff witness Elliott points out, while Aquila singles out natural gas prices among many variables, in an attempt to develop a convincing estimate for the price of purchased power, the Staff, by basing its spot purchase power inputs on actual experience, automatically captures and reflects all correlations and interactions that

---

[103] Aquila witness Korte Rebuttal, p. 11, ll. 12-13; [steam] p. 5, ll. 11-12.
[104] Staff witness Elliott Surrebuttal, p. 6, ll. 2-6; [steam] p. 6, ll. 8-12.
[105] Staff witness Elliott Surrebuttal, p. 6, ll. 9-15; [steam] p. 6, ll. 15-21).

affected such prices[106]. Accordingly, the Commission should adopt the Staff's methodology for determining spot purchased power prices as inputs to the fuel model.

> **Staff Position**: Aquila's actual historical costs during the test-year, updated through June 30, 2005; and further updated through October 31, 2005 after the true-up.

> 15. Purchased Power (Electric and Steam): How should prices for power based on purchased power contracts be determined?

> **Staff Position**: Rates should be set on the cost of Aquila-owned generation, not purchased power contracts Aquila entered into in lieu of building its own regulated generation facilities.

Rather than repeating its argument and support here, the Staff refers the reader to its argument under Issues 13 and 4 above.

> 16. Coal Prices (Electric and Steam): On what prices should Aquila's coal fuel expense be based in setting rates?

> **Staff Position**: Considerable uncertainty still exists as to what Aquila's actual, effective, cost of high-Btu coal will be at its Sibley and Lake Road plants. This is because of the pending litigation with its former supplier, CW Mining, over the latter's discontinuation of **the** coal supply contract that was to be in effect at least through 2006, with an option at Aquila's discretion to extend supply through 2008. With this significant matter still unresolved, it is Staff's view that it would be premature in the current rate case to charge Aquila's customers permanently for the cost of the more expensive coal with which Aquila has replaced the CW Mining coal. Rather, this considerably more expensive replacement coal should only be used in computing the Interim Energy Charge (IEC), thus allowing at IEC expiration a prudence review in which any outcome of the litigation process may be taken into consideration.

The overriding issue with respect to coal prices is whether, as the Staff contends, the cost of coal as specified in the contract between Aquila and CW Mining, which the supplier subsequently breached, should be included in the Company's cost of service. Aquila argues the contract with CW Mining should not be recognized for ratemaking purposes; and, instead, the cost of replacement coal pursuant to a contract Aquila entered into with Consolidation Coal Company ("Consolidation Coal") subsequent to the breach, a cost almost double that agreed to

[106] Elliott Surrebuttal, [electric] p. 7 ll. 4-10; [steam] p. 7 ll. 9-15.

under the contract with CW mining, should be reflected in Aquila's cost of service.

Aquila witness Jerry Boehm alleges the Staff is proposing to establish rates using the price of coal from a supplier who is no longer supplying coal.[107] In response Staff witness Graham Vesely reinforces the Staff's position that the lower costs should be included only in base rates, and that the higher coal rates should be included as part of the ceiling amount of an Interim Energy Charge ("IEC").[108] Indeed, the IEC mechanism is an ideal solution to a situation such as this. Because the forecast amount is subject to refund, to the extent that Aquila receives a judgment for damages due to the breach, that amount could then be refunded to customers following the true-up audit of the IEC.

Aquila raises the following arguments concerning the Staff's approach:

a) that the costs included by the Staff do not reflect the costs the Company will incur during the effective period of the new rates;

b) that there is no measurable outcome of the lawsuit that can be included in proposed rates;

c) that Aquila is being penalized by an adjustment that understates the known cost of coal by about $8 million; and

d) that Aquila's actions in securing a replacement supply of coal were prudent under the circumstances.[109]

Aquila's differences with the Staff on this point all ignore the question of timing. Aquila fails to recognize the IEC mechanism to address precisely the concerns listed above at a later time (*i.e.*, during the IEC true-up audit). Following any necessary adjustment to the monies collected by Aquila, the costs *will* likely reflect Aquila's prudently incurred costs of coal; the outcome of the lawsuit *will* likely be known and measurable; Aquila will likely *not* be penalized

[107] Aquila witness Boehm Rebuttal, p. 3, ll. 12-13.
[108] Staff witness Vesely Direct, p. 14, ll. 9-14; Staff witness Vesely Surrebuttal, p. 2 - p. 7.
[109] Aquila witness Korte Rebuttal, p 6 - p. 8.

by an adjustment understating the actual prudent cost of coal; and that the prudence of charging customers will likely also become known at the time of the true-up audit. Moreover, during the time the lawsuit for damages is being resolved, Aquila will not suffer any adverse financial effect, as it will be recovering via the IEC mechanism, its full costs under the current replacement coal contract.[110] Therefore, the Staff's proposal for treating this unfortunate and unsettled issue through the IEC mechanism is appropriate

17. Natural Gas Prices (Electric and Steam): On what prices should Aquila's natural gas expense be based in setting rates?

The Staff's approach to determining a price of natural gas, which for its direct case is approximately **HC _____ HC** per MMBtu, is entirely appropriate.[111] This price is based on Aquila's actual payments in June 2005, which is the end of the ordered test year update period in this case. The Staff determined this price was reasonable after giving consideration to Aquila's actual "true" cost of natural gas, which is the amount paid for the commodity to its suppliers, including any hedging gains or losses.[112] Moreover, the Staff proposes the overall price of natural gas be updated during the true-up period for this case, using the Staff's recommended methodology of basing natural gas prices on actual costs.[113]

In his Rebuttal testimony, Aquila witness Korte takes issue with the Staff's approach in this case on the following grounds:

a) It is inconsistent with the methodology use by the Staff in the last Aquila rate proceeding, Case No. ER-2004-0034;

[110] Staff witness Vesely Surrebuttal, p. 3 - p.-7.
[111] Staff witness Hyneman Direct, p. 12, l. 1; [steam], p. 11, l. 13.
[112] Over the last several months Aquila's hedging program has produced very significant financial gains, which is to be expected in today's market. Schedule 5 attached to Staff witness Hyneman's Surrebuttal testimony shows **HC ______________________________ HC**
[113] Staff witness Hyneman Surrebuttal, p. 14, l. 21 - p. 15, ll. 4; [steam] p. 6, ll. 6-10).

HC

b) June 2005 is a historically low-cost month, and thus, the Staff's selection of that month as the basis for its natural gas price recommendation introduces a downward bias in its price of natural gas; and further,

c) The selection of June 2005 is arbitrary.[114]

Instead of the Staff's method, Aquila recommends using the natural gas futures market of the New York Mercantile Exchange ("NYMEX"). Aquila witness Korte asserts Aquila's approach is a "comprehensive method" that provides a "more complete view of the actual marketplace."[115] In the discussion that follows, the Staff shows why Aquila witness Korte's criticisms are without merit, and why the Commission should reject Aquila's methodology and adopt the Staff's approach to determining the price of natural gas to be used in this case.

The methodology Staff used to develop its price of natural gas is clearly consistent with its practice of relying on <u>actual</u> costs to develop its cost of service recommendations. The Staff's comprehensive approach to its natural gas price recommendation used the actual prices paid for natural gas, with consideration given to the results of Aquila's hedging program. In the analysis leading up to its recommendation, the Staff also reviewed the price forecasts of experts in the natural gas industry.[116]

The Staff takes exception to Mr. Korte's assertion that Staff used a different method to arrive at its gas prices in this case than in the last Aquila general rate case (Case No. ER-2004-0034), where the Staff used an average of actual natural gas costs incurred by Aquila. The Staff emphasizes its approach in both cases is rooted in Aquila's actual gas costs. In the instant case, however, the Staff submits it could legitimately be faulted if it <u>failed</u> to recognize gas prices were trending upward and instead, mechanically averaged the more recent, higher prices with the

---

[114] Aquila witness Korte Rebuttal, p. 11 - p. 13, l. 7; [steam] p. 5, l. 22 - p. 6, l. 11.
[115] Aquila witness Korte Rebuttal, p. 13, ll. 6-7.
[116] Staff witness Hyneman Surrebuttal, p. 13, l. 19 - p. 14, l. 10; [steam] p. 4, ll. 3-7).

earlier, lower ones. Thus, the Staff's approach in this case is generally consistent with the approach it took in the last case, while at the same time, recognizes the difference in the recent natural gas price environment. The type of flexibility shown by the Staff in this instance is routinely exercised with respect to any number of cost issues in rate proceedings. It is common to determine appropriate values to include in rate cases using some type of average or a more recent time period, depending on circumstances. Curiously, at the same time he criticizes the Staff for employing "inconsistent" methods, Aquila witness Korte admits some modification of the Staff's approach to determining gas prices in the previous case was necessary under the circumstances of this proceeding.[117]

The Staff further points out, while the underlying consistency of the Staff's approach is clear, the same can hardly be said of the approaches Aquila has used in this and its last rate proceeding. Aquila arrived at its proposed level of natural gas prices in Case No. ER-2004-0034 by averaging price estimates made by experts in the natural gas industry.[118] However, Aquila completely abandoned that approach in this proceeding, and instead used a 30-day NYMEX futures strip average. Moreover, not only can no explanation for the dramatic switch be found anywhere in Aquila's testimony, Aquila's other witness in this case on the natural gas price issue, Mr. Jerry Boehm, argues Aquila used a NYMEX futures strip price in Aquila last rate case.[119] In fact, Aquila's primary witness on natural gas prices in that case, Mr. John Browning, very clearly told this Commission that NYMEX futures were in no way appropriate for ratemaking purposes. In his Rebuttal testimony, Staff witness Hyneman includes the following quotes from Mr. Browning's rebuttal testimony in the previous rate case, Case No. ER-2004-0034, concerning the use of NYMEX futures as a basis for setting rates:

[117] Aquila witness Korte Rebuttal, p. 12, l. 21 - p. 13, l. 3; [steam] p. 6, ll. 16-20.
[118] Staff witness Hyneman Surrebuttal, p. 12; [steam] p. 12. l.18 - p. 13, l. 2.
[119] Aquila witness Boehm Surrebuttal p. 4, ll. 7-8.

> As I mentioned in my direct testimony, the use of NYMEX futures is questionable in both the near term as well as the long term for predicting future spot prices. The near term futures can be highly volatile and react to short-term events irrationally. On the other hand, futures for years such as 2005 and 2006 are illiquid and lightly traded making them potentially meaningless as far as predicting future physical prices. [rebuttal page 10]
> Kwang Y. Choe, a Regulatory Economist with the Commission, filed testimony in Case No. ER-2001-672 that concurs with my opinion. Mr. Choe describes in great detail why the correlation between NYMEX futures and future spot prices is very weak and not suitable for ratemaking. [rebuttal page 11]
>
> I completely agree that the most realistic and most up-to-date price information should be used for ratemaking. That would exclude the use of historical costs from 2001 or 2002 and the usage of NYMEX futures. [rebuttal page 13].[120]

Clearly, Aquila has done a major flip-flop on the issue of NYMEX futures with absolutely no justification and without even acknowledging it has done so.

Aquila witness Korte claims that June 2005, which the Staff selected for its determination of actual natural gas cost, is a historically low-cost month. However, the Staff has not found that to be the case in recent time periods. Staff witness Hyneman discusses Aquila's response to Data Request No. 158, wherein Aquila provided information on its actual natural gas purchases from 2001 through the most current month.[121] Mr. Hyneman notes: "Schedule 1 [to his surrebuttal testimony] shows that in 2001, Aquila's cost of natural gas in June was the 6th highest of the year, in 2002, the 7th highest, in 2003, the 3rd highest and in 2004 the fourth highest. Aquila's cost of natural gas in June exceeded the price in January (presumably a high cost month) in 2002, 2003, 2004 and 2005."[122] Clearly, the Staff's selection of June 2005 did not introduce a downward bias in its recommended natural gas price. The Commission should reject Aquila's claim.

Neither should the Commission give any credence to Aquila witness Korte's contention

[120] Staff witness Hyneman Rebuttal, p. 5, ll. 7-22; [steam] p. 5, ll. 7-22.
[121] Staff witness Hyneman Surrebuttal, Schedule 1.
[122] Staff witness Hyneman Surrebuttal, p. 15, ll. 20-23; [steam] p. 16, ll. 3-6.

the Staff's selection of June 2005 was "completely arbitrary."[123] As explained above, June was chosen to give appropriate recognition to the fact natural gas prices were trending upward in 2005. Moreover, June was the most recent month in the update period ordered by the Commission.[124] Aquila witness Korte's suggestion the Staff selected June 2005 arbitrarily is baseless.

For its part, Aquila's reliance on NYMEX futures prices in this proceeding is totally misplaced for a number of reasons. First, the NYMEX strip price does not represent a transaction into which Aquila itself actually entered. Moreover, Aquila is relying on prices in a commodities futures market for natural gas to be delivered up to two years in the future, since Aquila's proposal is based on NYMEX futures prices through December 2006 as they existed during the period October through December 2004.[125] As such, unlike Staff's recommended natural gas price, Aquila's recommendation is not based on any actual experience.

Second, the NYMEX futures market is essentially of no use as a predictor of natural gas prices[126]. In his Rebuttal testimony, Staff witness Dr. Kwang Choe explains in some detail why this is the case.[127] As noted above, Aquila's own witness in the previous rate case, Mr. John Browning, provided testimony in support of this proposition and indicated that NYMEX futures should not be used as a basis for ratemaking. Predicting future prices of natural gas is not the purpose of the NYMEX futures market. The market exists primarily to provide interested parties

[123] Aquila witness Korte Rebuttal, p. 13, ll. 13-14.
[124] Staff witness Hyneman Surrebuttal, p. 15, ll. 7-8; [steam] p. 5, l. 23 - p. 6, l.2.
[125] Staff witness Hyneman Surrebuttal, p. 16, ll. 18-21; [steam] p. 4, ll. 17-18).
[126] Staff witness Hyneman Rebuttal, p. 5, l. 26 - p. 6. l. 1. The natural gas futures market is very much like the stock market, reacting in and unpredictable and at times, in an irrational manner, to events such as hurricanes, expectations relating to the weather and world events such as terrorist attacks. (Staff witness Hyneman Rebuttal, p. 6, ll. 11-18). Additionally, NYMEX prices are subject to a market where influences by unusual events such as reporting errors caused significant fluctuations. In the last year there was an increase in NYMEX prices of over $1/Mcf on day a false report was issued by Energy Information Administration (EIA). (Staff witness Hyneman Rebuttal, p. 6, ll. 21 - p. 7, l. 4).
[127] Staff witness Choe Rebuttal, p. 4, l. 20 - p. 6, l. 6.

with some certainty regarding an otherwise volatile commodity market.[128] If one buys a future quantity of natural gas at a certain price on the NYMEX, one can be assured of his/her net price when the time comes to actually make a physical purchase of the natural gas. In rebuttal testimony, Staff witness Hyneman discusses the decidedly unimpressive performance of NYMEX futures as a predictor of Aquila's actual natural gas prices in recent years, or even of actual prices in its own market, the Henry Hub.[129] Mr. Hyneman points out that in January 2002 NYMEX futures contract delivered at Henry Hub in January 2003 was $3.23/ Mcf while Aquila's actual cost for natural gas purchased by the Company was **HC _____ HC** /Mcf, which represented a difference in price of **HC _____ HC** /Mcf.[130] Mr. Hyneman provided other similar examples in his rebuttal testimony. Aquila offers no analysis to show that NYMEX futures market is a good predictor of natural gas prices.[131]

Third, the NYMEX is based on natural gas prices at the Henry Hub in Louisiana. Aquila does not even buy its natural gas there. Instead, Aquila purchases gas from the mid-continent region (Texas, Oklahoma and Kansas), which is considerably less expensive. The difference is called a basis differential, which Aquila has estimated at 40 cents per MMBtu.[132] More recently, that basis difference is considerably higher.

Fourth, NYMEX prices are subject to manipulation. In recent years, more than 30 energy and utility companies, including Aquila, have been charged with attempting to manipulate NYMEX and other natural gas pricing markets. As a result, the Commodities Futures Trading

[128] Staff witness Choe Rebuttal, p. 16, l. 16 - p. 4, l. 2.
[129] Staff witness Hyneman Rebuttal, p. 8, l. 22 - p. 10, l. 13.
[130] Staff witness Hyneman Rebuttal, p. 9, ll. 1-6.
[131] Staff witness Hyneman Rebuttal, p. 10, l 16.
[132] Staff witness Hyneman Direct, p. 9, ll. 15-18; Staff witness Hyneman Rebuttal, p. 2, l. 11 - p. 3, l. 11.

HC

Commission has assessed more than $300 million in fines on these companies.[133] In essence, Aquila is proposing to set rates on the basis of a financial market where it is accused of actions that would have the effect of price manipulation in that market – NYMEX futures.

In light of the foregoing, Aquila witness Jerry Boehm's description of Aquila's NYMEX futures method of predicting natural gas prices as "very accurate" can be dismissed as nothing more than wishful thinking. But Mr. Boehm's assertion does not make sense on additional grounds. As support for his statement, Mr. Boehm points to Aquila's proposed $5.64/Mcf natural gas price in its direct filing in the previous rate case and states that on the day said rate case settled, the 12-month NYMEX strip price for natural gas was $5.64/Mcf. However, Aquila actually developed a price of $5.14 per Mcf when it filed its direct case, a figure that was based not on NYMEX futures prices, but on analysts' predictions and on market prices at the Henry Hub. The $5.64 figure was arrived at by arbitrarily adding another 50 cents per Mcf to the $5.14 as part of a proposed cost recovery mechanism.[134] The fact that the two cited numbers matched is purely serendipitous and hence, meaningless.

As indicated earlier, the Staff considered Aquila's known hedged gas positions in its gas price recommendation. Natural gas cost, after factoring in the hedged cost is, after all, the true actual cost of natural gas to Aquila. It turns out Aquila's hedging program has significantly lowered its cost of natural gas. **HC ____

____

____ HC** Aquila, however, did not reflect its

[133] Staff witness Hyneman Rebuttal, p. 6, ll. 4-10.
[134] Staff witness Hyneman Rebuttal, p. 8, ll. 1-13.

HC

hedging operations in its direct filing in the instant proceeding.[135] In addition, the Staff has concerns regarding Aquila's hedging program, in that **HC ______________________________ ________________ HC** may be too rigidly followed in times of extremely high NYMEX futures prices. Some application of a reasonableness test is appropriate.[136]

For the reasons stated, the Commission should reject Aquila's recommended methodology for determining a price of natural gas in favor of that of the Staff.

> **Staff Position**: Natural Gas Prices - Due to the recent high level of volatility in the natural gas market, the Staff believes a range of natural gas prices should be included in an Interim Energy Charge (IEC) similar to Aquila's current IEC. This range of natural gas prices should be negotiated among the parties to this case. If an IEC is not ordered in this case then a single-point natural gas price must be used to set Aquila's rates. The Staff believes that the best method to use to determine natural gas prices for ratemaking purposes is to base the prices on Aquila's actual cost of natural gas, given appropriate consideration to the impact of recent events in the market, the opinion of experts in the industry, and the results of Aquila's natural gas hedging program.
>
> 18. Fuel Oil Prices (Electric and Steam): On what price should Aquila's fuel-oil-in-inventory expense be based in setting rates?
>
> **Staff Position**: The Staff's value for fuel oil should be relied on since it represents a price that Aquila actually paid in its most recent purchase. Alternatively, an actual average inventory cost could be used since that also represents prices actually paid by Aquila. A market price on an arbitrarily selected date, and at which Aquila has made no actual fuel oil purchases, should not be used, as it does not reflect the actual cost to Aquila of using fuel oil in its operations. The fuel oil inventories Aquila has are sufficient to last at least two years at the normal rate of usage, therefore the cost of the inventory is very likely representative of what fuel oil will cost Aquila during the period that rates issued in this rate case will be in effect.

[135] Staff witness Hyneman Direct, p. 14, ll. 5–9; [steam] p. 13, ll. 13-17). In fact, Aquila does not reflect the results (gains and losses) of its hedging program in its monthly reports submitted to the Staff under the currently effective IEC program. The Staff understood that this was to be done pursuant to the Stipulation And Agreement, but Aquila has a different interpretation. (Hyneman Direct, p. 14, ll. 10 – p. 15, l. 5; [steam] p. 13, ll. 13 – p. 14, l. 14).
[136] Staff witness Hyneman Direct, p. 18, l. 19 - p. 19, l. 4 [steam] p. 18, ll. 6-14.

HC

Aquila witness Korte criticizes the Staff's approach to developing the price of fuel oil input into the production cost model.[137] In particular, Mr. Korte was critical of Staff's use of the price at which Aquila last purchased fuel oil (500,000 gallons at $1.622 per gallon), which occurred in November 2004. Aquila witness Korte argues the price is too low and is outdated, as demonstrated by the fact that one year later, the price of #2 fuel oil (0.2% sulfur content, New York Barge spot) had risen by about 25%, from $1.5955 to $1.9955 per gallon. Aquila witness Korte then claims this "erroneous" price could have an adverse effect on the fuel model.[138]

As is its normal practice, the Staff based the price it supports on actual experience. It is significant, though, that Aquila has not purchased any fuel oil in well over a year. The reason for this is two-fold: a) Aquila has a considerable amount of fuel in inventory from which it is able to draw, and b) Aquila, in fact, uses very little fuel oil.[139] Because fuel oil is inventoried, the Staff combines price at which the latest purchase is made with the average price of the oil already in inventory. After the latest purchase is run through the inventory in this manner, it turns out that the market price of that purchase has a relatively minor influence on the price of fuel oil. For example, blending Aquila's most recent purchase price of $1.622/gallon with the pre-purchase average inventoried price yielded a revised inventoried price of only about $1 per gallon.[140] As Staff witness Vesely notes, "the Staff's price of $1.622 per gallon I am sponsoring is, if anything, too high and not too low as suggested by Mr. Korte."[141]

Added to this effect is the fact that Aquila does not use much fuel oil. The fuel's use is limited to a rarely used peaking unit at the Nevada facility, and as a back-up fuel at Aquila's Greenwood facility. When viewed as stand-alone systems, both Aquila Networks—L&P and

[137] Aquila witness Korte Rebuttal, p. 13, l. 8 – p. 14, l. 2.
[138] Aquila witness Korte Rebuttal, p. 13, l. 22 - p.14, l. 2.
[139] Staff witness Vesely Surrebuttal, p. 8 - p. 9.
[140] Staff witness Vesely Surrebuttal, p. 8.
[141] Staff witness Vesely Surrebuttal, p. 8 - p. 9.

Aquila Networks—MPS have enough fuel oil in inventory to last two years. Furthermore, assuming joint dispatch of the Aquila Networks—MPS and Aquila Networks-L&P systems, the operating reality, the Staff's fuel model results show zero usage of fuel oil to meet the load forecast.[142] Under such circumstances, what is the rationale for assuming that Aquila will rush out and purchase fuel oil at the relatively high price currently prevailing in the market?

For the reasons stated, the Staff's fuel oil price of $1.622 per gallon is reasonable and appropriate. The Commission should reject Aquila's suggested market price of approximately $2 per gallon.

19. 20 West 9th (Electric and Steam): What expense for Aquila's 20 West 9th headquarters/annex should be used in setting Aquila Networks-MPS's and Aquila Networks-L&P's rates?

Staff Position: The Staff has accepted Aquila's proposal to eliminate the costs of the downtown Kansas City headquarters building that is associated with excess office space. The excess office space was determined in accordance with industry standards.

For the same reasons set out under Issue 10 above, which is the rate base cost aspect of this same issue, the Staff and Aquila agree the costs of this office building associated with the excess office space, based on industry standards for office space costs, should not be treated as expenses recoverable from ratepayers. Likewise, the Commission should not include the costs associated with excess office space at Aquila's office space at 20 W. 9th in downtown Kansas City, Missouri as expenses recoverable from ratepayers when setting rates for Aquila Networks—MPS and Aquila Networks—L&P in these cases.

20. SERP(Electric and Steam): Are the costs of Aquila's supplemental employee retirement plan (SERP) an expense Aquila should recover from Aquila Networks-MPS and Aquila Networks-L&P ratepayers?

Staff Position: The costs of Aquila's SERP should not be included in rates. While a basic SERP is designed to restore the benefits on highly-compensated employees' pension benefit payments that have been reduced due to the Internal Revenue Service's

[142] Staff witness Vesely Surrebuttal, p. 9 - p. 10.

> compensation limits, Aquila's SERP goes way beyond this simple goal. Aquila's SERP includes executive officer "golden parachutes" type protections that seek only to prevent a change in control of the ownership of Aquila. Aquila's SERP includes benefits that are based, in part, on executive bonuses which are paid for work on nonregulated activities and are not included in rates. In addition, Aquila's SERP not only includes the basic restoration benefit, the bonus benefit, but also an additional supplemental executive officer benefit. Finally, because of the size of Aquila's SERP it accounts for the SERP under the same accounting rules as its regular all-employee pension plan. However, the dollars included in rates for the regular pension plan are invested in the pension fund and the financial return on this fund serves to reduce the cost of the pension plan to Aquila's ratepayers. Aquila's SERP is an unfunded plan. Because it is an unfunded plan, the SERP expense dollars collected from the ratepayers would not be included in a pension fund but could be used by Aquila for any reason, including the payment of additional executive bonuses. This unfunded nature of the SERP serves to increase the cost of the SERP to Aquila's ratepayers because there is not reduction in SERP expense from the financial return on the plan assets.

The costs of Aquila's SERP should not be included in rates. While a basic SERP is designed to restore the benefits on highly-compensated employees' pension benefit payments that have been reduced due to the Internal Revenue Service's compensation limits, Aquila's SERP goes way beyond this simple goal. The purpose of Aquila's Supplemental Executive Retirement Plan, as described in the plan itself, is to "provide specified benefits to a select group of management and highly compensated employees." The Staff opposes cost of service recovery for Aquila Networks—MPS and Aquila Networks—L&P shares of Aquila's SERP for two primary reasons. First, Aquila's SERP includes a "change in control" provision. This is a "golden parachute" provision that is designed to prevent a change in control of the ownership of Aquila. Specifically, this provision requires a funding of the plan in the event of a change in ownership as defined in the plan.[143] This provision serves no purpose but to protect the financial interests of Aquila's senior executives, especially its Chief Executive Officer, Mr. Richard C. Green. Under Aquila's definition, a change in control also occurs when there is a change in

[143] Staff witness Hyneman Direct, p. 33, ll. 14-21.

Aquila's board of directors, or if there is a merger and Mr. Richard Green does not continue as a member of the board of directors.[144]

A change in control might benefit ratepayers. Aquila's Missouri ratepayers could benefit if a more efficiently-run utility acquires Aquila's Missouri utility assets and provides safe and reliable utility service at a lower cost to its customers.[145] The change in control provision in Aquila's SERP seeks to prevent any such acquisition. Additionally, this provision is designed to deter another company to acquiring Aquila, also acting as a type of employment security for Aquila's top executives and other highly compensated employees.[146] While this protection may benefit Aquila's executives, and perhaps its shareholders, this SERP is not a cost necessary to run a utility company.[147]

Second, the Staff opposes Aquila's SERP because it includes a bonus benefit in the form of a supplemental executive officer benefit which is designed to provide executives additional retirement benefits based on executives' bonus pay.[148]

Along with the foregoing primary reasons, SERP costs should not be born by ratepayers is Aquila's SERP costs include executive bonuses that were awarded, and are currently being awarded, to Aquila's executives for work on nonregulated activities and Aquila has made no effort to eliminate those costs. Aquila's Form DEF 14A filed with the Securities and Exchange Commission (SEC) on April 15, 2003, lists bonus payments made to Aquila's eight highest-compensated employees. These bonuses average $2.3 million. Other Aquila

---

[144] Staff witness Hyneman Surrebuttal, p. 18, l. 22 - p. 19, l. 3.
[145] Staff witness Hyneman Direct, p. 18, ll. 22 - p. 19, l. 2.
[146] Staff witness Hyneman Direct, p. 33, ll. 21-23.
[147] Staff witness Hyneman Direct, p. 35, ll. 24-26.
[148] Staff witness Hyneman Direct, p. 34, ll. 3-7.

employees do not receive retirement benefits based on bonuses and these proposed supplemental retirement benefits for executives based on bonuses should not be paid by ratepayers.[149]

Q. Not only should the costs not be included in expenses for the foregoing reasons, there is concern that Aquila does not actually fund its SERP. If Aquila were to be allowed to recover these costs in rates, these dollars (collected under FAS 87 over the actual SERP payments made) would represent cost-free funds to Aquila to use however it chooses. Aquila could take the funds, investment them in financial securities, and retain the return on these funds as nonregulated income because there are no guarantees Aquila will ever make any SERP payments to retired executives.[150]

21. L&P Transition Costs (Electric and Steam): Are the transition costs of the merger of St. Joseph Light & Power Company with Aquila an expense Aquila should recover from Aquila Networks-MPS and Aquila Networks-L&P ratepayers?

Staff Position: Yes, to the extent they exceed merger savings. Aquila should be allowed to recover in rates prudently incurred and reasonable costs to transition the operations of St. Joseph Light & Power Company into Aquila; however, this case that merger savings significantly exceed the transition costs.

Transaction costs and transition costs differ. To the extent that transition costs exceed merger savings, these costs are an expense that may be recovered in rates. Transaction costs are defined as expenses that are incurred by combining companies and usually include such costs as fees charged by the investment bankers related to the transaction; fees for outside consultants for legal, accounting and public relations services. Transition costs, on the other hand, include costs for combining accounting systems, reprogramming computers, consolidating procedures and practices, customer service centers, and human resources as well as other merger-related costs directly associated with the acquisition.

---

[149] Staff witness Hyneman Surrebuttal, p. 16, ll. 6-21.
[150] 9-19.

AARP argues that merger transition costs should not be included in Aquila's cost of service unless it can be shown that the merger resulted in savings at least as great as the costs recovered in rates.[151] Staff agrees with this position and, in these cases, has determined that the merger savings are greater than the costs, that savings are directly related to the merger and that the savings could not have been achieved absent the merger. Staff has reviewed sufficient documentation to include approximately $4.6 million of transition costs in rates. Transition costs are costs to integrate the combining companies.[152]

For example, examination of the fuel and purchased power costs of both of Aquila's Missouri divisions, Aquila Networks—MPS and Aquila Networks—L&P indicates there is a savings much greater than the level of transition costs proposed by either Aquila or the Staff in these cases. Also, it is evident that the joint dispatch savings are related to the merger and could not have been obtained otherwise.[153]

Importantly, transition costs are not considered to be part of the acquisition premium. Staff witness Hyneman explained in his rebuttal testimony in Case No. EM-2002-292 that transition costs are not included in merger premiums:

> The term "merger premium" as commonly used, can mean either the purchase price in excess of the <u>book value</u> or the purchase price in excess of the <u>market value</u> of the net assets acquired. Unless otherwise indicated, when used in the Staff's testimony in this proceeding, the term merger premium means the purchase price in excess of the <u>book value</u> of the net assets acquired. Both the merger premium and merger transaction costs make up the acquisition adjustment.[154]

The Office of the Public Counsel suggests Aquila did not have Commission authority to defer transition costs for future recovery. Staff disagrees because, in rejecting Aquila's

[151] AARP witness Effron Rebuttal, p. 11.
[152] Staff witness Hyneman, Surrebuttal, p. 22, l. 1.
[153] Staff witness Elliott Direct, Schedule 4.
[154] Staff witness Hyneman Surrebuttal, p. 24, ll. 4-14.

regulatory plan, the Commission reserved the right to consider in a later proceeding the ratemaking treatment to be afforded the transactions involved here.

In summary, Aquila should be allowed to recover prudently incurred and reasonable transition costs to merge the operations of St. Joseph Light & Power Company into Aquila and, in this instance, the merger savings significantly exceed the transition costs.

22. FAS 106 Funding (Electric and Steam): How should Aquila's FAS 106 funding deficiency be addressed in this case?

Alternatively,

FAS 106 Funding: How should Aquila's FAS 106 funding deficiency, if any, be addressed in this case?

Staff Position: Staff has determined the funding deficiency to be ($2,982,099) and ($4,035,431) for the MPS and L&P divisions respectively through year-end 2005. Aquila made a contribution to its VEBA trust in this amount on December 14, 2005.. An additional annual funding requirement of $144,763 will be required starting with effective date of rates set in this case if the Staff's recommended recovery for the St. Joseph Light & Power merger transition costs is adopted by the Commission. The transition costs, recommended for recovery, include $1,447,631, amortized over 10 years, related to a FAS 106 curtailment in 2001 for the L&P division.

FAS 106 is the Financial Accounting Standards Board (FASB) approved accrual accounting method used for financial statement recognition of annual Other Post-Retirement Employee Benefit (OPEB) costs over the service life of employees.[155] Effective August 28, 1994 section 386.315 RSMo requires the use of FAS 106 for OPEB costs used in setting rates. After section 386.315 became effective the Staff recommended the use of FAS 106 for determining ratemaking recovery for OPEB costs. Before then, OPEB costs were based on a "cash" or pay as you go" basis for ratemaking purposes, which meant a utility's actual paid claims for OPEB cost for current retirees were included for recovery for ratemaking purposes.[156]

[155] Staff witness Traxler Direct, p. 7, ll. 19-22.
[156] Staff witness Traxler Direct, p. 8, ll. 1-12.

OPEB costs based on FAS 106 were adopted for the former St. Joseph Light & Power Co. (SJLP) Company in Case No. ER-94-163 and for what is now Aquila Networks—MPS in Case No. 97-394).

Section 386.315.2 RSMo 2000 requires an external funding mechanism that restricts disbursements for qualified retiree benefits. The recognition of FAS 106 for ratemaking purposes is conditioned on a requirement that annual FAS 106 costs collected in rates be funded in a separate funding mechanism to be used solely for the payment of OPEB benefit costs to retirees.[157] When Staff witness Traxler filed his direct testimony in these cases, Aquila was not in compliance with the funding requirement of Section 386.315 RSMo. Aquila admitted to being deficient in the funding at that time.[158]

The Staff determined the funding deficiency to be $2,982,099 and $4,035,431 for the Aquila Networks—MPS and Aquila Networks—L&P divisions respectively, through year-end 2005. The funding deficiency of $2,982,099 represents the accumulated difference between the annual FAS 106 costs and the amounts Aquila actual funded for Aquila Networks—MPS since March, 1998. The funding deficiency of ($4,035,431) represents the accumulated difference between the annual FAS 106 costs and the amounts Aquila actual funded for Aquila Networks—L&P since January of 2001().[159] Aquila agreed with the Staff to make an immediate contribution of $4.8 million and an additional contribution by the end of 2005 to address the funding deficiency, and the Staff understands Aquila has carried out that agreement, making the second contribution to its VEBA trust on December 14, 2005.[160]

---

[157] Staff witness Traxler Direct, p. ll. 1-5.
[158] Staff witness Traxler Direct, p. 9, l. 16 - p. 11, l. 13.
[159] Staff witness Traxler Direct, p. 11, l. 1-7.
[160] Staff witness Traxler Direct, p. 11, ll. 11-13.

An additional annual funding requirement of $144,763 will be required starting with effective date of rates set in this case, if the Staff's recommended recovery for the St. Joseph Light & Power merger transition costs is adopted by the Commission.[161] The transition costs, recommended for recovery, include $1,447,631, amortized over 10 years, related to a FAS 106 curtailment in 2001 for Aquila Networks—L&P.[162] The Staff does not agree with Public Counsel Witness Ted Robertson that the amount of $1,447,631 is due immediately.

23. FAS 106 Funding (Electric and Steam): Should the computation of Aquila's FAS 106 funding deficiency include the time value of the delay in the contributions to the fund?

Alternatively,

FAS 106 Funding: Should the computation of Aquila's FAS 106 funding deficiency, if any, include the time value of the delay in the contributions to the fund?

Staff Position: Yes. The Staff has restated Aquila's 2005 FAS 106 cost to eliminate the lost investment earnings (time value of money) resulting from Aquila's failure to make all required FAS 106 annual contributions in prior years. The Staff disagrees with the "time value of money" adjustment proposed by AARP witness, David Effron. Staff views Mr. Effron's adjustment as a penalty to Aquila for failing to fund its FAS 106 obligation. Any penalty should only be addressed in the complaint docket initiated by OPC, Case No. EC–2006-0171.

The Staff has restated Aquila's 2005 FAS 106 cost to eliminate the lost investment earnings (time value of money) resulting from Aquila's failure to make all required FAS 106 annual contributions in prior years. The Staff disagrees with the "time value of money" adjustment proposed by AARP witness, David Effron. The Staff views Mr. Effron's adjustment as a penalty to Aquila for failing to fund its FAS 106 obligation. The specific flaws in Mr. Effron's proposal are explained by Staff witness Traxler in his surrebuttal testimony.[163] of). Any

---

[161] Staff witness Traxler Direct, p. 11 l. 14 - p. 13, l. 7.
[162] Staff witness Traxler Direct, p. 11 l. 14 - p. 13, l. 7.
[163] Staff witness Traxler Surrebuttal, p. 3, l. 18 - p. 5, l. 14.

penalty by the Commission should be addressed in Commission Case No. EC–2006-0171, Public Counsel's complaint against Aquila for not timely funding Aquila's FAS 106 OPEB obligations.

24. South Harper Expenses (Electric): What expenses related to the South Harper facility should Aquila recover from Aquila Networks-MPS's ratepayers?

Staff Position: Only those expenses Aquila prudently incurred.

The Staff's position on this issue is the counterpart of its position on the inclusion of South Harper costs in rate base as set out above under Issue 5. As stated there, because the facility is unlawful, Aquila should recover from Aquila Networks—MPS ratepayers none of the expenses it has incurred regarding that facility. However, the Staff believes the Commission should recognize the benefit to ratepayers of the electricity Aquila Networks—MPS is obtaining from the unlawful South Harper facility. The Staff has used the expenses associated with acquiring a site and building three combustion turbine units having a total capacity of 315 MW as a substitute for the unlawful South Harper facility. For the expenses associated with acquiring that site and acquiring and installing those combustion turbine units, the Staff has used the actual expenses, from the standpoint of its regulated division Aquila Networks—MPA, Aquila prudently incurred in building its South Harper facility.[164]

a. <u>PILOTS:</u> Should the cost of payments-in-lieu-of-taxes (PILOTs) made as part of a Chapter 100 financing arrangement in connection with the South Harper facility be included as an expense Aquila recovers from Aquila Networks-MPS's ratepayers?

Staff Position: Staff believes that Chapter 100 financing is the least cost alternative compared to paying property taxes of the South Harper plant. Company and the City of Peculiar should have properly entered into an agreement for Chapter 100 financing. Therefore Staff will continue to include the cost of Chapter 100 financing in lieu of property taxes.

[164] Staff witness Featherstone Direct, p. 6, l. 21 - p. 7, l. 3, p. 51, ll. 20-23; Staff witness Williams Direct, p. 4, ll. 17-21, p. 14, l. 8 - p. 18, l.14; Staff witness Williams Surrebuttal, p. 20, l. 13 - p. 21, l. 13.

As discussed above under Issues 5, 5a, 5b, 5c, 5d, 5e, 5f and 13 above, the Staff has used costs and expenses Aquila has prudently incurred in acquiring its South Harper site and in acquiring and installing three utility-owned combustion turbine units capable of generating about 315 MW on that site as a proxy for about 300 MW of the five combustion turbine units having a total capacity of 500 MW the Staff asserts Aquila should own.

As stated above in the prudence subpart of the statutory requirement and applicable standards section of this brief, it is the Staff's position prudent financing of the South Harper facility is through a Chapter 100 financing and any failure of Aquila to effectuate such a Chapter 100 financing would be due to Aquila's imprudence. The benefit of a Chapter 100 financing is that the payments made in lieu of taxes in such an arrangement and the costs of entering into it are less than the taxes would have been, resulting in savings. Staff witness Williams has well-stated the Staff's position in his surrebuttal testimony:

> Staff believes a Chapter 100 financing arrangement is the most cost effective alternative for Aquila, and ultimately for ratepayers. Staff, therefore, believes Aquila should have entered into an agreement for Chapter 100 financing and taken the steps necessary to effectuate the financing as soon as it could have done so. Staff further believes that had Aquila and the City of Peculiar acted in a timely fashion and met all legal requirements to accomplish the transaction there would have been no adverse consequences to either Aquila and/or the City of Peculiar. Therefore, Staff believes that, in lieu property taxes for the South Harper facility, the costs of the Chapter 100 financing should remain in the rate case as the reasonable and prudent costs.[165]

b. <u>Property Taxes:</u> Should the cost of property taxes on the South Harper facility be included as an expense Aquila recovers from Aquila Networks-MPS's ratepayers?

Staff Position: Staff believes that Chapter 100 financing is the least cost alternative compared to paying property taxes of the South Harper plant. Company and the City of Peculiar should have properly entered into an agreement for Chapter 100 financing. Therefore Staff will continue to include the cost of Chapter 100 financing in lieu of property taxes.

[165] Staff witness Williams Surrebuttal, p. 16, ll. 12-20.

This issue is related to the preceding issue and the Staff's argument there is equally applicable here. Further, property taxes on the facility are not known and measurable. The following portions of the testimony of Staff witness Williams support the Staff's position and that it is consistent with Commission orders in other cases:

> Q. Mr. Rooney in his rebuttal testimony starting on page 4 line 17 states, "Staff should not merely exclude the PILOT payments, but should replace the PILOT payment with an estimate of the property taxes that would occur in the absence of the Chapter 100." Does Staff agree?
>
> A. No. Staff in its annualization of property taxes does not include plant under construction in its calculation of annualized property taxes. Staff calculated property taxes based upon the actual property taxes paid as a ratio of the plant-in-service as of December 31, 2004, the end of the Staff's test year. This calculation of annualized property taxes is based on the value of the property owned as of January 1, 2005, which is the date property is assessed for taxing purposes. This relationship reflects how tax payments are actually determined by the taxing authorities. Any property taxes paid on Construction Work In Progress (CWIP) would be capitalized as part of the construction cost to build the plant. Staff's annualization of property taxes does not recognize the additional plant and or retirements that occur after January 1 of the current year in the calculation of property taxes.
>
> Any property taxes on newly constructed plant will not be assessed as plant in service until January 1 following the year of completion. The taxing authority will assess the value as January 1 the actual taxes will not be paid until December 31 of that year, well over a year after the plant is completed. Staff believes that to include the additions and retirements in the calculation of the property taxes is unreasonable, as they are not known and measurable at the current time.
>
> Additionally Staff believes that if property taxes were incurred for 2004 and 2005 that they should not be allowed. Staff believes that Company could have obtained the proper Chapter 100 financing approval during 2004, thereby insuring the least cost alternative.
>
> Q. When will Aquila pay property taxes on the South Harper facility as plant in service if it does not take advantage of Chapter 100 financing?
>
> A. Any property taxes on South Harper facility which was placed in service during July 2005 and classified as plant in service will not have to be paid until December 31, 2006, a year and half after the plant became fully operational. South Harper, as plant in service, will be assessed as real property by taxing

authorities on January 1, 2006 if it does not have exemption from Chapter 100 financing status.

Q. Has the issue of when to include property taxes as expense in the case been presented to the Commission in the past? 22

A. Yes. The Commission has excluded property taxes on newly constructed plant previously in rate cases because they were not part of that year's assessment for property tax payments. The Commission has consistently made the distinction between plant in service assessed at January 1 of a given year and plant that was classified as construction of that same year. The Commission has treated property taxes paid on construction plant as capitalized in the year of construction. The next year, when the newly completed asset is plant in service, it is assessed on January 1 with the taxes paid December 31.

The Commission took this position on Empire's State Line Combined Cycle Unit in Case No. ER-2001-0299. The Commission also ordered this treatment in the 1996 Missouri Gas Energy rate case, Case No. GR-96-285 and St. Louis County Water Company rate case, Case No. WR-2000-0844.

The Commission, in Case No. ER-2001-299, stated in its Report and Order on page 26:

> The Commission finds that the arguments of Staff and Praxair regarding the property tax issue are persuasive. Staff's estimate of property taxes is based upon known and measurable factors and preserves appropriate matching of all revenue requirements, and is consistent with the Commission's past practice. Empire's position is not based upon known and measurable factors. In addition, it would be unreasonable for the Company to start charging ratepayers in October 2001 for (estimated) costs that the Company will not start paying until January 2002. The Commission determines that it will not increase the total company revenue requirement to account for property taxes on the additional plant in service.

Q. What is Staff's position concerning the property taxes versus Chapter 100 financing costs if is unable to obtain new Chapter 100 financing?

A. Staff believes that the current costs included in the current rate case which includes the upfront costs/fees and the PILOT payments should remain in the case.[166]

c. <u>Fees:</u> Should the amortization of costs of fee and professional services payments Aquila made to or for the benefit of the City of Peculiar for

[166] Staff witness Williams Surrebuttal, p. 17, l. 18 - p. 19, l. 28.

Aquila to enter into a Chapter 100 financing arrangement with the City of Peculiar in connection with the South Harper facility be included as an expense Aquila recovers from Aquila Networks-MPS's ratepayers?

Staff Position: Reasonable and prudent fees and professional services payments relating to the Chapter 100 financing should be included in Aquila's Networks-MPS rate structure.

No. As set out under Issue 5c, rather than being amortized as an expense recovered from ratepayers, reasonable and prudent fees and professional service payments related to a Chapter 100 financing should be included in rate base. The Staff has used those reasonable and prudent fees Aquila has incurred with regard to its Chapter 100 financing for the South Harper facility as a proxy for costs and expenses associated with three of the five combustion turbines the Staff asserts Aquila should own for replacement of the capacity it lost with the expiration of Aquila's purchased power agreement with Calpine on May 31, 2005.

25. Corporate Restructuring (Electric and Steam): Should there be a disallowance of corporate restructuring expenses for Aquila Networks-MPS and Aquila Networks-L&P and, if so, in what amount?

Staff Position: The Staff has made an adjustment to allocate a certain percentage of the costs of selected corporate overhead departments to restructuring activities. Aquila has accepted the Staff's proposed adjustment.

The Staff has made an adjustment to allocate a certain percentage of the costs of selected corporate overhead departments to restructuring activities. The Staff proposes an allocation of fifty percent (50%) of the costs of certain departments for restructuring activities.[167]

Aquila's restructuring activities are directed at restoring Aquila's financial stability. Costs related to correcting the financial impact of poor management decisions concerning nonregulated businesses should not be born by ratepayers.[168] Staff witness

[167] Staff witness Hyneman Direct, p. 20, ll. 15-20.
[168] Staff witness Hyneman Direct, p. 20, ll. 25-29.

Hyneman selected the departments to be allocated to corporate restructuring by applying knowledge gained in numerous rate case audits and by reviewing, among other things, board of director minutes, Aquila's annual reports, SEC filings, press releases, responses to data requests in this and previous cases.[169]

Aquila has not contested the Staff's proposed adjustment, which the Commission should implement.

26. Low Income Weatherization (Electric): Should an amount for low-income customer weatherization programs be included in Aquila Networks-MPS's and Aquila Networks-L&P's cost of service? If so, what amount should be included, how should it be funded, which programs should be included, and what kind of review should be ordered by the Commission?

Staff Position: The low-income weatherization program funding should be funded at $108,000 as proposed by DNR. The funding should be paid 50% by Aquila ratepayers and 50% by Aquila shareholders. Aquila should be ordered to file a report regarding this program within the parameters and time frame suggested in Ms. Mantle's testimony.

A. The low-income weatherization program funding should be funded at $108,000 as proposed by DNR Witness Anita Randolph and the funding should be paid 50% by Aquila ratepayers and 50% by Aquila shareholders. It is inappropriate to continuously fund a program or to increase funding for a program without reviewing the program. While there is little doubt as to the energy savings of such a program, it is also necessary to review the process side of these programs for efficiencies. Therefore, the Commission should order Aquila, along with the agencies to which it provides funding, to review the processes and procedures used to determine if there are any improvements that can be made. The Commission should order Aquila to file such a report with the Commission within 180 days of the effective date of the Commission's Report and Order in this case.[170]

---

[169] Staff witness Hyneman Direct, p. 23, l. 26 - p. 24, l. 5.
[170] Staff witness Mantle Rebuttal, p. 2, l. 10 - p. 3, l. 2.

The Commission has broad authority to approve experimental rates for the purpose of acquiring data needed to fix just and reasonable rates.[171]

The Staff submits the Commission should approve the low income weatherization program under the terms and conditions stated by Ms. Mantle.

27. Demand Side Management (Electric): Should an amount for energy efficiency services to residential and commercial customers be included in Aquila Networks-MPS's and Aquila Networks-L&P's cost of service? If so, what amount should be included, how should it be funded, which programs should be included?

Staff Position: While Staff has some concerns about the funding levels for this program, Staff supports increasing the funding for the Energy Start Change a Light, Change the World from $20,000 to $40,000 with 50% from Aquila ratepayers and 50% from Aquila shareholders. Staff recommends that the Commission approve the Commercial Audit program at the $75,000 level with 50% from Aquila ratepayers and 50% from Aquila shareholders.

Staff opposes the proposed energy efficiency program due to Ms. Randolph's failure to fully justify this program and to explain why Aquila ratepayers or Aquila shareholders should pay for it when there is a real possibility that the Aquila's ratepayers would not receive all of the benefits from the program.

Change a Light, Change the World Program

While the Staff has some concerns about the funding levels for the Change a Light, Change the World Program due to Ms. Randolph's failure to justify why the funding spent on this program should be increased from $20,000 to $40,000, the Staff also believes there are energy efficiencies to be gained from replacing standard light bulbs with high efficiency light bulbs.[172]

[171]See *In the matter of the investigation into all issues concerning the provision of extended area service (EAS) in the State of Missouri under Commission Rule 4 CSR 240-30.030,* 29 Mo. P.SC.(N.S.) 75, 106 (1987) citing to *State ex rel. Watts Engineering Company v. Missouri Public Service Commission*, 191 S.W. 412 (Mo. banc 1917); *State ex rel. Washington University v. Missouri Public Service Commission,* 272 S.W. 971 (Mo. banc 1925), *State ex rel. City of St. Louis v. Missouri Public Service Commission,* 296 S.W. 998 (Mo. banc 1927); and *State ex rel.. Laclede Gas Company v. Missouri Public Service Commission*, 535 S.W.2d 561 (Mo. App. 1976).
[172] Staff witness Mantle Rebuttal, p. 3, ll. 16-20.

The Staff did a quick review of a similar program Aquila included in its recent resource plan it submitted to the Staff as mandated by the Commission in another case. Aquila estimated this similar program it proposed would be more cost effective when funded at a much higher level.[173]

The Staff supports increasing the funding for the Energy Start Change a Light, Change the World from $20,000 to $40,000, with 50% from Aquila ratepayers and 50% from Aquila shareholders. Aquila did not request funding for this program in this rate case. Had Aquila desired to propose funding for this program or other programs it should have presented them in the direct testimony of its witnesses in this case. Commission Rule 4 CSR 240-2.130 (7) so requires. The Commission should disregard Aquila's attempt to first suggest other programs in its "Aquila Networks State of Missouri Electric Demand-Side Management Plan, 2006-2010" found in the surrebuttal testimony of its witness Matt Daunis. The Staff requests the Commission either grant the Staff's objection to its admissibility and strike it from the prefiled testimony or, if it allows the plan into evidence, limit the use which may be made of it to respond to DNR witness Randolph's rebuttal testimony, or to allow the Staff and any other party the opportunity to respond. The Staff proposes these options in the Staff's Motion In Limine filed on January 9, 2006.[174]

Commercial Audit Program

The Commercial Audit program proposed by DNR witness Randolph is similar to audit programs in currently in various stages of implementation by other investor owned utilities in Missouri. Ms. Randolph failed to provide any justification for the amount of the funding or give an estimate of the impact of her proposed program on Aquila's system. The Staff found a similar

[173] Staff witness Mantle Rebuttal Testimony, p. 3, l. 6 - p. 4, l. 9.
[174] Aquila witness Daunis Surrebuttal, p. 2, ll. 11-15.

program in Aquila's resource plan and the $75,000 requested by Ms. Randolph is substantially lower. The Staff recommends the Commission approve the Commercial Audit program at the $75,000 level with 50% from Aquila ratepayers and 50% from Aquila shareholders.[175]

Residential Efficiency Program

The Staff opposes the energy efficiency program DNR proposes due to Ms. Randolph's failure to fully justify this program and to explain why Aquila ratepayers or Aquila shareholders should pay for it when there is a real possibility that the Aquila's ratepayers would not receive all of the benefits from the program. Under this DNR proposal, Aquila would fund the training and certification of private sector contractors who would then provide a comprehensive evaluation of the energy efficiency of a home to determine which improvements would provide the homeowner with the most energy efficiency benefits. Such contractors could work for whoever would hire them, including consumers who are not Aquila ratepayers, and the contractors could leave and relocate anywhere to offer their services for hire.[176]

For the foregoing reasons, the Staff opposes DNR's Residential Energy Efficiency Program.

CLASS COST OF SERVICE/RATE DESIGN

28. Rate Design/Cost-of-Service (Electric): How should the Commission determine what, if any, shifts in class revenues for Aquila Networks-MPS and Aquila Networks-L&P should be made in this case?

Staff Position: The Commission should determine what revenue shifts, if any, are appropriate to better align class revenues with class cost of service based on the Staff's class cost-of-service model, the Staff's allocation factors and the revenues and costs for each division determined to be reasonable and prudent by the Commission in this case. The Commission should consider the margin of error in the class cost-of-service studies

[175] Staff witness Mantle Surrebuttal, p. 4, ll. 10-22.
[176] Staff witness Mantle Rebuttal Testimony, p. 4, ll. 1-13.

and the overall impact on customers of both shifts in class revenues and overall increases in revenues in determining appropriate revenue shifts.

As discussed in the all relevant factors subpart of the statutory requirement and applicable standards section of this brief, in setting rates the Commission must consider all relevant factors. As supported by the 1986 decision the Missouri Supreme Court, *en banc*, mentioned in that subpart of this brief, Commission approval of different rates for different customers, "rate design," requires sufficient findings of fact to support the rates.[177]

One of the factors relevant to new rates is any discrepancy between the revenues a company receives from a group of similarly-situated group of customers—a class of customers—and the costs the company incurs in serving those customers.[178]

Class cost-of-service studies are performed to examine the relationship between the revenues received from each class and the costs to serve each class. Class cost-of-service studies have as inputs class load data, cost data class revenue data and special distribution cost studies. In Case No. EO-2002-0384 Aquila collected load data on electric customer usage, calculated hourly weather-normalized class loads, and performed a number of special distribution cost studies. Each party in that case performed class cost-of-service studies using the same cost and revenue data from Case No. ER-2004-0034 and the foregoing information as inputs into their studies. The parties' study results differed only due to differences in the methodologies each used for determining allocation factors.

In Case No. ER-2005-0436 the Staff used the same allocation factors and inputs it used in Case No. EO-2002-384 to perform an updated class cost-of-service study, except it has used as inputs cost and revenue data based on the Staff's filed positions in this case.[179] Because the

[177] *State ex rel. Monsanto Company v. Public Service Commission*, 716 S.W.2d 791 (Mo. banc 1986).
[178] Staff witness Busch Direct, p. 4, l. 1-15; Staff witness Watkins Direct, p. 2, ll. 10-14, p. 3, ll. 1-7.
[179] Staff witness Busch Direct, p. 3, l. 2-23.

Staff's most recent class cost-of-service study results differ so much from those it developed in Case No. EO-2002-384 due to the significant factors mentioned following, as it did in Aquila's most recent class cost of service / rate design case, Case No. EO-2002-384, the Staff advocates the Commission rely on cost allocation methods based on the allocation factors used in the class cost-of-service studies filed in Case No. EO-2002-384 together with the more recent cost and class revenue data it determines in this case, from the Test Year 2004 updated through June 30, 2005 and trued-up through October 31, 2005, in determining any interclass revenue shifts it determines are appropriate to better match, class-by-class, the revenues that should be collected from the class with the costs Aquila prudently incurs to serve the class.

In his direct testimony Staff witness James A. Busch identifies the changes in the distribution of costs between the class cost-of-service study the Staff presented in Case No. EO-2002-384 and the class cost-of-service study it presents here.[180] Production costs increased markedly due to increases in generating capacity, replacement of certain generating capacity with higher cost capacity and substantial increases in fuel costs.[181]

Additionally, Case No. ER-2004-0034 resulted in an interim energy charge which included part of Aquila's energy costs; however, the only those energy costs included in permanent rates in Case No. ER-2004-0034 were considered by the parties, including the Staff, in Case No. EO-2002-384. In this case, however, Aquila has not requested an IEC; therefore, the Staff included all energy-related costs in its updated class cost-of-service study. An accurate depiction of the need for class revenue shifts may only be seen when all relevant costs are included in the class cost-of-service study, as they have in the study the Staff is presenting in this

[180] Staff witness Busch Direct, Schedule 2-1 & 2-2.
[181] Staff witness Watkins Surrebuttal, p. 3, ll. 14-17.

case.[182]While the Staff has presented class cost-of-service study results in this case based on the Staff's allocation methods and filed cost and revenue data, again, as it did in Case No. EO-2002-384, the Staff recommends the Commission determine in Case No. EO-2002-384 the issue of which class cost-of-service study allocation ***methods*** should be used for generating the class cost-of-service study ***results*** the Commission considers as a ***relevant factor*** in setting Aquila's rates in Case No. ER-2005-0436. It was the collection of the class load data, computation of the hourly weather-normalized class loads, and performing the special distribution cost studies used as inputs in calculating the allocation factors which took so much time to obtain, not the calculations of the allocation factors or the calculation of the cost-of-service study results.

The Staff specifically recommends the Commission determine the need for any shifts in class revenue responsibility by:

(a) First, determining the overall revenue requirement for Aquila Networks—MPS and the overall revenue requirement for Aquila Networks—L&P on an issue-by-issue basis.

(b) Second, input those results into the Staff's class cost-of-service model to determine the cost of serving each class and the revenue shifts required to equate revenues with cost of service.

(c) Third, evaluate the need for any revenue shifts by considering the following:

  (i) Consider only the magnitude of the shifts required for the "major" classes---Residential (RES), Small General Service (SGS), Large General Service (LGS), and Large Power Service (LPS). No revenue shifts should be made to the other classes.

[182] Staff witness Watkins Surrebuttal, p. 3, l. 18 - p. 4, l. 2.

(ii) If none of these shifts exceed the accuracy of the model, no shifts should be made. The Staff has traditionally used 5% as a rule-of-thumb when the load research data is for the same time period as the cost and revenue data. There will be a higher level of error in this case because neither the cost and revenue data from Case No. ER-2004-0034, nor from this case is from the time period in which the load research data was collected.

29. (iii) If no revenue shifts are required, any revenue increase should be accomplished as an equal percentage increase to each rate component on each of the "regular" rate schedule. (The parties have agreed that certain rates should not be changed, (*e.g.,* the avoided cost rate paid to cogenerators, etc).[183] Rate Design/Cost-of-Service (Electric): How should any revenue increase for Aquila Networks-MPS or Aquila Networks-L&P that results from this case be implemented in rates?

Staff Position: After adjusting each rate component on each tariff to accomplish any shift in class revenues determined appropriate by the Commission, each rate component on each tariff should be increased by the percentage required to recover each division's cost of service.

The Commission should first consider only the required increases. If class revenue increases are required to bring any class's revenues to within the band, such increases should be limited for each class by the smaller of the amount of the increase that is required to bring class revenues within the band and the amount of increase that could be tolerated by customers in that class in addition to the overall rate increase.

After determining the total amount of the increases from the revenue shifts, the Commission should determine the amounts of the corresponding revenue reduction that should go to each class whose revenues should be reduced to align revenues with cost of service. The reduction in revenues should be applied as follows:

[183] Staff witness Watkins Surrebuttal, p. 5, l. 21 - p. 6, l. 22.

(a) First, the reduction in revenues should be applied only to those "major" classes outside the band of accuracy for class revenue responsibility revenue shifts determined in accord with the Staff's recommendation above as an equal percentage of class revenues in excess of the upper limit of the band.;

(b) If the total amount of the revenue reductions exceeds that amount, it should then be applied to all classes based on each classes adjusted revenues.

This will limit the amount of the rate increases required to align class revenues with class cost of service to the amount required to bring class revenues within the band for each class the appears to have revenues in excess of its cost of service. This will prevent the result that, due to the margin of error, some classes receive reductions that cause their revenues to fall below cost of service.[184]

Alternatively, to 28 and 29,

What is the appropriate way to adjust class revenues for any revenue increase that results from this case?

RELIABILITY ISSUES

30. Service Reliability (Steam): Should Aquila be directed to study any alleged recent reliability problems on its steam system, identify solutions, and report its findings to the Commission and interested parties?

Staff Position: Staff has no position on this issue at this time.

31. System Resource Study and Plan: (Steam) Should Aquila be directed to perform a study of steam production resources to include the results of the reliability review and to identify economical alternatives for the provision of steam service, and report its findings to the Commission and interested parties?

Staff Position: Staff has no position on this issue at this time.

[184] Staff witness Watkins Surrebuttal, p. 6, l. 23 - p. 7, l. 17.

FUEL COST RECOVERY

32. IEC (Electric and Steam): If the Commission adopts an interim energy charge, how should it be structured?

    a. What natural gas costs/prices should be included in the charge?

Staff Position: The IEC should have a range for natural gas prices of between $5 per mmbtu and $10 per mmbtu.

    b. What coal costs/prices should be included in the charge?

Staff Position: The IEC should have a range for high btu coal for Sibley and Lake Road should be between the CW Mining contract amount and the replacement coal.

    c. What purchased power costs/prices should be included in the charge?

Staff Position: The IEC should have a range for purchased power should be between $35 per mwh and $65 per MWh.

    d. What SO_2 emission credits should be included in the charge?

Staff Position: Staff has reservations of including SO2 emission credits in the IEC, but would support the inclusion in an IEC if other parties believe it appropriate.

        i. Should Aquila be required to use pet coke as a fuel to reduce SO_2 emissions?

Staff Position: Staff does not have a position on this issue.

    e. Should the IEC be established and trued-up on a divisional basis (for MPS and for L&P separately) or on a unified basis (MPS and L&P combined?

Staff Position: If the Commission adopts an interim energy charge, it should be established and trued-up on a divisional basis based on actual prudently incurred costs assigned to each Aquila MPS and L&P division.

    f. Additional items to consider include treatment of off-system sales and hedging program cost/benefits.

Staff Position: If the Commission adopts an interim energy charge, it should not include the margin from off-system sales. The annualized level of for off-system sales (revenues and costs) should be included in permanent (or "base") rates. The hedging program benefits and reasonably incurred costs should be included in the interim energy charge.

In light of the extreme volatility in the natural gas and purchased power markets, the Staff supports the implementation of an Interim Energy Charge ("IEC") in the instant cases. In its direct filing, Aquila proposed, as its primary position, implementation of a fuel adjustment clause pursuant to Senate Bill 179, provided that the bill was signed into law.[185] On July 14, 2005, the Governor signed SB 179 into law.[186] However, contrary to the opinion of Aquila[187] the Staff believes it is not possible, in the absence to date of the necessary supporting Commission rules, to implement a fuel adjustment clause.[188]

Aquila's position on whether or not to seek implementation of a fuel adjustment clause has evolved since its direct filing. In rebuttal testimony, Aquila witness Williams states "[a] properly constructed fuel adjustment mechanism *or an IEC* can effectively pass on to customers those fuel costs which are prudently incurred."[189] (Emphasis added). Although he expressed a preference for a fuel adjustment mechanism,[190] Aquila witness Williams provides testimony on the structure of an IEC that Aquila deems acceptable.[191] In surrebuttal testimony, Aquila states it is no longer proposing implementation of a fuel adjustment clause in this proceeding.[192] Clearly, Aquila has warmed to the idea of implementing an IEC. Indeed, in its position statement, filed December 23, 2005, Aquila stated that it is "open to discussions to determine the appropriate

---

185 Aquila witness Empson Direct, p. 11, ll. 15-23.
186 Staff witness Featherstone Rebuttal, p. 3, ll. 24-25.
187 Aquila witness Williams Rebuttal, p. 9, ll. 4-5.
188 Staff witness Featherstone Direct, p. 44, l. 11-16 and 23-27. See the Direct testimony of Staff witness Cary Featherstone (p.42, l. 22 - p. 43, l. 19) for a discussion of the ongoing rulemaking process.
189 Aquila witness Williams Rebuttal, p. 10, ll. 3-4).
190 *Id*, at ll. 5-7.
191 Aquila witness Williams Rebuttal, p. 13, l. 12 - p. 15, l. 11.
192 Aquila witness Williams Surrebuttal, p. 22, ll. 15-18. If the Commission does not order an IEC, the Commission should utilize the Staff's recommended processes to determine natural gas and purchased power prices (discussed respectively under issues 15 and 17 above.

structure of an IEC in the context of a settlement with all parties in the case."

While the Staff anticipates any IEC emerging from this proceeding will be the result of negotiations, the Staff proposes the IEC reflect a natural gas price of in the order of $5.00 per MMBtu, to be included in base rates, and a price of about $10 per MMBtu, to be included in the ceiling or forecast price. In order to substantially reduce the risk of a utility "gaming the system," and as a result, reaping windfall profits, the Staff recommends the cost of purchased power also be included in the IEC.[193] This is consistent with the approach used in all three cases where IEC have been implemented, *i.e.*, Case No. ER-2004-0034 for Aquila and Case Nos. ER-2001-299 and ER-2002-424 for The Empire District Electric Company. The purchased power prices to be included in the floor and ceiling should be about $35 and $65 per MWH, respectively.[194]

With respect to natural gas, Aquila has proposed the same ceiling price, along with a $7 base (or floor) price. The Company's purchased proposed purchased power range is from $50 to $80 per MWH. (Williams Rebuttal, p. 14, ll. 2-3). The Staff regards Aquila's proposed natural gas price range as too narrow, and its proposed purchased power range to be too high. (Featherstone Surrebuttal, p. 24, ll. 5-6).

Further, as noted earlier, the current Consolidation Coal contract cost of $38-$42 per ton[195], which Aquila is incurring as a replacement for the CW Mining coal, should be included in the IEC forecast amount, while the base amount should reflect the CW Mining cost of $19.99 per ton,[196] which Aquila would be paying were it not for the coal supplier's breach. In this manner, the higher Consolidation Coal costs may be entirely, or partially, subject to refund to Aquila's

[193] Staff witness Featherstone Direct, p. 24, ll. 5-15.
[194] Staff witness Featherstone Surrebuttal, p. 24, ll. 10-15.
[195] (Korte Rebuttal, p. 6, ll. 6-10).
[196] (Korte Rebuttal, p. 6, ll. 12-14).

customers to the extent that Aquila is able to recover in the courts for the breach. To incorporate the latest Consolidation Coal contract in both base and ceiling rates, as Aquila suggests,[197] would remove a considerable incentive for Aquila to vigorously pursue its judicial remedy.[198]

In rebuttal testimony Aquila proposes the cost of SO_2 emission allowances be incorporated in the IEC, as well. Aquila proposes respective floor and ceiling values of $1000 and $1200.[199] The Staff generally agrees, but at the same time, has some reservations about doing so. In particular, the Staff is concerned inclusion of SO_2 emissions costs in the IEC places the burden of determining prudence during the IEC true-up phase on the Staff when Aquila bears the responsibility for its status as the only electric utility in the state that needs to purchase emission allowance credits. Nevertheless, recognizing an IEC will likely come about through a negotiation process, the Staff would support inclusion of an annualized expense for SO_2 emission allowances, if the other parties believe it is appropriate.[200]

Furthermore, the Staff agrees with Aquila's proposals that: a) the term of the IEC be two years; variable costs recorded in FERC Account Nos. 501, 547 and 555 should be included in the IEC; and gains and losses from hedging, recorded in FERC Accounts 509, 421 and 426.5, should be included.[201]

The Staff takes issue, however with a major change to the IEC mechanism proposed by Aquila. In particular, Aquila seeks deferral for recovery in its next general rate case of "all prudently incurred fuel costs that are un-recovered at the at the end of the IEC term (fuel costs above the ceiling) . . .using a two-year amortization period."[202] Aquila argues that this will

---

[197] Aquila witness Williams Rebuttal, p. 14, ll. 16-17.
[198] Staff witness Vesely Direct, p. 14, ll. 9-14; Staff witness Featherstone Direct, p. 34, ll. 19-22; Staff witness Featherstone Surrebuttal, p. 25, ll. 5-17.
[199] Aquila witness Williams Rebuttal, p. 14, ll. 3-4.
[200] Staff witness Featherstone Surrebuttal, p. 23, l. 8 - p. 24, l. 2.
[201] Staff witness Featherstone Surrebuttal, p. 23, ll. 3-9.
[202] Aquila witness Williams Rebuttal, p. 15, ll. 3-6.

protect the Company from extreme price increases outside its control, while the deferral and amortization proved customers with "the benefit of spreading any unanticipated increases over a period of time."[203] As Staff witness Featherstone notes, one of the features of previously negotiated IECs is that they seek to *balance* the price risk by allowing the utility to keep any monies collected up to the base amount, in the event its actual fuel and purchased power costs fall below the base amount. However, Aquila's proposal makes no mention of that feature. The Staff is opposed to such a one-sided and certain recovery proposal.[204]

33. IEC Rate Design (Electric and Steam): If the Commission adopts an interim energy charge, how should the cost of the charge be allocated to customer classes in setting rates?

Staff Position: Generally, they should be allocated to customer classes based on class contribution to annual sales.

a. How should natural gas costs be allocated to customer classes?

Staff Position: All variable fuel and purchased power costs should be allocated to customer classes based on class contribution to annual sales.

b. How should coal costs be allocated to customer classes?

Staff Position: All variable fuel and purchased power costs should be allocated to customer classes based on class contribution to annual sales.

c. How should purchased power costs be allocated to customer classes?

Staff Position: All variable fuel and purchased power costs should be allocated to customer classes based on class contribution to annual sales.

d. How should SO_2 emission credits be allocated to customer classes?

Staff Position: All variable fuel and purchased power costs should be allocated to customer classes based on class contribution to annual sales.

e. How should off-system sales and hedging program cost/benefits be allocated to customer classes?

---

[203] *Id*. at ll. 8-11.
[204] Staff witness Featherstone Surrebuttal, p. 26 to p.27, l. 7.

> **Staff Position**: Only variable fuel and purchased power costs should be included in an IEC; however, if the margin from off-system sales are included, they should be allocated to customer classes based on class contribution to annual sales. Hedging program cost/benefits should be allocated to customer classes based on class contribution to annual sales.

Any fuel and purchased power costs collected under an IEC should be allocated and collected on an equal-cents-per-kilowatt-hour basis (adjusted for loses).[205] To do so makes sense because these costs are strictly variable, and they are related to increases in the prices of fuel and purchased power that increase the cost of energy on a cents-per-kilowatt-hour basis.[206] In his direct testimony, Maurice Brubaker, a witness for Federal Executive Agencies, Sedalia Industrial Energy Users' Association, and St. Joe Industrial Group, recommends a different approach. SIEUA/FEA witness Brubaker proposes any revenue increase granted by the Commission in this proceeding, including implementation of any IEC, "should be applied as an equal percentage increase to the revenues of all customer classes after the interclass revenue shifts [to be ordered in pending rate design Case No. EO-2002-384] have been accomplished."[207] Mr. Brubaker argues that his approach will preserve the rate relationships the will exist following the Commission's decision in the rate design case.[208] His proposal would, however, preserve *improper* rate relationships, because the fuel costs included in the IEC were not included in the class cost of service studies prepared in Case No. EO-2002-384. His proposal in this case is contrary to the allocation method he proposed for fuel and purchased power costs in Case No. EO-2002-384, which was that these costs should be allocated on an equal-cents-per-kilowatt-hour basis, or equivalently, on class contribution to annual sales.[209] As Staff witness Watkins states:

---

[205] Staff witness Watkins Rebuttal, p. 4. ll. 5-7.
[206] *Id*. at ll. 13-16.
[207] SIEUA/AGP/FEA witness Brubaker 10/28/05 Direct, p. 4, ll. 9-11.
[208] *Id*. at ll. 13-15.
[209] Staff witness Watkins, Rebuttal, p. 3, ll. 3-7.

> Mr. Brubaker has not justified why using revenue and cost data, which is limited to the amount of fuel costs included in permanent rates and is based on data from calendar 2002, updated through September 30, 2003, is an appropriate basis for determining interclass revenue adjustments in this case. Furthermore, even if that data were appropriate for determining interclass revenue adjustments for permanent rates, it does not follow that fuel costs above the level included in permanent rates should be allocated on an equal percentage basis to maintain the interclass revenue adjustments, when only one element of cost of service is included in an IEC.[210]

The Commission should reject Mr. Brubaker's recommendation for allocating the IEC to rate classes and instead adopt the equal-cents-per-kilowatt-hour basis (adjusted for loses), as recommended by the Staff.

ANALYSIS OF FUEL OPTIONS (Steam and Electric)

34. High Btu Western Coal Option: Should Aquila have considered alternatives to high Btu Western Coal for burning at Sibley and Lake Road, including petroleum coke and various emission control options?

Staff Position: Staff does not take a position on this issue.

WHEREFORE the Staff submits the foregoing as its prehearing brief for both Case Nos. ER-2005-0436 and HR-2005-0450.

[210] Staff witness Watkins Rebuttal, p. 3. l. 17 - p. 4, l. 2.

Respectfully submitted,

/s/ Nathan Williams____________________

Nathan Williams
Senior Counsel
Missouri Bar No. 35512

Attorney for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-8702 (Telephone)
(573) 751-9285 (Fax)
nathan.williams@psc.mo.gov

Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record this 10th day of January 2006.

/s/ Nathan Williams____________________