BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
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In the Matter of Aquila, Inc. d/b/a Aquila Networks-MPS For Authority To File Tariffs Increasing Electric Rates For the Service Provided to Customers in the Aquila Networks-MPS area	))))	**Case No. ER-2005-0436**

FEDERAL EXECUTIVE AGENCIES PRE-HEARING BRIEF

In accordance with the Commission's order in this docket the Federal Executive Agencies (FEA) hereby submit this pre-hearing brief. At this time the FEA will only address the issues upon which a position has been developed. Depending on the evidence positions on additional issues may be provided at a later time as permitted by the Commission.

Rate of Return (Steam and Electric)

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

Position: The ROE should be 9.8%.

Discussion: Michael Gorman recommends a return on common equity of 9.8%. Recent regulatory decisions show that this is a reasonable figure. Regulatory Research Associates Inc. July 6, 2005 Major Rate Case Decisions shows the average electric utility authorized return for the first 6 months of 2005 as 10.36%. It is expected that this figure will be lower for the second 6 months of 2005. Mr. Gorman's recommendation is based upon a constant growth

Discounted Cash Flow (DCF) method, Risk Premium (RP) and Capital Asset Pricing Model (CAPM) analyses.

Dr. Hadaway rejected the results of his own constant growth DCF model solely on the basis that the results were too low, Michael Gorman (MG) Direct p. 32 ll. 10 – 20. Mr. Gorman used a GDP growth rate of 5.5% based on economists' consensus of a reasonable estimate of investors' growth estimates. Dr. Hadaway used 6.5%. Mr. Gorman showed that Dr. Hadaway's average for his DCF models is actually 9.7% which is very close to the 9.8% recommended by Mr. Gorman, MG Direct p. 35 ll. 8 - 13 and Schedule MPG-15. In his GDP analysis, Dr. Hadaway also improperly used inflation rates based primarily on data for the 1970s and 1980s, needless to say these rates are not applicable to the current market and improperly inflate Dr. Hadaway's GDP projection, MG Surrebuttal pg. 7 ln 11 –15.

In his risk premium analysis, Dr. Hadaway has used only forecasted interest rates and this is troubling because in recent history projected interest rates have been incorrect compared to actual interest rates, MG Direct p. 37 ll. 4 – 6. Although some consideration should be given to the possibility of increased interest rates, current interest rates should not be ignored. Dr. Hadaway is projecting A-rated bonds to increase from 5.5% to 6.7%, which is higher than the increase a consensus of economists project for interests rates, MG Direct, p. 37 ll. 9 – 16.

In his risk premium analysis Dr. Hadaway used an inflated figure for utility bond yields and he used overall stock market studies not utility industry studies. Utility bond yields have declined since Dr. Hadaway filed his direct testimony. For his risk premium analysis, Dr. Hadaway used an inflated A-rated utility bond yield, MG Direct p. 37 ll. 19 – 20. Based on the current A-rated unity bond yield of 5.5% and Dr. Hadaway's estimated equity risk premium, the return on equity for Aquila would be 9.75% which is in the range of Mr. Gorman's recommended ROE. Dr. Hadaway based his risk premium on improper studies. He used risk premium studies for the overall market, not the utility industry, MG Direct p. 39 ll. 4 – 5. It is well known that the utility industry risk is less than the overall market risk, MG Direct p. 39 ll. 8 – 9. If the studies relied on by Dr. Hadaway were adjusted to account for utility industry risk the proper ROE would be 9 to 9.5%, MG Direct p. 40 ll. 2 – 4.

Dr. Hadaway's attempt to add 50 basis points to Aquila's authorized return on equity should be rejected. Dr. Hadaway bases his adder on the need for additional capital for construction, small company risks, and the risks resulting from the lack of a fuel adjustment mechanism. Dr. Hadaway's adder can not be justified by traditional rate making standards. Dr. Hadaway did not establish that increased return on equity is needed so that Aquila can attract additional capital. An ROE that is fair and reasonable will permit Aquila to attract capital for construction without violating the used and useful requirement. Granting

Aquila's request for what is best labeled advance ROE is also inconsistent with the rate making principle that a utility can only recovery costs that are known and measurable. The Commission has rejected arguments for recovery of future costs on the basis that there is no certainty that future costs will be expended as anticipated by the utility, p. 527 of *Re Missouri Gas Energy,* 235 PUR 4th 507 Mo. PSC 2004.

The plea for additional ROE based on small company risk should be rejected as well. As ably stated by Mr. Gorman, Aquila is a regulated franchised monopoly that does not face the competitive market place risks of an unregulated un-franchised company, MG Direct p. 41 ll. 4 –6. Aquila is insulated from competition with other companies.

Finally, Dr. Hadaway lobbies for an adder because of the risks associated with the lack of a fuel adjustment clause. The prohibition on fuel adjustment mechanisms no longer exists. Missouri has recently passed Senate Bill 179, which provides authority to implement fuel adjustment mechanisms. As a result regulatory risk has diminished considerably. This lower regulatory risk should be reflected in reduced, not increased returns on equity, MG Direct, p. 39 ll. 5 – 9.

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

Position: The capital structure that is appropriate to use is: 45% common equity and 55% debt.

Discussion: The FEA relied on Value Line's projections and the Company's actual capital structure in arriving at a reasonable forecasted capital structure for the 2006 rate effective year. For calendar year 2006, Value Line is projecting a common equity ratio for Aquila of 43%, MG Surrebuttal pg. 4 ln 4 – 6. This is dramatically lower than Dr. Hadaway's proposed common equity ratio of 48%.

The FEA recommended capital structure reflects the expected sale of utility assets and use of the proceeds to pay down debt. This expected asset sale and expected debt retirement will increase Aquila's common equity ratio during the period rates determined in this proceeding will be in effect.

Common equity is the most expensive form of capital. If as proposed by Dr. Hadaway, Aquila's capital structure is weighted too heavily with common equity, rates for customers will be set too high, MG Surrebuttal p. 2 ll. 5 – 13. Dr. Hadaway has attributed too much common equity to Aquila by using a hypothetical capital structure. Recent Commission decisions have rejected the use hypothetical capital structures unless they are used to protect customers from management decisions, p. 518 of *Re Missouri Gas Energy* 235 PUR 4th 507 Mo. PSC 2004, and p. 38 *Report and Order Empire District Electric Company General Rate Increase*, Docket ER-2004-0570, Issued: March 10, 2005, Effective Date: March 27, 2005.

Dr. Hadaway attempts to justify use of a hypothetical capital structure on the basis that Aquila's capital structure is not reasonable. He departs from Aquila's actual capital structure in 2 ways. His capital structure is based not on Aquila's but on his proxy group's projected capital structure, and his projected common equity ratio for Aquila is based on Value Line's three to five year projection for Aquila, not on the year rates will go into effect, 2006, MG Surrebuttal p. 4 ll. 8 – 11. The Commission has stated that it is generally preferable to use data that reflects the Company as it will exist on the day new rates will take effect, p. 38 *Report and Order Empire District Electric Company General Rate Increase*, Docket ER-2004-0570, Issued March 10, 2005, Effective Date: March 27,2005. Along those same lines it would be better to use data for the rate effective year.

Staff witness David Murray found additional reasons not to rely on Aquila's projected capital structure. Mr. Murray states that in a recent analyst conference call, Aquila's Chief Financial Officer, Greg Dobson, refused to give guidance on what Aquila's capital structure might look like after the proposed utility asset sales are completed, see MG Surrebuttal p. 4 ll. 16 – 24. This is significant because if Mr. Dobson is able to reasonably estimate what Aquila's capital structure will look like after the asset sale is completed, one would expect he could provide the market some guidance. The Company's non-public capital structure projections are not supported as reasonable by an officer of Aquila in

this proceeding and are, therefore, not suitable for setting Aquila's rates in this proceeding.

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

Position: The cost of debt for St. Joseph Power and Light Company is 7.96% and the cost of debt for Missouri Public Service Company is 6.70%.

Discussion: The FEA has accepted the cost of debt submitted by Dr. Hadaway. We do not understand why Dr. Hadaway is taking issue with our acceptance of his figures, MG Surrebuttal p. 5 ll. 4 – 9.

Expense Issues

16. What coal prices should be utilized in this case?

Position: The price in the contract with CW Mining should be what is included in this case.

Discussion: CW Mining has breached it's contract with Aquila by incorrectly asserting a force majeure based on a labor strike. It appears that the labor problems stemmed from CW Mining's hiring of illegal aliens at below market wages and CW Mining's improper treatment of it's miners, Cary Featherstone Surrebuttal Schedules 4-16, 4-19 and 4-20. Aquila has filed suit in the United States District Court of Utah to recover the difference between contract price and replacement price, Cary Featherstone Surrebuttal Schedules 5-1 – 5-4.

But Aquila has also included the replacement price in this rate case. The FEA believe that the contract price should be utilized in this rate case.

We anticipate that CW Mining will lose the suit because force majeure should not be a shield to liability, if as indicated, the evidence shows that CW Mining engaged in illegal actions. A civil remedy should not be a shield to immunize CW Mining from illegal acts.

We are concerned that granting Aquila's request to include replacement cost in this rate case could jeopardize recovery in the pending lawsuit. The remedy for breach of contract is to place the plaintiff in the position they would have been in absent the breach. If Aquila is given replacement costs in the rate case then they would be whole. A double recovery is not permitted and Aquila could jeopardize its right to receive damages from CW Mining. Ratepayers are not an insurance company. Aquila should continue to aggressively pursue it's suit against CW Mining the party who at this point appears most culpable for the coal replacement cost.

17. <u>Gas Prices</u>: (Steam and Electric) What natural gas price should be utilized in this case?

Position: The price of Aquila's gas hedged at NYMEX, adjusted for the basis differential to the market area where Aquila buys gas should be the price utilized in this case.

Discussion: Aquila can purchase natural gas at a price less than the NYMEX price. Aquila transports its gas on Southern Star Central Gas Pipeline (Southern Star) and with Panhandle Eastern Pipeline Company (Panhandle). The typical pricing point for gas that Aquila purchases for transport on these pipelines is at a discount to the Henry Hub/NYMEX prices, Maurice Brubaker (MEB) Surrebuttal p. 13.

The magnitude of the discount (negative basis) depends upon the overall level of gas prices and conditions in the market, Mr. Brubaker's Surrebuttal Schedule 5SR is a graphical presentation of this basis differential over the period January 2004 through November 2005. Page 1 of 5SR compares the gas price data, by month, at each of three pricing points – NYMEX, Texas Oklahoma Panhandle, and Southern Star. Page 2 of this schedule shows the differential over the same period of time. During the early portion of this time period, the basis was about $0.50 per MMBtu below the Henry Hub price. More recently, with the substantially elevated market gas prices, the basis has been significantly more negative, ranging to over $4.00 per MMBtu, below the Henry Hub price.

Mr. Brubaker recommends the base price for natural gas be set equal to the swap price under Aquila's hedges for the period April 2006 through March 2008, minus the basis differential to the market area where natural gas is purchased. In the absence of explicit information from Aquila, Mr. Brubaker would recommend using a subtraction of $3 per MMBtu from the hedge price, consistent with the information shown on Schedule 5SR. Mr. Brubaker may update this figure once pending data requests are answered.

Class Cost of Service/Rate Design

29. *Rate Design/Cost of Service: What is the appropriate way to adjust class revenues for any revenue increase that results from this case?*

Position: After adjusting for any change in interclass revenues from the rate design case, Case No. EO-2002-384, any increase awarded in this case should be allocated as an equal percentage across-the-board increase. Alternatively, if changes in variable fuel and purchased power costs are separately treated, then any remaining change in revenue levels should be allocated as an equal percentage applied to the current revenues (after adjustment from the cost of service case) that recover costs other than the cost of fuel.

Discussion: The first important step determining appropriate interclass revenues is determining the class revenues adjustments in EO-2002-384. Our recommendation in this case, ER-2005-0436, is based on the assumption that that appropriate interclass revenues will be determined in EO-2002-384. On page 7 of the Commission's August 23, 2005 Order Regarding Consolidation and Procedural Schedule issued in EO-2002-384 and ER-2005-0436 it states that the

purpose of the EO-2002-384 is "a comprehensive examination of the costs involved in serving Aquila's various electric service customer classes and identifying any adjustments necessary to match costs with revenues and eliminate any subsidies." Later in the same order the Commission states:

> Having considered the points raised by the parties, the Commission agrees with SIEUA, FEA and Aquila that the best course would be to resolve this class-cost-of-service case separately from the rate case now pending. That will permit the class-cost-of-service issues and rate design issues to be resolved separately from the revenue requirement issues that generally receive most of the attention in a rate case. It will also reduce the number of issues to be presented and determined in the rate case.

The results from EO-2002-384 should be identification of any adjustments necessary to match costs to revenues and eliminate any subsidies. The Commission should select the cost of service methodology in EO-2002-384 that best reflects how Aquila incurs costs to serve it's various customer classes. Then is ER-2005-0436 any increase can be allocated as an equal percentage across-the-board increase, this will preserve the rate relationships established by the Commission in EO-2002-384.

One area of concern for the FEA is the allocation of fuel and purchased power costs. In the MPS service area, the large power service (LPS) class represents 13% of non-fuel revenues but 23% of the fuel-related revenues, Mr. Brubaker (MEB) Surrebuttal Schedule 2SR pg. 2. For the MPS LPS class, allocation of increases in non-fuel costs on total revenues would assign them 16%

of the total, whereas they are responsible for only 13% of the non-fuel revenues, MEB Surrebuttal p. 7 ll. 3 - 16.

Since total revenues include both fuel-related and non-fuel revenues, allocating increases in non-fuel costs on total revenues (which included fuel costs) would distort rate relationships, MEB Surrebuttal p. 7 ll. 17 – 19. If fuel-related costs are to be passed through on a kWh basis, then the tracking of changes in non-fuel costs should be related to the level of non-fuel revenue in each class. In other words, if increases in fuel costs are to be reflected in customer rates by increasing the per kWh charges, then any increases in the level of non-fuel costs should be allocated as a uniform percentage applied to the non-fuel revenues in each customer class.

Schedule 3SR of Mr. Brubaker's Surrebuttal testimony shows how fuel and non-fuel revenues could be allocated properly. Column 1 of 3SR shows the allocation of additional fuel-related costs that are to be included in base rates. The allocation is on the basis of current responsibility for fuel-related costs, which is equivalent to a per kWh allocation. Column 2 of 3SR shows the allocation of additional non-fuel costs in base rates and is accomplished by increasing the existing non-fuel revenues of each class by an equal percent. Column 3 shows new base rates, which are equal to current base rates plus the two components of the increase shown in columns 1 and 2. Column 4 shows the allocation of an

amount of fuel in an IEC allocated based on kWh sales. Finally, column 5 shows the sum of the new base rates and the IEC.

In order to properly allocate costs to those who cause the costs and prevent subsidization, we recommend that the Commission adopt Mr. Burbaker's proposal regarding the allocation of fuel and non-fuel revenues.

Fuel Cost Recovery

33. Fuel Cost Recovery: If the Commission adopts an interim energy charge, how should it be structured

Position: The amount of refundable variable fuel and purchased power amounts attributed to each rate schedule should be converted to a per kWh charge within each rate schedule.

Discussion: The dollar amount allocated to each rate schedule can be collected as a percent of base rates or converted into a per kWh value.

Analysis of Fuel Options

34. Analysis of Fuel Options (Steam and Electric): 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?

Position: Yes. Aquila was deficient by not giving appropriate consideration to these alternatives.

Discussion: Aquila failed to use the most prudent alternative for coal. Aquila has not performed any studies in the last three years to determine the optimum-price blend of coals and petroleum coke to purchase for the last three years, Sharon Hennings (SH) Direct p.7 ll. 8 – 11 and SIE Data Request SIE-0005. Other utilities are studying the use of petroleum coke as a substitute for

high BTU Western coal, SH Direct p. 7 ll. 12 – 18 and SH Direct Schedule 1. The combined costs of a petroleum coke blend would have been the least-cost option, $1.7 million less expensive than the planned 2004 C.W. Mining Company coal blend, SH Surrebuttal pp. 2 – 3. Aquila paid $4.9 million more than necessary for the 2004 combined costs of delivered fuel and sulfur dioxide allowances by ignoring the least-cost option after CW Mining breached it's contract.

Sharon Hennings Surrebuttal schedule 1SR showing her calculations in considering the alternatives available to Aquila. The data used in preparing Schedule 1SR is based on Aquila's 2004 FERC Form 423 or when Aquila data was not available, average delivery data for all utilities based on FERC Forms 423 was used, SH Surrebuttal pg. 5, ll 6 – 12.

Sharon Hennings calculations show that the blend of Powder River Basin (PRB) coal and petroleum coke is the least-cost solution, SH Surrebuttal p. 6 ll. 3 – 8. Using the total 42,116 GBtu in coal purchases for 2004, the petroleum coke blend could have saved $1.7 million as compared with C.W. Mining Company combined cost had the CW Mining contract been honored by CW Mining, *id.*

Aquila would have paid $4.9 million less had they used the PRB coal and petroleum coke alternative in 2004 after CW Mining terminated delivery. Actual 2004 delivered coal costs and sulfur allowance credits were calculated on line 15 of Schedule 1SR, using the data from the 2004 FERC Form 423 Reports and

continuing to assume the cost of $200 for each sulfur dioxide allowance. The combined average cost was 111.2 cents per MMBtu, $4.9 million more expensive than the combined average cost of the PRB petroleum coke blend alternative.

Mr. Brubaker and Sharon Hennings have identified some prudent options to obtain coal at a lower price. The FEA recommend the Commission require Aquila to evaluate the options for lower price coal and report their findings and efforts to the Commission.

Respectfully submitted,

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Certificate of Service:

I certify that on this 10th day of January 2006 I served the FEA Pre-Hearing brief upon the parties to this case via e-mail.

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