BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

FEDERAL EXECUTIVE AGENCIES'
PRE-HEARING BRIEF

COME NOW the Federal Executive Agencies ("FEA") and submit this pre-hearing brief in accordance with the Commission's Order in this docket. At this time, the FEA will only address issues that are the subject of a developed position. Depending on evidence to be adduced at hearing, additional issues may be provided and addressed by the FEA at a later time, as permitted by the Commission.

RATE OF RETURN

1. Return on Common Equity

A. What is the appropriate proxy group to be used in calculating Aquila's return on equity?

Mr. Michael Gorman selected a proxy group that approximates Aquila's Missouri utility investment risk based on the following criteria: 1) S&P bond rating in the category of "A" and "BBB", 2) Moody's bond rating within the categories of "Baa" and "A", 3) Common equity ratio within the range of 40% to 60%, 4) S&P business profile score of 4 to 6, 5) Consensus analysts growth rates available, 6) No significant merger or acquisition activity, 7) No dividend suspension within the last two years, and 8) no restructuring. [1]

[1] Gorman Direct, p. 19.

Mr. Gorman demonstrated that his proxy group was a reasonable risk proxy for Aquila. As noted above and in Mr. Gorman's Schedule MPG-4, this group has an average bond rating from S&P and Moody's of BBB and Baa1. [2] The group members have a common equity ratio of 50% from Value Line, and a common equity ratio of 46% from AUS Utility Reports. These risk factors are reasonably comparable to Aquila's target investment grade bond rating, its proposed hypothetical capital structure, its target S&P business profile score of 6, and contains a 47.5% common equity ratio. Finally, the group average S&P business profile score is 5. Selecting a group that meets Aquila's target risk parameters is consistent with protecting the Missouri retail customers from Aquila's restructuring efforts as outlined by Aquila witness Mr. Jon Empson. This proxy group accommodates that objective. [3]

As noted above, the selection criteria resulted in a proxy group that reasonably reflects a minimum investment grade utility company, with approximately average business risk and financial risk as estimated from S&P business profile scores and the common equity ratios. [4] S&P estimates that most integrated electric utility companies, like Aquila's Missouri utility operations, have business profile scores in the range of 4 to 6.2. Therefore, the proxy group represents an average operating business risk for integrated electric utility companies. [5]

Mr. Gorman explained that the selection of an appropriate proxy risk group would allow for an estimate of a fair return for Aquila's risk, including its small size risk. Mr. Gorman explained that the companies that were selected were comparable to Aquila in total investment risk. Part of Aquila's investment risk relates to its small

[2] Gorman Direct, Schedule MPG-4.
[3] Gorman Direct, pp. 18 – 9.
[4] Gorman Direct, p. 19.
[5] Gorman Direct, pp. 19 – 20.

capitalization size. By selecting companies that have similar total investment risk to Aquila, the proxy group can be used to estimate a fair rate of return to compensate investors in utility companies with Aquila's investment risk characteristics. [6]

Mr. Gorman explained that a company's size would impact its operating risk in the following ways:

1. Small companies typically have less ability to attract qualified management pools. [7]
2. Small companies usually do not have the economies of scale to minimize operating expenses by spreading expertise over a larger customer base and buying materials and supplies in larger quantities.
3. Small companies do not have the geographic diversification to mitigate sales variations caused by weather and local economic cycles.

These small company risk factors are considered by credit rating analysts and security analysts in assessing a utility's investment risk and valuation. Therefore, when selecting a group of comparable risk companies, if one relies on a group of companies with bond ratings that are comparable to the proxy company and business profile scores in particular, that reasonably compare to the utility's business profile score, then the proxy group itself would reflect these risk factors. Under these circumstances, it is unreasonable and would be redundant to add an equity risk premium to a proxy group return if that proxy group already reasonably captures Aquila's total investment risk. [8]

Since Mr. Gorman's proxy group and Dr. Hadaway's proxy group reasonably emulate the investment risk for a minimum investment grade utility, with a higher than average integrated electric utility business profile score from Standard & Poor's, the proxy group reasonably captures Aquila's construction risk, small size risk, and all other

[6] Gorman Rebuttal, p. 5.
[7] Gorman Rebuttal, p. 5.
[8] Gorman Rebuttal, p. 6.

risk factors. Therefore, there is no need to add an equity risk premium to the return on equity estimated from this proxy group. [9]

B. What is the appropriate model (discounted cash flow, capital asset pricing model, risk premium) to be used in estimating Aquila's return on equity?

Mr. Gorman relied on three models: DCF, risk premium, and CAPM, to estimate a fair return for Aquila. Any single model could produce unreasonable results based on varying market and industry conditions. Therefore, Mr. Gorman relied on the three models to produce a broad based analysis to draw upon market and industry information to estimate a fair return for Aquila. [10]

C. In the event that the Commission decides to utilize a DCF model for estimating return on equity, should the Commission utilize a constant growth or multistage DCF model?

The Commission should adopt the constant growth model. The results of the constant growth DCF analysis in general in today's marketplace, reflect rational investment financial metrics and reflect today's very low cost capital market. [11]

D. For any DCF model, what is the appropriate growth rate?

The appropriate growth rate to be used in the DCF model, in this instance, is 5.33%. The consensus analysts' growth rate for Mr. Gorman's comparable groups is 5.33% and for Dr. Hadaway's group is 5.16%. [12] The appropriate growth rate to use in a DCF model is one that captures rational consensus market expectations. Security analysts' three to five-year projected growth rates are the most likely growth rate that reflects current investor expectations. [13]

---

[9] Gorman Rebuttal, p. 6.
[10] *See Generally* Gorman Direct, pp. 20 – 35, Gorman Rebuttal, pp. 8 – 14.
[11] Gorman Direct, p. 23.
[12] Gorman Direct, p. 23.
[13] Gorman Direct, p. 22 – 4.

On the other hand, Dr. Hadaway relied on an excessive growth rate that is not reflective of investor expectations. Dr. Hadaway used a GDP growth rate of 6.6% as one of three growth rates. He states that the GDP growth rate is based on the achieved GDP growth over the last 10, 20, 30 and 40-year periods. Dr. Hadaway's projected GDP growth rate is unreasonable. Historical GDP growth over the last 20 and 40-year periods was strongly influenced by the actual inflation rate experienced over that time period.[14] Projected GDP inflation is much lower than the historical inflation used by Dr. Hadaway in his GDP estimate. Dr. Hadaway's nominal GDP inflation factor of 6.6% reflects a real GDP of 3.2% and an inflation GDP of 3.3%. Current economists' projections of nominal GDP include real GDP and GDP inflation expectations over the next five and ten years of 3.0%, and 2.1%, respectively. [15] Dr. Hadaway's historical GDP reflects historical inflation, which is much higher than expected forward-looking inflation. Dr. Hadaway's 6.6% nominal GDP growth is not reflective of consensus market participant expectations. [16]

E. In the event that the Commission decides to utilize a risk premium model for estimating a return on equity, what is the appropriate premium to account for the difference in risk between equity and bondholders?

The appropriate premium to account for the difference in risk between equity and bondholders should 3.7% and 5.2% for utility bonds and Treasury bonds, respectively. [17] A risk premium should be selected based on the relative investment risk difference between equity investments and bond investments. Risk premiums do not fluctuate based on nominal changes to interest rates alone. The academic literature clearly supports the concept that risk premiums will expand when the risk of equity investment

[14] Gorman Rebuttal, p. 8.
[15] Gorman Rebuttal, p. 9.
[16] Gorman Rebuttal, p. 9.
[17] Gorman Direct, p. 28.

increases relative to bond investments, and will contract when equity risk declines in relationship to bond investment risk. This risk return relationship is not changed merely by changes to nominal interest, but changes in nominal interest rates can be a factor that impacts risk. [18]

In constructing his risk premium study, Mr. Gorman relied on the spread between utility bonds and Treasury bonds as a proxy for estimating the relative risk differential between utility equity investments and bond investments. This analysis indicates that equity risk premiums for utility equity investments are not higher relative to historical actual risk premiums. This finding is consistent with a review of the industry that has been mitigating risks by reverting back to low risk utility operations. [19]

F. In the event the Commission decides to utilize a risk premium model for estimating return on equity, what is the appropriate interest rate for utility bonds?

Relying on both current observable interest rates and projected interest rates, for the near future, is the appropriate interest rate to use in an equity risk premium study. Future interest rates are highly uncertain and there is no reasonable method for accurately determining what future interest rates will be. Indeed, current observable interest rates are just as likely to be the prevailing interest rates once rates determined in this proceeding are in effect, as are economists' projections of future interest rates. [20]

For these reasons, Mr. Gorman relied on both current observable interest rates and projected interest rates in formulating his recommended return on equity in this proceeding. In contrast, the Company relied only on projected interest rates, which were significantly higher than current observable interest rates. This is inappropriate

[18] Gorman Rebuttal, pp. 10 – 5.
[19] Gorman Direct, pp. 26 – 7.
[20] Gorman Direct, pp. 26 – 7, Gorman Rebuttal, p. 11.

because, again, interest rate projection accuracy is at best problematic, and serves only to unnecessarily increase the authorized return on equity in this proceeding. For this reason, the Company's reliance on only projected interest rates is ignoring relevant information to determine what future interest rates might be and thus overstates Aquila's cost of equity in this proceeding. [21]

G. Is an equity add-on appropriate to account for Aquila's construction risk and small company nature?

No. The proposed equity add-on of 25 basis points is meritless and should be rejected out-of-hand. The justification for this add-on is a perception (on the part of Dr. Hadaway) that Aquila poses greater investment risk because of greater construction risk and due to the fact that it is a small utility. [22] As noted in subparagraph (A), above, the proxy group consists utilities of the same general size, and pose the same investment risks, as Aquila. Aquila's size is just a factor that describes its investment risk. Therefore, any such proposed add-on is superfluous and should be denied on that basis.

H. What is the appropriate return on equity to use in calculating cost of service?

The Commission should award MPS and L&P a return on common equity of 10.0%. This recommended return on equity for Aquila is based on an average of the constant growth Discounted Cash Flow ("DCF"), Risk Premium ("RP") and Capital Asset Pricing Model ("CAPM") analyses noted in Mr. Gorman's testimony. These analyses estimate a fair return on equity based on observable market information for a group of

[21] Gorman Rebuttal, pp. 11 – 2.
[22] Gorman Rebuttal, pp. 1 – 2.

publicly traded electric utility companies that proxy Aquila's going forward investment risk. [23]

In general, determining a fair cost of common equity for a regulated utility has been framed by two decisions of the U.S. Supreme Court: Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of West Virginia, 26 U.S. 679 (1923) and Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944). These decisions identify the general standards to be considered in establishing the cost of common equity for a public utility. Those general standards are that the authorized return should: (1) be sufficient to maintain financial integrity; (2) attract capital under reasonable terms; and (3) be commensurate with returns investors could earn by investing in other enterprises of comparable risk. The decisions do not contemplate the inclusion of inflated analyses, "padding" that serves to insulate utilities from every conceivable eventuality, or the granting of the ability for the utility to instantly rise "head and shoulders" above comparators as an assured investment risk.

Mr. Gorman's recommended return on equity of 10.0% is at the mid-point of the estimated return on equity range for Aquila of 9.4% to 10.6%. [24] The high end of the estimated range is based on the figure derived from the CAPM analysis, and the low end of the estimated range is based on the figure derived from the constant growth DCF analysis. The midpoint of that estimated range is 10.0%. Using Dr. Hadaway's proxy group, as appropriately adjusted, would indicate a return on equity in the range of 9.5% to 10.6%. The high end of that estimated range is based on a CAPM return using Dr. Hadaway's proxy group, the low end is based on a DCF study using Dr. Hadaway's

[23] Gorman Direct, p. 2.
[24] Gorman Direct, p. 34.

group. The midpoint of that estimated range is 10.0%. Based on this assessment, the recommended return on equity will fall within the overall range of 9.8% to 10.0%. As a conservative estimate, the Commission should set Aquila's rates based on a 10.0% return on equity. This figure reflects Dr. Hadaway's proxy group and it is higher than is reasonable, based on a more reasonable assessment of proxy companies reasonably comparable in risk to a typical integrated utility company with a minimum investment grade bond rating. [25]

2. Capital Structure

The FEA proffer that the capital structure proposed by Aquila is consistent with the consolidated capital structure presented as of the third quarter of 2006. Therefore the numbers proposed (47.5% Common Equity, 52.5% Debt) reflect the actual capitalization mix that Aquila will use to support Missouri operations during the effect of the rates determined by this proceeding. [26]

3. Cost of Debt

The FEA assert that the proper embedded debt cost estimate for Aquila's MPS operations is 6.54%. Mr. Gorman rejected the MPS cost of debt proposal, because the company failed to re-price certain debt issues that were retiring by year end 2006 and in January, 2007. In order to reflect an estimate of the refinanced price of the maturing securities, Mr. Gorman proposed that the MPS embedded debt cost be reduced to 6.54% from the company's proposed 6.73%. [27]

---

[25] Gorman Direct, p. 35.
[26] Gorman Direct, pp. 8 – 11.
[27] Gorman Direct, pp. 11 – 14, Gorman Surrebuttal, pp. 15 – 8.

Mr. Gorman also raised significant concern about L&P's 7.95% embedded cost of debt. He noted that the L&P embedded cost of debt is well above current capital market costs in the range of 6.0% to 6.5% and significantly higher than all other Missouri utility companies embedded debt costs, which fall into a range of 5.473% to 7.020%. [28]

Mr. Gorman recommends that the Commission direct Aquila to explain what it is doing to reduce L&P's embedded debt cost, and if Aquila fails to provide an acceptable explanation of its efforts to reduce this debt to market levels, then it should reject L&P's debt cost and set L&P's rates using MPS's embedded debt cost as a proxy for L&P. [29]

EXPENSE ISSUES

7. What is the appropriate percentage for the allocation of fuel and purchased power between MPS and L&P operating divisions?

In order to determine allocation of fuel and purchased power between the MPS and L&P operating divisions, the FEA recommend use of the average of percentages from the stand-alone model runs in the Commission Staff's direct testimony, and in Aquila's direct and true-up filings. The L&P percent would be 19.0 and the MPS percent would be 81.0. [30]

8. What purchased power price should be utilized in the production dispatch model?

Based on the strong relationship between natural gas prices and spot power purchased prices, the Commission should include a $10.292 adjustment (MPS gets 81%, and L&P gets 19%) to purchased power prices based on known, measurable, and historical natural gas prices. [31]

---

[28] Gorman Direct, pp. 11 – 14, Gorman Surrebuttal, pp. 15 – 8.
[29] Gorman Direct, pp. 11 – 14, Gorman Surrebuttal, pp. 15 – 8.

[30] Brubaker Supplemental Direct, p. 10.
[31] Brubaker Supplemental Direct, Schedule MEB-TU-3, pp. 2 – 4, 6.

9. Should coal prices reflect the option prices reflected in the coal contract with C.W. Mining?

Customers should only be charged the C.W. Mining contract price. Aquila entered into the contract with C.W. Mining based on its own evaluations and analyses. Aquila is the party that was responsible for the procurement of the contract and was in the best position to control the procurement situation. In addition, Aquila has taken legal action to assert its rights under that contract. Until this litigation process is complete, and until there is a full airing of Aquila's actions surrounding the execution of the contract, its management of the contract, and the legal proceedings, customers should not be required to pay anything more than the initial contracted price. [32] The appropriate cost per ton would be the average contact price specified for the 2007 and 2008 option years of $22.17/ton. [33] This would result in the below calculations with respect to the claimed revenue requirement concerning the C.W. Mining issue, as of true-up. As of the true-up filing, the number of tons of high Btu western coal purchased at Lake Road was 78,191, at Sibley 313,258 and a total of 391,449. With a cost difference of $15.89 per ton, the overall adjustment becomes $1.242 million for Lake Road, $4.978 million for Sibley, with a total of $6.22 million. [34]

10. What natural gas price should be utilized in the production dispatch model?

The Commission should adopt a pricing method based on known, measurable, and historical data, such as a forecast based on the past twelve months actual commodity prices. In their submission, Aquila uses futures prices for 2007. To estimate the monthly prices for 2007, Aquila averaged the daily reports of 2007 futures

[32] Brubaker Direct, p. 8.
[33] Brubaker Direct, p. 9.
[34] Brubaker Supplemental Direct, p. 4.

prices over the last three months of 2006. [35] This creates substantial concerns about Aquila's cost methodology. This concern arises from the fact that natural gas futures prices have exhibited significant volatility, and, since September of 2005, have exhibited what is aptly called a "fear factor" that has kept the futures prices generally much higher than what the actual cash prices have turned out to be as the forward month becomes an actual month. This continues to be the case. Aquila's true-up filing used January and February 2007 Henry Hub prices of approximately $8 MMBtu. The actual end of December 2006 closing price for the January 2007 contract was $5.84 and the end of January close for the February 2007 contract was $6.92. As a result, Aquila's estimated prices for January and February that are included in its revenue requirement are substantially in excess of what the actual costs they incurred turned out to be. The most reliable and appropriate values would be to use experience for the most recent 12-month period. This data is the most current actual data available, and its use avoids some of the problems associated with the "fear factor" that continues to influence the futures prices. [36] The disparity (NYMEX over-pricing versus actual cost to the utility) is demonstrated by a comparison of Columns 1 (NYMEX Settle Price) and 2 (Actual Aquila Commodity Costs) in the attachment at Schedule MEB-TU-1 of Mr. Maurice Brubaker's true-up testimony. [37]

12. What average service life should be used in calculating depreciation rates for the Other Production plant accounts (Accounts 342 through 346)?

The FEA recommend a 35-year service life for items in Accounts 342 through 346 and a 60-year service life for Account 341 items. The Other Production average service

[35] Brubaker Supplemental Direct, p. 4.
[36] Brubaker Supplemental Direct, p. 5.
[37] Brubaker Supplemental Direct, Schedule MEB-TU-1.

lives that were approved in a Stipulation in Case No. ER-2005-0436, are short when compared to the average service lives proposed for other utilities' Other Production plant accounts in Missouri. The average service life is one of the key components used to develop book depreciation rates. [38] Mr. Michael Gorman recommends that the Commission utilize a 35-year average service life to develop the Other Production plant depreciation rates for Accounts 342 through 346. Mr. Gorman further does not propose any changes to the net salvage ratio that are used to develop the depreciation rates. In addition, Mr. Gorman supports the continued use of a 60-year average service life for Account 341, Structures and Improvements. The basis for this recommendation is that the currently approved Other Production average service lives are short when compared to average service lives proposed for other utilities in Missouri. Specifically, AmerenUE proposed a 35-year average service life for its Other Production plant accounts. This represents a lengthening of 10 years from the lives previously approved. In addition, the MPSC Staff has proposed average service lives for Other Production significantly in excess of the lives used to develop Aquila's Other Production depreciation rates. Mr. Gorman does not propose adjustment of the average service life for Account 341 items because the investment in this account is related to the site and not specific equipment used to generate electricity. The sites will continue to be used for the next generation of Other Production generating plants. [39] The site has access to the transmission system, therefore, the site will be useful in the future. As a result, Account 341's average service

[38] Gorman Direct, p.38.
[39] Gorman Direct, p. 40.

life of 60 years is reasonable. One final note, for Account 343.1, Wind Turbines, Mr. Gorman does not proposing a revision to the average service life. [40]

Mr. Gorman proposes depreciation and salvage rates for items in Accounts 341 through 346, as outlined in Table 6 of his Direct Testimony. Schedule MPG-17 shows the impact on Aquila's Other Production depreciation expense as a result of his proposed recommendations. As the Schedule shows, utilizing a 35-year life for Accounts 342 through 346 results in reducing Aquila's depreciation expense by $2.102 million for MPS and $217,000 for L&P. [41]

Utilizing an average service life to calculate book depreciation rates that is shorter than the actual average service life results in an accelerated recovery of investment. As a result, customers near the end of the asset's actual useful life will not have included in their rate base and rates any or minimal investment associated with the assets. This produces intergenerational inequities and provides for a larger cost burden on today's ratepayers. [42] As a result, the currently approved depreciation rates allow Aquila to recover the investment in its Other Production assets over a life that is shorter than the useful life. [43]

HEDGING

14. Should the Commission allow rate recovery of the results of Aquila's hedging program?

Due to the fact that Aquila is substantially over-hedged, the FEA recommend the following disallowances: $4,518,932 for natural gas swap positions and $864,742 for over-hedged call options, for a total of $5,383,674 in disallowed costs. The justification

[40] Gorman Direct, p. 41.
[41] Gorman Direct, p. 42.
[42] Gorman Direct, p. 39.
[43] Gorman Direct, p. 40.

for this disallowance is the fact that Aquila's hedging is far in excess of the requirements under its risk management program. [44]

FUEL COST RECOVERY MECHANISM

1. What is the appropriate mechanism (base rates, interim energy charge, fuel adjustment clause ("FAC") to be implemented by Aquila for the recovery of fuel and purchased power expense?

The appropriate mechanism for recovery of fuel and purchased power expenses is situation-dependent. Movement between base rates, an interim energy charge, and a fuel adjustment clause is hierarchical and is dependent on need, as discussed below. The recovery through base rates, where it includes the optimal protections and advantages for consumers, is the optimal answer for the ultimate beneficiary of these proceedings: the consumer. [45] Movement to an interim energy charge, then a fuel adjustment clause as a means of recovery of fuel and purchased power expenses, should be based on an "acute need." [46] Only upon establishment of this "acute need," should the utility be able to recover the costs via a fuel adjustment clause. [47] The mere fact that fuel costs fluctuate (a long-standing reality of the utility industry) does not justify the use of a fuel adjustment clause, which effectively denies consumers many of the regulatory protections they would enjoy under more traditional and conservative fuel recovery mechanisms. [48]

2. What standard should be utilized by the Commission in determining whether a utility should be granted a FAC?

---

[44] Brubaker Direct, pp. 6 – 8.
[45] Johnstone Direct (1/18/07), pp. 9 – 10.
[46] Johnstone Rebuttal, pp. 9 – 10.
[47] Johnstone Rebuttal, pp. 9 – 10.

[48] Johnstone Rebuttal, p. 10; Johnstone Direct (1/25/07), p. 8.

Any utility, including Aquila, should be granted a fuel adjustment clause based on the establishment of an "acute need." This is because a fuel adjustment clause (in pure form) automatically flows fluctuating costs, unmitigated, through to consumers. Retail utility rates are then made volatile and inure to the detriment of consumers. Among the negative effects are rate volatility, unpredictable utility bills, reduced incentives for the utility to achieve low and stable costs, distorted investment incentives, and the complexities of the rate administration. Therefore, Aquila, before shifting this cost burden to consumers, should first be required to demonstrate an acute need and then that need must be weighed against the negative effects of the proposed FAC on the consumers. [49]

3. In the event that the Commission implements a fuel adjustment clause, what level of sharing between the ratepayers and the shareholders should be reflected in the FAC?

The level of sharing that would optimally balance the interests of the utility and the consumers is a 50 / 50 split. In order to incentivize optimal economic behavior on the part of utilities, the fuel adjustment clause must continue the base rate treatment for a portion of the fuel costs. The most straight-forward and workable example is a design that provides a fuel adjustment clause for 50% of the fuel costs and continues base rate treatment for the other 50%. The mechanism has the same simplicity of a fuel adjustment clause that would pass through all fuel costs, but would address any incentive problem on the part of the utility by retaining half of the fuel costs in base rates with the effect of changes to accrue to the utility between rate cases. Optimization of the interests of both the utility and the consumers would continue because *both*

[49] Johnstone Direct (1/18/2007), p. 3.

Aquila and its ratepayers would continue to be better off if fuel and purchased power costs are minimized. [50]

4. Should any FAC provide for the recovery of demand costs?

As a matter of policy, a fuel adjustment clause should never provide for recovery of demand costs. First, demand costs do not fluctuate as much or as dramatically as energy costs, that are more properly contemplated under a fuel adjustment clause. Second, the inclusion of such costs permits the passing of additional costs through to the consumer via a process that that imparts far less scrutiny than would be the case for base rate examination. *See generally* Louisiana Public Service Commission General Order, dated 11/6/1997. [51]

5. What level of line losses should be applied to any FAC?

Line loss factors should be accounted for by rate class and voltage level of service. This will allow for an appropriate distinction and apportionment of costs among rate classes and voltage levels of service. [52]

6. What accumulation period should be used in the FAC?

The accumulation period (three months, as proposed by Aquila) should be extended to six months. This extension would allow for increased rate stabilization via an averaging of highs and lows in cost over the longer accumulation period. [53]

7. What recovery period should be used in the FAC?

The recovery period should be set at twelve months. Aquila has proposed three-month recovery periods. This, in effect, would cause summer costs to collected in winter

---

[50] Johnstone Direct (1/25/2007). p. 10.
[51] Louisiana Public Service Commission General Order, Docket No. U-21497, dated 6 November 1997.
[52] Johnstone Rebuttal, p. 26.
[53] Johnstone Rebuttal, p. 22.

and winter costs would be collected the following summer. The same would hold true with respect to spring and fall. Since there can be significant differences in retail kilowatt hour sales between these four periods of the year, the effect of volatility in costs can be magnified if there is a large variation in one period and the variations are collected in a the period with fewer kilowatt hour sales. The twelve-month recovery period would have the beneficial effect of spreading out cost variations over a slightly longer period, thereby mitigating the rate impacts on consumers. Cost variations would also not be moved from one season to another, instead they would be spread over a twelve-month period. The consistent application of this approach would minimize any unintended shifting of cost between or among customer classes. [54]

8. Should the FAC provide for definitive production standards?

The fuel adjustment clause should adopt definitive production standards as a means of guaranteeing consumer protection. Under traditional base rate regulation, the utility bears the brunt of the additional cost if there is an outage in one of its lower cost base load generating units. In particular, these costs are the fuel and purchased power costs that are incurred when the low-cost generation is replaced with higher cost generation during the period of an outage. The traditional base rate regulation ensures that the consumers, the party least able to control outages, are protected from the costs of outages. A recent example is illustrative: if a fuel adjustment clause had been in effect when Taum Sauk went out of service, the consumers could have been immediately responsible for the higher cost of fuel and purchased power. The fuel adjustment clause recovery of the cost of replacement power is tantamount to providing "outage insurance" for Aquila. There is no reason for consumers to assume such risk and

[54] Johnstone Rebuttal, p. 23.

effectively provide such insurance for Aquila, where they are simply not in control of the circumstances. [55]

The performance standard that should be adopted for a coal-fired MWh is an output of not less than 96 percent of the coal-fired MWh output that is a part of the Commission Staff's fuel run in this proceeding. This Staff fuel run is based on a normal level of outages. The Staff has examined the outage history and built into its analysis a reasonable level of performance. This model does not reflect either the best or the worst performance possible, but rather a reasonable, normal level based on the analysis of several recent years of experience. As a means of bolstering the figure proffered, the attachment to Mr. Rooney's direct testimony at Schedule HDR-8 is illustrative. That schedule provides a forecast of coal-fired generation for the period of 2006 through 2010. The year with the lowest amount of coal fired generation had generation equal to 96.7 percent of the average for the entire period. [56] If Aquila generation does not come up to the level of the performance standard (in either of the accumulation periods), then additional generation would be imputed. The generation would be imputed at the average cost of coal-fired generation during the period. In order to give effect to the lower-cost generation that is imputed, it would be necessary to remove a corresponding quantity of high-cost generation from the generation mix. [57]

9. Should the FAC reflect a rate cap on the amount of fuel costs increases that can be passed through to ratepayers?

The Commission should adopt what is referred to as a "soft rate cap." The effect of this "soft cap" is to limit the immediate increase, but to provide for the

[55] Johnstone Rebuttal, pp. 16 – 7.
[56] Johnstone Rebuttal, p. 18.
[57] Johnstone Rebuttal, p. 19.

intended recovery through an extended recovery period while providing interest to Aquila to compensate it for the carrying cost. [58] The cap should be set at 1.5%. This would, in effect, allow the average retail customer to experience a rate increase of up to 3% per year. The effect would still vary from customer to customer and among other rate classes, but it would provide a reasonable level of protection to all consumers. Such a rate cap contains other, beneficial features besides extending recovery time and limiting dramatic rate increases. By definition, the rate cap would come into effect only when there are significant increases in the cost of fuel purchase power and off system sales margins. Under these circumstances, it is likely that the parties, and perhaps the Commission itself, would wish to have an investigation before the full amount of the increase is passed through to consumers. By limiting the initial amount of any increase to 1.5 percent, there would be a twelve-month delay during which a prudence review or any other review could be conducted by the commission. Under these circumstances, besides just limiting the extent of any increase at any point in time, there is the beneficial effect of better ensuring that the costs recovered ultimately will only be those of that had been prudently incurred by Aquila. [59]

10. What should be the recovery period for any fuel costs that exceed the rate cap?

In addition to limiting the initial amount of any increase to 1.5 percent, a twelve-month delay during which a prudence review or any other review could be conducted by the commission would be a sufficient protection for consumers, while allowing for a reasonable cost recovery by the utility. Besides just limiting the extent of any increase at any point in time, there is a beneficial effect of better ensuring that the

[58] Johnstone Rebuttal, p. 24.
[59] Johnstone Rebuttal, p. 25.

costs recovered ultimately will only be those of which had been prudently incurred by Aquila and would prevent "sticker shock" on the part of consumers. [60]

Respectfully submitted this, the 29th day of March, 2006.

FRANK D. HOLLIFIELD, Capt, USAF
Utility Litigation and Negotiation Attorney
For the Federal Executive Agencies

[60] Johnstone Rebuttal, p. 25.

CERTIFICATE OF SERVICE

I hereby certify that copies of this brief have been mailed or transmitted by facsimile or electronic mail to all counsel of record in this proceeding, as provided for by the Secretary of the Commission, this, the 29th day of March, 2007.

FRANK D. HOLLIFIELD, Capt, USAF
Utility Litigation and Negotiation Attorney
For the Federal Executive Agencies