

*Exhibit No.:*

*Issues: Gas Prices  
Corporate Allocation Adjustments  
SJLP Merger Transition Costs*

*Witness: Charles R. Hyneman*

*Sponsoring Party: MoPSC Staff*

*Type of Exhibit: Direct Testimony*

*Case No: HR-2005-0450*

*Date Testimony Prepared: October 14, 2005*

**MISSOURI PUBLIC SERVICE COMMISSION**

**UTILITY SERVICES DIVISION**

**DIRECT TESTIMONY**

**OF**

**CHARLES R. HYNEMAN**

**AQUILA, INC. d/b/a AQUILA NETWORKS – L&P**

**CASE NO. HR-2005-0450**

*Jefferson City, Missouri  
October 2005*

**\*\*Denotes Highly Confidential Information\*\***

**NP**

**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	)	Case No. HR-2005-0450
Retail SteamHeat Service Provided to Customers	)	Tariff No. YH-2005-1066
in Its L&P Missouri Service Area.	)	

**AFFIDAVIT OF CHARLES R. HYNEMAN**

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Charles R. Hyneman, being of lawful age, on his oath states: that he has participated in the preparation of the following Direct Testimony in question and answer form, consisting of 35 pages to be presented in the above case; that the answers in the following Direct Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

  
\_\_\_\_\_  
Charles R. Hyneman

Subscribed and sworn to before me this 13<sup>th</sup> day of October 2005.



  
\_\_\_\_\_  
Notary

TONI M. CHARLTON  
Notary Public - State of Missouri  
My Commission Expires December 28, 2008  
Cole County  
Commission #04474301

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**TABLE OF CONTENTS OF**  
**DIRECT TESTIMONY OF**  
**CHARLES R. HYNEMAN**  
**AQUILA, INC. d/b/a AQUILA NETWORKS - L&P -STEAM**  
**CASE NO. HR-2005-0450**

Executive Summary ..... 2

Natural Gas Prices..... 5

Corporate Allocation Adjustments ..... 18

    Corporate Restructuring Adjustment ..... 19

    Community Relations Adjustment..... 28

    Corporate Lobbying Adjustment ..... 29

    20 West 9th Headquarters Adjustment ..... 30

    Supplemental Executive Retirement Plan (SERP) ..... 32

SJLP Merger Transition Costs ..... 33

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1 Q. With respect to Case No. HR-2005-0450, have you made an examination of  
2 the books and records of Aquila Inc. (Aquila or Company) its Light & Power (L&P)  
3 operating division?

4 A. Yes, in conjunction with other members of the Commission Staff (Staff).

5 Q. What is the purpose of your direct testimony?

6 A. The purpose of this testimony is to provide a recommendation to the  
7 Commission that it should order an Interim Energy Charge (IEC) for L&P's variable fuel  
8 costs, including costs of natural gas purchased for electric generation. If an IEC is not  
9 adopted in this case, I provide a recommendation on what the Staff believes to be an  
10 appropriate cost of natural gas for L&P's electric generation operations. This price is  
11 representative of an amount on which an IEC price range can be developed. Finally, I will  
12 describe Aquila's natural gas hedging policies.

13 In addition to my recommendation on natural gas costs, I will be supporting certain  
14 Staff adjustments to Aquila's allocated corporate overhead charges to its L&P operating  
15 division.

16 Finally, I will be proposing to include an amortization of the transition costs incurred  
17 by Aquila in the integration of L&P into its corporate structure after the acquisition of  
18 St. Joseph Light & Power Company (SJLP). This acquisition was approved by the  
19 Commission in December 2000.

20 **Executive Summary**

21 Q. Please summarize the Staff recommendations included in your testimony.

22 A. The Staff is proposing an IEC in substantially the same format as Aquila's  
23 current IEC. The Staff believes an IEC is needed in this period of historically high and very

1 volatile gas prices. In his direct testimony, Staff witness Cary G. Featherstone will provide  
2 additional information on the IEC and the Staff's proposed modification to Aquila's existing  
3 IEC.

4 I am also proposing the Staff's recommended cost of natural gas burned for electric  
5 generation if an IEC is not granted in this case. This price is representative of an amount on  
6 which an IEC price range can be developed. The Staff is proposing L&P's actual natural gas  
7 costs in the month of June 2005 (the end of the Commission's ordered updated test year in  
8 this case) as the level of natural gas costs to include in cost of service, absent an ordered IEC  
9 in this case. Aquila's pre-hedged cost of natural gas for L&P's electric generation was  
10 approximately \*\* \_\_\_\_\_ \*\* in June 2005.

11 Finally, with respect to natural gas prices, my testimony includes a description of  
12 Aquila's natural gas hedging procedures.

13 On the issue of corporate allocations, I will be supporting several Staff adjustments to  
14 Aquila's proposed level of corporate overhead costs. I will be sponsoring the adjustment to  
15 allocate fifty percent of the cost of several corporate departments to Aquila's current  
16 corporate restructuring operations.

17 I will also be sponsoring adjustments to reclassify corporate lobbying costs and a  
18 portion of corporate community development costs from above the line accounts (included in  
19 cost of service) to below the line accounts (not included in cost of service). The nature of the  
20 costs that I am reclassifying have traditionally been treated by this Commission as below-the-  
21 line costs for ratemaking purposes.

22 My other adjustments to corporate allocated costs is to remove all of Aquila's  
23 supplemental executive retirement plan (SERP) costs and \*\* \_\_\_\_\_

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In the last section of my testimony I will be proposing an amortization of transition costs incurred by Aquila in its acquisition of its L&P division in 2000.

Q. What knowledge, skill, experience, training or education do you have with regard to auditing Aquila's natural gas costs and its corporate cost allocation procedures?

A. I have significant experience auditing Aquila's corporate overhead cost allocations as I have audited these costs in both of Aquila's most recent rate cases, Nos. ER-2001-672, ER-2004-0034, HR-20040024 and GR-2004-0072. In addition, I was the primary Staff witness on the issue of corporate overhead cost allocations in other major rate cases before this Commission.

My college undergraduate and graduate coursework included accounting and auditing classes. I also completed several high-level federal contract administration classes through the Air Force Institute of Technology which included an emphasis on cost causation and cost allocation methods.

As it relates to natural gas prices and hedging activities, my formal education at the undergraduate and graduate level included courses in business statistics and finance. I participated in post-graduate work on financial stock options, calls and puts, which included a study and presentation at a financial symposium of the variables that influence the prices of stock options. I also recently completed two training sessions specifically focusing on natural gas purchasing and natural gas hedging procedures.

Q. What Income Statement adjustments to the Staff Accounting Schedules are you sponsoring?

1           A.     I am sponsoring numerous adjustments to Accounting Schedule 9, Income  
2 Statement, that are listed on Accounting Schedule 10, Adjustments to Income Statement.

3 These adjustments are:

4           Corporate Allocations Adjustment Numbers:

5           L&P (Steam)

6           Restructuring: S-18.12, S-30.12, S-32.12, S-41.4, S-47.12

7           Lobbying: S-18.13, S-30.13, S-32.13, S-41.5, S-47.13

8           Community Relations S-18.14, S-30.14, S-32.14, S-41.6, S-47.14

9           20 W 9th: S-18.15, S-30.15, S-32.15, S-41.7, S-47.15

10          SERP: S-18.16, S-30.16, S-32.16, S-35.9, S-41.8, S-47.16

11 The adjustment to include merger transition costs is S-40.14.

12          Q.     Are you sponsoring any other components of the Staff's Accounting  
13 Schedules?

14          A.     Yes. I am also sponsoring Shared Corporate Plant, listed on Accounting  
15 Schedule 3, Total Plant in Service.

16          Q.     Are you sponsoring any adjustments to Shared Corporate Plant for L&P?

17          A.     No, not at this time. The Staff still has some questions on some of the  
18 individual shared corporate plant accounts that have not been resolved. The Staff anticipates  
19 resolving these questions soon after its direct filing in this case. The Staff is currently  
20 reviewing corporate plant workorders to ensure that all capitalized costs are appropriate to  
21 include in rates.

22 **Natural Gas Prices**

23          Q.     What is the Staff's recommendation on the cost of natural gas used for  
24 generation this case?

25          A.     Aquila currently has an IEC in place from its last rate case, No.  
26 ER-2004-0034. This IEC is scheduled to expire when new rates from this case go into effect



1 in April 2006. The volatility in the natural gas and energy markets that caused the need for  
2 an IEC in the 2004 case has not subsided. This continued volatility is the basis for the Staff's  
3 recommendation that the IEC process for L&P's fuel costs should be continued. Staff  
4 witness Cary G. Featherstone presents a detailed discussion on the IEC from a historical  
5 perspective and the current need for a continuation of the IEC in his direct testimony in this  
6 case.

7 Q. Is the Staff recommending a range of natural gas prices to be used as a  
8 "ceiling" and "floor" in its direct filing?

9 A. No. The Staff is not proposing a specific dollar range of an IEC in direct  
10 testimony. The Staff believes it is in the best interests of this case if the actual range of  
11 natural gas prices to include in an IEC are negotiated by the parties to this case during the  
12 upcoming case settlement discussions. This has been the process in which past IEC  
13 mechanisms have been developed. The Staff believes that Aquila's actual costs of natural  
14 gas in June 2005 will serve as a basis around which the IEC "floor" and "ceiling" prices can  
15 be negotiated.

16 Q. Will the Staff continue to evaluate Aquila's natural gas prices through the  
17 remainder of this case including the true-up phase of its audit?

18 A. Yes. The Staff will evaluate the recent extreme volatility in the energy market  
19 and will address this issue and Aquila's post June 2005 natural gas costs in the true-up audit.

20 Q. If a new IEC is not ordered in this case, what level of natural gas prices is the  
21 Staff recommending be included in cost of service for L&P?

1           A.     The Staff is recommending that Aquila's cost of natural gas for electric  
2 generation during the month of June 2005, weighted by generation unit, be used as the level  
3 of natural gas costs to include in L&P's cost of service in this case.

4           Q.     Please describe the L&P's electric generation unit that uses natural gas as a  
5 fuel source.

6           A.     The L&P generating unit that use natural gas as a fuel source is the Lake Road  
7 plant. Please see the direct testimony of Staff witness Graham A. Vesely for a more detailed  
8 description of this generation unit.

9           Q.     What are the June 2005 natural gas prices per MMBtu by generation unit  
10 recommended by the Staff if an IEC is not ordered in this case?

11          A.     \*\* \_\_\_\_\_ \*\*. This pricing data was  
12 obtained from Aquila in response to Staff Request Nos. 158, 158.1 and 158.2.

13          Q.     Where will these natural gas prices be reflected?

14          A.     Staff witness David W. Elliot of the Commission's Energy Department used  
15 these natural gas prices as input data into the RealTime TM production cost model (fuel  
16 model) to prepare the fuel and purchased power cost calculations used in the Staff's direct  
17 filing.

18          Q.     Does the price you listed above include the impact of Aquila's natural gas  
19 hedging operations?

20          A.     No, they do not. These prices represent actual prices paid to Aquila's natural  
21 gas suppliers. However, as will be described later, only one-third of Aquila's gas purchases  
22 are subject to current market prices. Two-thirds of its supplies are hedged either through  
23 NYMEX futures contracts or options contracts.

1 Q. How did you develop your current recommended level of natural gas prices?

2 A. I had many discussions with Company personnel responsible for Aquila's gas  
3 purchases and hedging operations. I reviewed several publications that report on natural gas  
4 prices and current issues in the natural gas industry. I read many articles and publications on  
5 hedging, especially hedging with natural gas futures contracts and options. I read the  
6 testimony on the issue of natural gas prices in this case and previous Aquila rate cases. I read  
7 the testimony of Staff witnesses and Company witnesses in other rate cases. I reviewed  
8 workpapers and analysis of natural gas purchases produced by the Staff and Company  
9 witnesses in other rate cases. I reviewed the response to data requests on natural gas and  
10 hedging operations in this case. I attended training sessions on natural gas purchasing and  
11 hedging practices. Finally, I had discussions with senior staff auditors with vast experience  
12 on this issue as well as other auditors who have recently worked on natural gas prices in  
13 utility rate cases.

14 Q. Is the Staff's proposed level of natural gas prices representative of today's  
15 current market prices?

16 A. No. Recently, natural gas prices have been in the \$11 to \$14/MMBtu range at  
17 the Henry Hub. The Henry Hub is the pricing point for natural gas futures contracts traded in  
18 the New York Mercantile Exchange, or NYMEX, and is a common reference point for the  
19 current price of natural gas. The Henry Hub is a point on the natural gas pipeline system in  
20 southern Louisiana. It is owned by Sabine Pipe Line LLC.

21 Q. Does Aquila buy any of its natural gas from the Henry Hub?

1           A.     No. Aquila purchases its natural gas from sources in the Texas, Oklahoma  
2 and Kansas region. Natural gas prices in these markets are typically less than prices at the  
3 Henry Hub.

4           Q.     Is there a significant difference in the prices of natural gas sourced in the Gulf  
5 region, such as the Henry Hub and the region where Aquila purchases its natural gas for  
6 generation because of the recent hurricane activity?

7           A.     Yes. For example, in the Wednesday October 12, 2005 Gas Daily, the  
8 October 11, 2005 price at the Henry Hub was \$13.665/MMBtu, which was representative of  
9 all the natural gas prices in the Gulf region. The average natural gas price where Aquila  
10 purchases its natural gas in Oklahoma was around \$10.75/MMBtu.

11          Q.     What has led to the current high level of natural gas prices?

12          A.     The recent hurricane activity in the Gulf of Mexico (Hurricanes Katrina and  
13 Rita) has led to reduced energy production, which has contributed to lower supplies and  
14 therefore higher prices. According to the September 29, 2005 edition of its Natural Gas  
15 Weekly Update, the Energy Information Administration (EIA) reported that “the  
16 combination of Hurricanes Katrina and Rita has disrupted natural gas supplies and continued  
17 to prop up prices at near-record highs around the nation.” In its October 6, 2005 edition, the  
18 EIA reported that “with large amounts of offshore production still shut-in in the Gulf of  
19 Mexico, natural gas spot prices increased at all market locations over the period covered by  
20 this report (September 28 to October 5).”

21          Q.     What is the EIA?

22          A.     The EIA was created by Congress in 1977. It is a statistical agency of the  
23 U.S. Department of Energy. The EIA provides policy-independent data, forecasts, and

1 analyses to promote sound policy making, efficient markets, and public understanding  
2 regarding energy and its interaction with the economy and the environment. On its website,  
3 the EIA produces a weekly report entitled Natural Gas Weekly Update.

4 Q. What was the price of natural gas at the Henry Hub the month before the  
5 impact of Hurricane Katrina was felt in the market?

6 A. Hurricane Katrina's impact was reflected in the Henry Hub price on  
7 August 26, 2005. On that date, the market price of natural gas was \$9.86. On August 31,  
8 2005, market prices at the Henry Hub closed at \$12.70 an almost 30 percent increase.

9 Q. Have you looked at natural gas price forecasts made prior to the impact of  
10 Hurricane Katrina?

11 A. Yes I have.

12 Q. What have you found?

13 A. A summary of the price forecasts is shown below:

14 \*In early June 2005, the EIA lowered its estimate of the 2005 overall Henry  
15 Hub price by 11 cents to \$6.90/Mcf and its 2006 estimated price by 23 cents  
16 to \$7.10/Mcf.

17  
18 \*In its July short-term energy outlook, the EIA adjusted its full year 2005 and  
19 2006 projections to \$7.21/Mcf and \$7.41/Mcf respectively.

20  
21 \*On August 1, 2005, Mark Rodekohr, director of EIA's Energy Markets and  
22 Contingency Information Division told a Denver, Colorado audience of  
23 executives attending the Rocky Mountain Natural Gas Strategy Conference  
24 that U.S. natural gas prices will remain at or near current levels for at least  
25 two more years. The week prior to his prediction, natural gas prices at the  
26 Henry Hub were trading in a range of \$7.38 to \$7.77.

27  
28 \*On June 16, 2005, Energy and Environmental Analysis projected gas prices  
29 for 2007 at the Henry Hub to be a very bullish \$8.50/MMBtu. EEA kept its  
30 2005 price prediction of \$6.45/MMBtu unchanged and left its 2006 forecast of  
31 \$7.50/MMBtu intact.  
32

1                   \*On Thursday July 21, 2005 Jeffries & Co. energy analyst Frank Bracken  
2                   increased his 2005 Henry Hub natural gas price forecast to \$6.80/MMBtu and  
3                   adjusted his 2006 forecast to \$6.20/MMBtu.

4           Q.     What do these natural gas forecasts indicate?

5           A.     These forecasts indicate that when you carve out the extraordinary impacts of  
6           the Hurricane activity in the Gulf of Mexico (these forecasts were made prior to  
7           Hurricane Katrina), the projections of the 2006 average "market price" of natural gas  
8           prices by experts in this field were all at or under \$7.50 per MMBtu. If these forecasts are  
9           reasonably accurate, and assuming that the market impact of the hurricane activity has faded  
10          from the market in April 2006 (when rates from this case go into effect), these forecasts  
11          indicate that the \*\* \_\_\_\_\_ \*\*. The  
12          Staff's proposal is even further substantiated if Aquila's hedging strategy results in a net  
13          lower natural gas cost than the \*\* \_\_\_\_\_ \*\* level proposed by the Staff.

14          Q.     Does Aquila have a hedging program in place to help address volatile natural  
15          gas prices?

16          A.     Yes. Aquila began its current hedging program in July 2004. The program  
17          was implemented around the same time Aquila's current IEC took effect. Prior to July 2004  
18          Aquila did not have any significant hedging activities.

19          Q.     What is the purpose of a natural gas hedge?

20          A.     The sole purpose of a hedge is to lock in a price today for natural gas that will  
21          be delivered in the future. Locking in a price now for a future delivery of a commodity such  
22          as natural gas is an attempt to mitigate or lessen price risk. While this describes the purpose  
23          of a physical hedge (taking actual delivery of the gas) it is equally applicable to a financial  
24          hedge (selling the financial instrument at current market prices prior to taking delivery of the

1 gas). In a financial hedge, the gain on the sale of the financial hedge instrument (futures  
2 contract or option) is used to offset the current market price that you pay for the gas.

3 Q. Please describe Aquila's 2004 hedging program.

4 A. \*\* \_\_\_\_\_  
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8 \_\_\_\_\_  
9 \_\_\_\_\_  
10 \_\_\_\_\_  
11 \_\_\_\_\_ \*\*

12 Q. What percentage of Aquila's natural gas volumes is hedged?

13 A. \*\* \_\_\_\_\_  
14 \_\_\_\_\_  
15 \_\_\_\_\_  
16 \_\_\_\_\_  
17 \_\_\_\_\_ \*\*

18 Q. What is a natural gas futures contract?

19 A. A natural gas futures contract is a rigidly standardized, monthly forward  
20 contract that is traded on the NYMEX for 72 months into the future. It is a firm obligation to  
21 buy or sell a defined monthly quantity of natural gas at a specific future time, price and  
22 location. Delivery of the physical commodity is possible but occurs infrequently. Most  
23 contracts are sold at prevailing market prices prior to the contract expiration.

1 Q. How far in to the future does Aquila hedge?

2 A. \*\* \_\_\_\_\_

3 \_\_\_\_\_ \*\*

4 Q. Does Aquila engage in any physical hedges, where it would actually take  
5 delivery of hedged natural gas or does Aquila engage solely in financial hedges?

6 A. Aquila engages solely in financial hedges. It does not take physical  
7 ownership of any of the gas it hedges.

8 Q. Mechanically, how does Aquila transact its financial hedges?

9 A. \*\* \_\_\_\_\_

10 \_\_\_\_\_

11 \_\_\_\_\_ \*\* Aquila has decided to record these financial settlements, which result in  
12 either a gain or a loss, in FERC account 417.1 Expenses of non-utility operations.

13 Q. Has Aquila reflected any of its hedging operations in its direct filing in this  
14 case?

15 A. No. No impact of Aquila's hedging is reflected in its rate case filing. In fact,  
16 the Staff has found no reference to Aquila's hedging operations in any testimony filed by  
17 Aquila in this case.

18 Q. Has Aquila reflected the results of its natural gas hedging in the monthly IEC  
19 reports submitted to the Staff?

20 A. No. In tracking its variable fuel and purchase power costs since the  
21 implementation of the IEC in its last rate case, Aquila has not reflected the results of its  
22 hedging operations.



1           In discussions with Aquila personnel the Staff has learned that since they believe that  
2           the IEC language included in the Stipulation and Agreement in Case No. ER-2004-0034 did  
3           not call for the IEC to be adjusted for gains and losses from Aquila's financial hedges, it did  
4           not include these gains and losses in the monthly IEC calculations. In order words, hedging  
5           gains, which would reduce fuel expense and hedging losses, which would increase fuel  
6           expense, are not being reflected in Aquila's current estimate of its over or under recovery of  
7           variable fuel expense under its existing IEC.

8           Q.     Prior to this rate case was the Staff under the impression that Aquila's current  
9           IEC calculations included the impact of its hedging operations?

10          A.     Yes. Through discussions with Company personnel, the Staff was aware that  
11          Aquila's administrative costs of its hedging program was not in the IEC calculation.  
12          However, the Staff was under the assumption that the actual gains and losses of the hedges  
13          were reflected in the monthly IEC calculations. The Staff made it known to Aquila that it  
14          intended to include the administrative costs of the hedging program in the IEC.

15          Q.     Has Aquila's hedging program been successful?

16          A.     This has been hard for the Staff to determine. The Staff has asked Aquila to  
17          provide it with monthly pre-hedged and post-hedged gas prices since it instituted its hedging  
18          program. Aquila has advised the Staff that it has had great difficulty doing this calculation  
19          and has to date not provided this information to the Staff.

20          However, when you look at the gains and losses from its financial hedging  
21          transactions that Aquila records in a below the line FERC account No. 417.1, the results, to  
22          date, do not appear to be impressive. Since it began recording gains and losses from this  
23          hedging plan in July 2004, Aquila has recorded a cumulative loss of \$269,840.

1 For calendar year 2004 it recorded a loss of \$2,192,610. In 2005, with the recent  
2 escalation of natural gas prices, the financial results of Aquila's hedging program have  
3 improved. From January through September 2005, Aquila has recorded a gain of  
4 \$1,922,770, with all of this gain occurring in the last three months of July, August and  
5 September, with Aquila recording close to a \$1 million gain in September. This information  
6 was provided to the Staff in response to Data Request No. 448.

7 Q. What are some of the variables that could influence whether a gain or loss on  
8 financial hedging transactions is realized?

9 A. With all other factors remaining equal, when prices rise in the physical  
10 market, a gain is more likely on an existing futures contract as the futures contract becomes  
11 more valuable (contract price is less than current market price). The opposite is true. When  
12 current market prices of natural gas drop, the value of the futures contracts also drops which  
13 causes a loss in the hedging program for that period.

14 This is one reason why it is difficult to determine at this point if Aquila's hedging  
15 program has been successful without further analysis. Its continuing losses up until the  
16 recent months could simply be the result of declining gas prices. The Staff has done no  
17 analysis to make this determination.

18 Q. Please provide an example of a hedge where a NYMEX futures contract  
19 results in a gain.

20 A. Assume it is October 10, 2005 and you are a natural gas buyer who plans to  
21 purchase December natural gas at the Henry Hub. You are concerned that actual December  
22 prices will be higher than the current price of the December futures contract, which is  
23 currently trading at \$5.00/MMBtu. The first thing you would do is to purchase a futures

1 contract on the NYMEX for December 2005 delivery. Assume now that it is November 25,  
2 2005 and you go out and buy your physical natural gas. You were correct and the price has  
3 risen to \$7.00/MMBtu. After you purchase your physical gas you no longer have a need for  
4 your futures contracts so you call your broker and sell one NYMEX contract at the \$7 current  
5 market price. Since one NYMEX contract is for 10,000 MMBtu, you record a gain of  
6 \$20,000 (\$2 gain per MMBtu times 10,000 MMBtu).

7 Q. Please provide an example of a hedge where a NYMEX futures contract  
8 results in a loss.

9 A. Assume the same facts in the example above except that at November 25,  
10 2005 when you go into the market to buy your physical natural gas the price has dropped to  
11 \$2.50/MMBtu. You purchased your physical gas so you call your broker and close out your  
12 futures position. You take a \$2.50/MMBtu loss on the futures contract (purchased for \$5 and  
13 sold for \$2.50 current market price) and you pay \$2.50/MMBtu for your physical gas for a  
14 total cost of \$5/MMBtu.

15 Q. Please provide an example of a hedge using options.

16 A. Again, assume it is October 10, 2005 and you are a natural gas buyer that  
17 plans to purchase December natural gas at the Henry Hub. You expect that natural gas prices  
18 will fall but you want to have some insurance against a spike in prices. One action you could  
19 take is to establish a price cap by purchasing a call option. Assume you buy a \$4.50 call  
20 option on a December 2005 natural gas futures contract. The premium or price of the option  
21 is \$.50 per MMBtu.

22 In late November you go into the market and purchase natural gas. You predicted  
23 incorrectly and the market price of natural gas has risen to \$8.00/MMBtu. After you

1 purchase your physical gas you no longer have a need for your call option so you sell your  
2 call option. Since the market is at \$8/MMBtu and you purchased the call option at \$4.50, the  
3 intrinsic value of the option is \$3.50. This amount, less the \$.50 premium results in a gain of  
4 \$3.00. Your cost of natural gas is the market price of \$8.00/MMBtu less the \$3.00 gain for a  
5 net cost of \$5.00/MMBtu. By purchasing a call option you are able to participate in a price  
6 declining market, but you also establish a ceiling price you will pay. In this example, the  
7 ceiling is the sum of the strike price of the call option, \$4.50, and the premium \$.50, or  
8 \$5.00/MMBtu.

9 If the price of natural gas had declined as you expected, for example to  
10 \$2.50/MMBtu, your cost of the gas would be \$3.00. This is the cost of the gas in the market  
11 of \$2.50 plus the \$.50 premium. Since the market price of the gas is less than the option to  
12 purchase gas (at the option expiration date) the option would expire worthless. The purchase  
13 of the call option allowed you to establish a ceiling price while also allowing you to  
14 participate in a declining price market.

15 Q. Is the Staff prepared at this time to provide the Commission with an overall  
16 opinion of Aquila's hedging operations?

17 A. No. This is the first rate case in which Aquila has a hedging program. The  
18 program is still relatively young and hopefully Aquila is and will be adjusting its hedging  
19 program to make it more effective.

20 Q. Will the Staff be closely monitoring the effectiveness of Aquila's hedging  
21 program in the future?

1           A.     Yes. Because of the impact of Aquila's hedging program on its current and  
2 possibly future IEC, the Staff will be paying very close attention to Aquila's hedging  
3 operations in the future.

4           Q.     While the Staff has not formulated an overall opinion on Aquila's hedging  
5 program, does the Staff have any concerns about Aquila's current hedging program?

6           A.     Yes. \*\* \_\_\_\_\_  
7 \_\_\_\_\_  
8 \_\_\_\_\_  
9 \_\_\_\_\_  
10 \_\_\_\_\_  
11 \_\_\_\_\_  
12 \_\_\_\_\_  
13 \_\_\_\_\_  
14 \_\_\_\_\_ \*\*

15           It would be appropriate for Aquila to give serious thought and consideration to  
16 delaying the purchase of financial hedges in certain situations. One situation is when the  
17 market is experiencing extremely high and even unprecedented prices that could very well be  
18 caused by a short term extraordinary event, such as the two major hurricanes of historical  
19 levels that hit the Gulf region in the last two months. While the decision to buy the hedge  
20 may still be appropriate in this situation, the Staff believes Aquila should at least give serious  
21 consideration to delaying such purchases.

22           **Corporate Allocation Adjustments**

23           Q.     Please describe the process Aquila uses to allocate costs to its business units.

1           A.     A description of Aquila's corporate overhead cost allocation process is  
2 included in the direct testimony of Staff witness Lesley R. Preston.

3           Q.     What adjustments are being proposed by the Staff to L&P's test year corporate  
4 allocated costs?

5           A.     The Staff's adjustments can be classified into nine categories of adjustments to  
6 L&P's per book corporate allocated costs. I will be sponsoring adjustments 4, 5, 6, 7 and 8.  
7 Staff witness Preston will be sponsoring adjustments 1, 2, 3, and 9. These adjustments are  
8 included in Accounting Schedule 10, Adjustments to Income Statement:

- 9                   1.     Adjust test year cost to reflect Aquila's corporate allocation adjustment;
- 10                  2.     Modify Aquila's Massachusetts factor as a general allocator;
- 11                  3.     Reflect the Staff's proposed South Harper plant costs in the
- 12                         Massachusetts factor;
- 13                  4.     Reclassify 50 percent of the cost of certain corporate departments to
- 14                         restructuring operations (Restructuring adjustment);
- 15                  5.     Charge corporate lobbying costs to below the line accounts (Lobbying
- 16                         adjustment);
- 17                  6.     Charge 25 percent of Community Relations department related to
- 18                         charitable contributions to below the line accounts (Community
- 19                         Relations adjustment);
- 20                  7.     Include rent revenues for Aquila's to reflect a more efficient use of
- 21                         office space in its 20 W 9th Headquarters building (20 W 9th
- 22                         adjustment);
- 23                  8.     Remove supplemental executive retirement costs (SERP adjustment);
- 24                  9.     Include Aquila's Six Sigma costs.

25     **Corporate Restructuring Adjustment**

26           Q.     Please describe the corporate restructuring adjustment.

27           A.     This adjustment reclassifies 50 percent of the costs of selected corporate  
28 departments to Aquila's restructuring activities. Restructuring activities are activities  
29 engaged in by Aquila employees (mostly at the senior management level) with the purpose of  
30 restoring Aquila to financial health. Aquila's failed non-regulated business adventures in  
31 2002 have taken the Company to the brink of bankruptcy. Aquila has been working diligently

1 over the last three years, in various restructuring activities, to recover from this financial  
2 distress. It is the Staff's position and Aquila's position that the costs of Aquila's restructuring  
3 activities should be borne by its utility customers.

4 Q. Did Aquila make a commitment that its ratepayers would not be negatively  
5 impacted by its current financial difficulties?

6 A. Yes. At page 7 of his direct testimony, in Case No. EF-2003-0465 dated  
7 April 30, 2003, Mr. Jon R. Empson, Aquila's Senior Vice President, Regulatory, legislative,  
8 and Gas Supply Services stated "...while Aquila accepts full responsibility for its past  
9 strategy, Aquila is also taking full responsibility for restoring financial stability without  
10 adversely impacting the customer."

11 Q. Which corporate overhead departments did the Staff determine should be  
12 allocated restructuring operations?

13 A. The Staff determined that the following corporate departments have been  
14 significantly involved in Aquila's restructuring operations:

15 Dept 4030 Chief Operating Officer  
16 Dept 4035 Chief Financial Officer  
17 Dept 4040 Chairman and CEO  
18 Dept 4043 Board of Directors Management  
19 Dept 4155 Corporate Compliance  
20 Dept 4033 Energy Resources  
21 Dept 4120 Corporate Communications  
22 Dept 4223 HR Executive  
23 Dept 6370 Regulatory Administration

24 Q. Please describe the progress made by Aquila in its restructuring activities over  
25 the last three years.

26 A. Aquila has been in a corporate restructuring mode since about March 2002  
27 when it launched an initiative, known internally as Project BBB+/Baa1. This project was

1 implemented to reduce costs by \$100 million and sell \$500 million in assets in an effort to  
2 improve Aquila's credit standing. For the remainder of 2002 and 2003 Aquila's management  
3 was very heavily engaged in its restructuring operations.

4 In a press release dated November 6, 2003, Aquila announced that it is continuing to  
5 execute its restructuring plan. Mr. Richard C. Green, Aquila's chairman and chief executive  
6 officer (CEO) is quoted in this press release as saying "Aquila still has significant work  
7 ahead to ensure a firm foundation for the company. Our focus in the coming months will be  
8 finalizing our pending U.K. and Canadian asset sales and continuing to pursue much-needed  
9 rate relief. At the same time, we are committed to further improving our financial condition  
10 by selling our investment in independent power plants, and by exiting our remaining tolling  
11 agreements."

12 On March 14, 2005 Aquila announced plans to further reposition its business and  
13 enhance its ability to realize Aquila's long-term growth opportunity as an integrated natural  
14 gas and electric utility focused on providing safe and reliable service to customers.  
15 Mr. Green, Aquila's CEO is quoted in the press release:

16 Over the last two years, we have made significant progress on Aquila's  
17 repositioning and have successfully executed more than 30 major  
18 initiatives to stabilize the company's financial condition and improve  
19 the financial performance of our regulated utility business.

20 With these advances, Aquila now has the opportunity to accelerate its  
21 repositioning plan, which will significantly improve our credit metrics  
22 and increase investment in the years ahead to meet the needs of our  
23 customers.

24 This accelerated repositioning effort will include the selective  
25 divestiture of regulated utility assets to raise funds to further  
26 strengthen the company's balance sheet and provide the catalyst for  
27 future investment in regulated capital projects. Aquila has the  
28 opportunity to invest in generation, transmission and electric and  
29 natural gas distribution capacity, as well as required environmental  
30 upgrades. These investments will strengthen our utility business and



1 improve our returns and earnings. We believe the incremental  
2 investment opportunity is approximately \$650 million over the next  
3 five years. By pursuing this course, our goal is to put Aquila on a clear  
4 path to achieve an average annual EBIT growth rate on post-  
5 divestiture rate base of 3 percent to 5 percent and move further toward  
6 investment grade credit metrics.

7 On September 21, 2005 Aquila announced that it has signed definitive agreements to  
8 sell four utility businesses identified for potential sale on March 14, 2005, for a total of  
9 \$896.7 million.

10 Q. How long does Aquila estimate it will take to complete the regulatory  
11 approvals of the sales?

12 A. Aquila anticipates receiving timely regulatory approvals for these transactions  
13 within approximately 12 months.

14 Q. Did several of Aquila's top executives receive significant compensation for  
15 the work done on the utility asset sales portion of Aquila's overall restructuring operations?

16 A. Yes. In its Form 8-K filed with the Securities and Exchange Commission on  
17 September 21, 2005, Aquila described the bonus it was paying to its corporate executive  
18 team for the work done on the utility asset sales:

19 On September 22, 2005, the Compensation and Benefits Committee of  
20 the Company's Board of Directors adopted an executive cash bonus  
21 plan. The objective of the plan is to acknowledge the **successful**  
22 **execution of the initial phase of the Company's strategy to reduce**  
23 **debt through the sale of the utility properties described above as**  
24 **well as to provide an incentive to complete each of the four**  
25 **announced transactions.** Under the bonus plan, executive officers of  
26 the Company will immediately receive a cash bonus of 25% of base  
27 salary and, if all of the transactions are consummated, will receive a  
28 further cash bonus of 75% of base salary. (emphasis added).

29 Q. Does the Staff consider activities and efforts undertaken by Aquila's senior  
30 management to dispose of a significant portion of its utility assets to be efforts to restore  
31 Aquila's financial stability?

1           A.     Yes, it does. Aquila is engaged in several different types of restructuring  
2 activities designed to restore financial health. The sale of a portion of its domestic utility  
3 business is only one of these activities.

4           Q.     How did you select the corporate departments to be allocated to restructuring  
5 operations?

6           A.     As I have done in Aquila's two previous rate cases, I reviewed board of  
7 director minutes, Aquila's annual reports, SEC filings, press releases, responses to data  
8 requests in this case and previous cases, payments to outside contractors, and used the  
9 experience gained in auditing Aquila's corporate allocations process in its previous two rate  
10 cases to develop a general understanding of the extent of Aquila's corporate department's  
11 involvement in Aquila's restructuring operations. I gave significant weight to documents  
12 filed with the SEC such as quarterly and annual reports as these documents provide  
13 information with a high degree of reliability.

14          Q.     Was the Staff's restructuring adjustment influenced by Aquila's Board of  
15 Directors' decision to pay \$3.339 million in bonus payments for work done to date on  
16 Aquila's utility asset sales and as an incentive to complete the sales over the next year or  
17 two?

18          A.     Yes. Of all the senior management employees selected for restructuring  
19 bonuses, I have only excluded Department 4031, General Counsel. A review of this  
20 departments corporate cost allocation showed that 47 percent of payroll costs are charged to  
21 corporate retained departments. Corporate retained departments are departments where costs  
22 are charged that are not allocated to the utility operating divisions, but are retained at the  
23 corporate level. It appears that this is the only Aquila corporate department that made the

1 effort to charge a portion of its payroll costs to non-utility operations, including restructuring  
2 operations.

3 I have also included an allocation of 50 percent of the costs of Department 4043,  
4 Board of Directors Management. A review of the minutes of the board meetings reveals that  
5 a significant part of the board's focus in on Aquila's restructuring operations, including how  
6 to sufficiently compensate Aquila's senior executives for its work on restructuring  
7 operations.

8 Q. You described Aquila's restructuring operations since it began to experience  
9 financial problems in 2002. What was Aquila's corporate structure in 2001, prior to its  
10 financial problems?

11 A. In 2001, Aquila was organized and its businesses were independently  
12 managed by business segments. Its four business segments were 1) Energy Merchant 2) U.S.  
13 Networks 3) International Networks and 4) Services. In November 2001, Aquila combined  
14 its U.S. Networks segment and its International Network segment into the Global Networks  
15 business segment.

16 Its Energy Merchant business provided risk management products and services,  
17 traded energy-related and other commodities, and marketed natural gas and electricity to  
18 industrial and wholesale customers in the U.S. and Canada. Aquila also marketed energy in  
19 Europe through its offices in the U.K., Germany and Norway. Through its Aquila Gas  
20 Pipeline Corporation subsidiary, Aquila gathered, transported and processed natural gas and  
21 gas liquids in Texas and Oklahoma. Aquila is still in the process of winding down its  
22 merchant operations. In 2001 the Merchant business had \$37.7 billion in sales, which

1 accounted for 94 percent of Aquila's total sales and had \$6.2 billion in assets, or 52 percent  
2 of total Company assets.

3 In 2001, Aquila's operating divisions in the U.S. served 349,000 electric distribution  
4 customers in three states: Missouri, Kansas and Colorado; and 831,000 natural gas  
5 distribution customers in seven states: Missouri, Kansas, Colorado, Nebraska, Iowa,  
6 Michigan and Minnesota. Its seven domestic utility divisions were, and still are today  
7 Missouri Public Service, St. Joseph Light & Power, Kansas Public Service, Peoples Natural  
8 Gas, WestPlains Energy, Northern Minnesota Utilities and Michigan Gas Utilities.

9 In 2001, Aquila operated electric and gas utility networks in Australia, New Zealand,  
10 and Canada. Aquila was the manager and 34 percent owner of United Energy in the  
11 Australian State of Victoria. United Energy has four business units including Distribution,  
12 Energy Merchant, Utili-Mode and UeComm. The distribution business serves 1.1 million  
13 electricity and gas customers in Melbourne and the Mornington Peninsula. UeComm, a  
14 telecommunications business, has developed networks in Sydney, Melbourne and Brisbane.

15 Aquila and United Energy jointly own 45 percent of AlintaGas Limited, a natural gas  
16 distributor in the state of Western Australia. AlintaGas is based in the city of Perth and has  
17 more than 430,000 customers.

18 Aquila owned 55 percent of UnitedNetworks Limited, a company that serves  
19 approximately 600,000 customers, mostly in the Auckland and Wellington areas.  
20 UnitedNetworks Limited is New Zealand's largest electricity lines company and natural gas  
21 distributor.

22 Aquila began operating in Canada since its acquisition of West Kootenay Power in  
23 1987. In February 2000 Aquila acquired TransAlta Corporation's distribution and retail

1 operations in Alberta for \$480 Million. Prior to its sale, Aquila operated this business as  
2 Aquila Networks Canada (Alberta), Ltd.

3 Aquila's Services segment in 2001 consisted of Quanta Services and Aquila  
4 Communications Services. During this time period Aquila held a 38.5 percent equity interest  
5 in Quanta Services, a Houston-based firm that builds and maintains networks carrying energy  
6 and telecommunications. In 2001 and the beginning of 2002, Aquila spend considerable time  
7 and resources trying, unsuccessfully, to achieve control over Quanta's operations. Aquila  
8 eventually failed in its attempt to take over Quanta and had to record a loss of nearly \$700  
9 million on this investment.

10 Formed in early 2000, Aquila Communication Services provided a range of  
11 broadband services including local and long-distance voice, high-speed Internet access and  
12 digital television. Aquila's joined partners with Unite, a competitive local exchange carrier  
13 serving an area north of Kansas City, and Everest Connections Corporation, a St. Louis-  
14 based telecommunications company involved in the construction and operation of broadband  
15 fiber-optic networks to homes and businesses.

16 Q. When did Aquila's current financial problems begin?

17 A. Aquila's current financial problems occurred with the announcement in April  
18 2002 by Moody's Investors Services that it was changing Aquila's outlook to negative. In  
19 response to this action, Aquila issued a press release on April 29, 2002 describing its current  
20 focus on its balance sheet and investment grade rating. In this press release, Aquila stated  
21 that it has taken a number of positive steps over the previous 12 months to strengthen its  
22 balance sheet and liquidity position. Aquila announced that it has issued over \$1 billion in  
23 equity, plans to sell \$500 million in less strategic assets, and was implementing cost-cutting

1 and revenue-enhancement measures with a goal of increasing earnings by \$100 million. This  
2 initiative became known as Project BBB+/Baa1. In addition to these actions, Aquila  
3 announced the following steps it has taken to strengthen its financial position:

4 On May 21, 2002 Moody's Investors Service's placed Aquila under review for  
5 possible downgrade. In a press release issued on this date, Robert K. Green, Aquila's then  
6 President and Chief Executive Officer stated "We've maintained an open dialogue with  
7 Moody's and made them aware of our plans to improve cash flow. We've already identified  
8 approximately \$96 million in savings as a result of staff reductions, elimination of executive  
9 incentives and a tightening on all expenditures. We expect to make significant progress in  
10 short order."

11 The next day, May 22, 2002, Aquila announced today that it is eliminating  
12 approximately 200 positions from its Merchant Services and Corporate staffs. This staff  
13 reduction is in addition to the elimination of 500 positions with completion of the previously  
14 announced restructuring of its Networks business.

15 On Jun 17, 2002 Aquila announced a new three-part plan includes: (1) a significant  
16 reduction and downsizing of its wholesale energy services business in response to the  
17 increased cost of capital for that business; (2) an anticipated \$.50 per share reduction in the  
18 annual common dividend to a new rate of \$.70 per share and (3) the issuance of \$900 million  
19 of new equity and debt securities in order to balance the capital structure and satisfy the  
20 company's remaining 2002 liquidity needs, including the funding of previously announced  
21 acquisitions.

1        Less than a month after it announced that it will restructure the wholesale energy  
2        marketing and trading business of its Merchant Services segment, On Aug 6, 2002, Aquila  
3        announced that it was totally eliminating all wholesale energy marketing and trading

4        On October 1, 2002, Aquila's President and Chief Executive Officer Robert Green  
5        resigned from all executive officer positions with the company and from Aquila's board of  
6        directors. Robert Green's separation package has a value of approximately \$7.6 million. The  
7        board has reassigned Robert Green's CEO responsibilities to longtime Chairman Richard C.  
8        Green, Jr.

9        On October 16, 2002 Aquila reported additional asset sales under its previously  
10       announced restructuring program, bringing the current total of assets it has sold or agreed to  
11       sell to \$976.6 million. The company's stated goal since May has been to sell at least  
12       \$1 billion in assets to strengthen its balance sheet and credit. Aquila's Chairman, President  
13       and Chief Executive Officer Richard C. Green, Jr. stated that "we are continuing to focus on  
14       our transition back to our roots as a regulated utility company and our exit from the elements  
15       of our previous energy merchant strategy that are not consistent with our current business  
16       model."

17       Aquila has been continuing in its restructuring mode through 2003, 2004 and  
18       continuing into 2005. With the recently announced sale of a significant portion of its utility  
19       businesses, its restructuring efforts will continue well into 2006.

20       **Community Relations Adjustment**

21       Q.     Please explain the corporate Community Relations department adjustment.

22       A.     This adjustment reclassifies 25 percent of the costs accumulated in Aquila's  
23       corporate overhead Department 6124, Community Relations – Missouri. This department

1 includes ten employees with a total base payroll cost of \$650,000. From a meeting with  
2 representatives of this department the Staff learned the employees assigned are involved in  
3 various activities. The community relations activities include working with and maintaining  
4 relationships with local government officials, dealing with ice storm issues, right of way  
5 ordinances and street light issues. In addition, this department is involved with economic  
6 development issues for Missouri and other states, which include managing the economic  
7 development data base for total Aquila operations. Department 6124 is also responsible for  
8 key customer accounts, which involves working with Aquila's largest 200 customers in  
9 Missouri. Finally, this department administers Aquila's charitable contributions program in  
10 Missouri.

11 Q. What is the basis for this adjustment?

12 A. In addition to my knowledge and understanding gained through meeting with  
13 department employees, I also did an analysis of the types of costs accumulated in this  
14 department. Of the non-payroll and benefit costs accumulated in this department,  
15 approximately forty percent of the costs are related to charitable contributions, social and  
16 community gifts, business promotion, and entertainment costs. All these costs should be  
17 charged below-the-line, and the costs of the employees responsible for these costs should  
18 also be charged below-the-line. Based on this analysis, the Staff believes that a twenty-five  
19 percent allocation to below-the-line non-utility operations is reasonable and appropriate.

20 **Corporate Lobbying Adjustment**

21 Q. Please explain the Staff's corporate Lobbying adjustment.

22 A. The Staff made an adjustment to charge all of Aquila's Department 6376,  
23 Regulatory Legislative Services – Missouri costs to a below-the-line account. This



1 department supervises the work of all of Aquila's outside lobbyists, conducts lobbying  
2 activities on behalf of Aquila and interacts with other utility-related lobbying groups such as  
3 the Missouri Energy Development Association (MEDA).

4 Q. What is the basis of you adjustment to Department 6376?

5 A. I reviewed payment vouchers, work products of outside lobbyists, expense  
6 reports and an explanation of Aquila's accounting for lobbying costs obtained from Aquila in  
7 response to Data Request Nos. 125, 193, 124 and 124.1.

8 Q. Are there other Aquila employees who engage in lobbying activities that are  
9 not in Department 6376?

10 A. Yes. The Staff is aware that Mr. Richard Green, Aquila's Chairman and Chief  
11 Executive Officer, Mr. Keith Stamm, Aquila's Chief Operating Officer, and Mr. Jon  
12 Empson, Aquila's Senior Vice President, Regulated Operations have participated in lobbying  
13 activities to some extent. For example, Mr. Stamm is on the Board of Directors of MEDA, a  
14 utility-lobbying association.

15 **20 West 9th Headquarters Adjustment**

16 Q. Please describe the 20 West 9th Headquarters adjustment.

17 A. This adjustment adds \$1.0 million of lease revenue to the accumulated costs  
18 Department 4010, Corporate Services – 20 West 9th Headquarters building in downtown  
19 Kansas City, Missouri.

20 Q. What is the basis of this adjustment?

21 A. Aquila has incorporated the Six Sigma business process improvement  
22 methods into its business to reduce costs and improve efficiency. Aquila commissioned  
23 Deloitte & Touche USA LLP (Deloitte) to help with its implementation of its Six Sigma

1 program. In October 2003 Deloitte produced a report that included several cost reduction  
2 suggestions. One such suggestion was that Aquila should relocate 153 seats occupying  
3 floors 5 through 10 at 20 West 9<sup>th</sup> Headquarters to floors 1 through 4 of the building and the  
4 annex building and relocate the remaining 20 to 30 seats to Aquila's office building in  
5 Raytown, Missouri. Deloitte's analysis showed that savings to Aquila could start in the first  
6 quarter of 2004, but the process could take six to eighteen months. Deloitte also estimated  
7 that Aquila could receive \$1.2 million in lease revenue in 2005 and into the future.

8 This recommendation was also included in a November 2003 report by Aquila  
9 entitled "Aquila, Inc. Identification of Six Sigma Opportunities." While Deloitte is  
10 estimating that Aquila could generate \$1.2 million in annual lease revenue, the Staff is  
11 imputing only \$1 million in annual lease revenue. The remaining \$200,000 would be applied  
12 to initial and recurring costs of getting the facility ready to lease and for the incremental costs  
13 of the personnel relocation.

14 Q. Did you take a tour of the 20 W 9th Headquarters building?

15 A. Yes. I have taken several tours of this facility, the most recent one on  
16 August 11, 2005 during the audit of Aquila's rate increase filing. From this tour I noticed  
17 that a significant amount of office space was unoccupied. Based on this visual inspection of  
18 the facility and the recommendation from Deloitte, I believe it is reasonable to include  
19 \$1 million in annual lease revenues for this department. These revenues should be realized  
20 by a more efficient use of Aquila's available office space.

21 Q. Has Aquila made any attempts to lease this space based on the Deloitte  
22 recommendation?

1           A.     No. According to Aquila's response to Data Request No. 368, Aquila has not  
2 pursued any attempts to lease this space since it investigated a sale/leaseback scenario in  
3 2002.

4           Q.     Earlier you mentioned Six Sigma. Please define this term.

5           A.     A simple definition of Six Sigma is:

6                   A rigorous and disciplined methodology that utilizes data and  
7 statistical analysis to measure and improve a company's operational  
8 performance, practices and systems. Six Sigma identifies and prevents  
9 defects in manufacturing and service-related processes. In many  
10 organizations, it simply means a measure of quality that strives for  
11 near perfection.

12           Staff witness Lesley R. Preston discusses Six Sigma in her direct testimony and  
13 explains that the Staff is including all of Aquila's Six Sigma costs in this case either through  
14 annual recovery of annual ongoing costs and an amortization of the initial Six Sigma startup  
15 costs.

16           **Supplemental Executive Retirement Plan (SERP)**

17           Q.     Please explain the Staff's adjustment to remove the costs of Aquila's SERP.

18           A.     A SERP a promise by a company to pay a future retirement benefit to its  
19 executives, over and above any qualified retirement plans that the company may sponsor.  
20 The purpose of Aquila's SERP, as described in the plan itself, is to "provide specified  
21 benefits to a select group of management and highly compensated employees."

22           The Staff opposes cost of service recovery for L&P share of Aquila's SERP for three  
23 primary reasons. First, Aquila's SERP includes a "Change in Control" provision. This  
24 provision requires a funding of the plan in the event of a change in ownership as defined in  
25 the "Change in Control" provision of the plan. This provision acts as deterrence for another  
26 company to acquire Aquila and thus acts as employment security protection for Aquila's top

1 executives and highly compensated employees. These are the employees who are at a higher  
2 risk of not be retained by a company that successfully merges with or acquires Aquila.  
3 While this protection may be beneficial to Aquila's executives and highly compensated  
4 employees, it is not a cost that could reasonably be considered necessary to run the  
5 operations of a utility company.

6 Second, Aquila's SERP was significantly modified on January 1, 2001 to add  
7 additional SERP Benefits. The modifications increase the benefits to SERP participants by  
8 adding a Bonus SERP Benefit (designed to provide executives an additional retirement  
9 benefit based on the executives' annual bonus pay) as well as a Supplemental SERP Benefit  
10 (designed to provide executives an additional market-based retirement benefit).

11 Third, the individuals in Aquila's SERP are or have been participants in all of Aquila's  
12 other benefit plans, including Aquila's regular pension plan and 401(K) plan. In the Staff's  
13 view, these plans provide sufficient retirement benefits for all of Aquila's employees and the  
14 addition of another retirement plan is excessive.

15 Q. Is a significant portion of this total amount related to negotiated SERP  
16 payments between Aquila's senior management and SJLP's senior management as part the  
17 Aquila's acquisition of SJLP in 2000?

18 A. Yes. At least \$253,688 of this amount is related to the SERP contracts  
19 negotiated as a part of Aquila's acquisition of SJLP and relates to payments to former SJLP  
20 executives who did not become part of Aquila's senior management after the acquisition.

21 **SJLP Merger Transition Costs**

22 Q. Is Aquila seeking to recover costs it deferred on its books and records that are  
23 related to its acquisition of SJLP in the 2001 merger?

1           A.     Yes. Company witness Davis Rooney is sponsoring the adjustment to recover  
2 costs related to the SJLP merger. Mr. Rooney's direct testimony discusses both the merger  
3 transaction and merger transition costs.

4           Q.     Please define "transaction costs."

5           A.     Transaction costs are expenses that are incurred by combining companies  
6 usually prior to the close of the merger and that are necessary to consummate the merger.  
7 These include fees charged by the investment bankers related to the transaction; fees for  
8 outside consultants for legal, accounting and public relations services; and other merger-  
9 related costs directly associated with the acquisition. Since these costs are directly associated  
10 with the acquisition, they should be included with the acquisition premium and charged to  
11 the acquisition adjustment account.

12          Q.     Please define "transition costs."

13          A.     "Transition costs" are costs, which the combining companies must incur in  
14 order to combine the systems and processes of the pre-merged companies. Generally,  
15 accounting systems will be combined; computers will be reprogrammed; procedures and  
16 practices will be consolidated; customer service centers will be integrated; human resources  
17 will redesign benefit packages for consistency; and these changes all have costs associated  
18 with their implementation.

19          Q.     What is the Staff's position on rate recovery of transaction and transition  
20 costs?

21          A.     The Staff's position is that transition costs found to be prudent and appropriate  
22 should be amortized above-the-line to expense over an appropriate period of time. The Staff  
23 has proposed a 10-year amortization period in the past. The Staff believes that here is a

1 correlation between the transition costs, which facilitate the joining of two utilities and the  
2 merger savings that result following the completion of the integration process. At that point,  
3 Aquila's customers should share in any savings that are generated from the merger, and  
4 therefore, should also pay for prudent "costs to achieve" these savings.

5 Q. Has the Staff reflected the amortization of the SJLP merger transition costs in  
6 this case?

7 A. Yes. From reading Mr. Rooney's testimony and from a meeting with him on  
8 this issue at Aquila's offices, it appears that the Staff and Aquila agree as to what types of  
9 costs constitute merger transition costs that should be reflected in rates in this case.  
10 However, there appears to be a substantial amount of merger "transaction costs" in the  
11 \$7.3 million amount the Company is proposing to recover through an amortization to  
12 expense. The Staff has identified approximately \$2 million in costs that are appropriate  
13 merger transition costs and has included a 10 year amortization of this \$2 million in this case.  
14 The Staff intends to meet with Aquila on this issue prior to or at the prehearing conference to  
15 determine the final amount of transition costs eligible for recovery in this case.

16 Q. Does this conclude your direct testimony?

17 A. Yes.

**CHARLES R. HYNEMAN****CASE PARTICIPATION**

<b>Date Filed</b>	<b>Issue</b>	<b>Case Number</b>	<b>Exhibit</b>	<b>Case Name</b>
7/16/1993	Cash Working Capital; Other Rate Base Components	TR93181	Direct	United Telephone Company of Missouri
8/13/1993	Cash Working Capital	TR93181	Rebuttal	United Telephone Company of Missouri
8/25/1993	Cash Working Capital	TR93181	Surrebuttal	United Telephone Company of Missouri
4/11/1994	Pension Expense; Other Postretirement Benefits	ER94163	Direct	St. Joseph Light & Power Company
5/16/1994	Pension Expense; Other Postretirement Benefits	HR94177	Direct	St. Joseph Light & Power Company
4/20/1995	Pension Expense; OPEB Expense; Deferred Taxes; Income Taxes; Property Taxes	GR95160	Direct	United Cities Gas Company
5/7/1996	Merger Premium	EM96149	Rebuttal	Union Electric Company
8/9/1996	Income Tax Expense; AAO Deferrals; Acquisition Savings	GR96285	Direct	Missouri Gas Energy
9/27/1996	Income Tax Expense; AAO Deferrals; Acquisition Savings	GR96285	Rebuttal	Missouri Gas Energy
10/11/1996	Income Tax Expense; AAO Deferrals; Acquisition Savings	GR96285	Surrebuttal	Missouri Gas Energy
6/26/1997	Property Taxes; Store Expense; Material & Supplies; Deferred Tax Reserve; Cash Working Capital; Postretirement Benefits; Pensions; Income	GR97272	Direct	Associated Natural Gas Company Division of Arkansas Western Gas

Date Filed	Issue	Case Number	Exhibit	Case Name
	Tax Expense			Company
8/7/1997	FAS 106 and FAS 109 Regulatory Assets	GR97272	Rebuttal	Associated Natural Gas Company Division of Arkansas Western Gas Company
11/21/1997	OPEB's; Pensions	ER97394	Surrebuttal	UtiliCorp United Inc. d/b/a Missouri Public Service
3/13/1998	Miscellaneous Adjustments; Plant; Reserve; SLRP; AMR; Income and Property Taxes;	GR98140	Direct	Missouri Gas Energy, A Division of Southern Union Company
4/23/1998	Service Line Replacement Program; Accounting Authority Order	GR98140	Rebuttal	Missouri Gas Energy, A Division of Southern Union Company
5/15/1998	SLRP AAOs; Automated Meter Reading (AMR)	GR98140	Surrebuttal	Missouri Gas Energy, A Division of Southern Union Company
7/10/1998	SLRP AAOs; Reserve; Deferred Taxes; Plant	GR98140	True-Up	Missouri Gas Energy, A Division of Southern Union Company
4/26/1999	Merger Premium; Merger Accounting	EM97515	Rebuttal	Western Resources Inc. and Kansas City Power and Light Company
9/2/1999	Accounting Authority	GO99258	Rebuttal	Missouri Gas



Date Filed	Issue	Case Number	Exhibit	Case Name
	Order			Energy
3/1/2000	Acquisition Detriments	GM2000312	Rebuttal	Atmos Energy Company and Associated Natural Gas Company
5/2/2000	Deferred Taxes; Acquisition Adjustment; Merger Benefits; Merger Premium; Merger Accounting; Pooling of Interests	EM2000292	Rebuttal	UtiliCorp United Inc. / St. Joseph Light and Power
6/21/2000	Merger Accounting Acquisition	EM2000369	Rebuttal	UtiliCorp United Inc. / Empire District Electric Company
11/30/2000	Revenue Requirements	TT2001119	Rebuttal	Holway Telephone Company
4/19/2001	Revenue Requirement; Corporate Allocations; Income Taxes; Miscellaneous Rate Base Components; Miscellaneous Income Statement Adjustments	GR2001292	Direct	Missouri Gas Energy, A Division of Southern Union Company
12/6/2001	Corporate Allocations	ER2001672	Direct	UtiliCorp United Inc. d/b/a Missouri Public Service
12/6/2001	Corporate Allocations	EC2002265	Direct	UtiliCorp United Inc. d/b/a Missouri Public Service
1/8/2002	Acquisition Adjustment	EC2002265	Rebuttal	UtiliCorp United Inc. d/b/a Missouri Public Service
1/8/2002	Acquisition Adjustment	ER2001672	Rebuttal	UtiliCorp United Inc. d/b/a Missouri Public Service

<b>Date Filed</b>	<b>Issue</b>	<b>Case Number</b>	<b>Exhibit</b>	<b>Case Name</b>
1/22/2002	Acquisition Adjustment	ER2001265	Surrebuttal	UtiliCorp United Inc. d/b/a Missouri Public Service
1/22/2002	Acquisition Adjustment; Corporate Allocations;	EC2001265	Surrebuttal	UtiliCorp United Inc. d/b/a Missouri Public Service
4/17/2002	Accounting Authority Order	GO2002175	Rebuttal	Utilicorp United Inc. d/b/a Missouri Public Service & St. Joseph Light & Power
8/16/2002	Prepaid Pension Asset; FAS 87 Volatility; Historical Ratemaking Treatments-Pensions & OPEB Costs; Pension Expense-FAS 87 & OPEB Expense-FAS 106; Bad Debt Expense; Sale of Emission Credits; Revenues	ER2002424	Direct	The Empire District Electric Company
3/17/2003	Acquisition Detriment	GM20030238	Rebuttal	Southern Union Co. d/b/a Missouri Gas Energy
12/9/2003	Current Corporate Structure; Aquila's Financial Problems; Aquila's Organizational Structure in 2001; Corporate History; Corporate Plant and Reserve Allocations; Corporate Allocation Adjustments	HR20040024	Direct	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P
12/9/2003	Corporate Plant and Reserve Allocations; Corporate Allocation Adjustments; Aquila's Financial Problems; Aquila's Organizational Structure in 2001;	ER20040034	Direct	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P

Date Filed	Issue	Case Number	Exhibit	Case Name
	Corporate History; Current Corporate Structure			
1/6/2004	Corporate Allocation Adjustments; Reserve Allocations; Corporate Plant	GR20040072	Direct	Aquila, Inc.
2/13/2004	Severance Adjustment; Supplemental Executive Retirement Plan; Corporate Cost Allocations	HR20040024	Surrebuttal	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P
2/13/2004	Severance Adjustment; Corporate Cost Allocations; Supplemental Executive Retirement Plan	ER20040034	Surrebuttal	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P
4/15/2004	Pensions and OPEBs; True-Up Audit; Cost of Removal; Prepaid Pensions; Lobbying Activities; Corporate Costs; Miscellaneous Adjustments	GR20040209	Direct	Missouri Gas Energy
6/14/2004	Alternative Minimum Tax; Stipulation Compliance; NYC Office; Executive Compensation; Corporate Incentive Compensation; True-up Audit; Pension Expense; Cost of Removal; Lobbying.	GR20040209	Surrebuttal	Missouri Gas Energy
1/14/2005	Accounting Authority Order	GU20050095	Direct	Missouri Gas Energy
2/15/2005	Accounting Authority Order	GU20050095	Direct	Missouri Gas Energy

**SCHEDULE 2**

**HAS BEEN DEEMED**

**HIGHLY CONFIDENTIAL**

**IN ITS ENTIRETY**