BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

PREHEARING BRIEF OF AQUILA, INC.

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COMES NOW Aquila, Inc. ("Aquila" or the "Company") d/b/a Aquila Networks-MPS ("MPS") and Aquila Networks-L&P ("L&P"), by and through counsel, and respectfully submits the following to the Missouri Public Service Commission (the "Commission") as Aquila's pre-hearing brief in the above-referenced matters:

STATEMENT OF THE CASE

On May 24, 2005, Aquila, doing business as Aquila Networks – MPS and as Aquila Networks – L&P, filed with the Commission certain proposed tariff sheets designed to implement a general rate increase for retail electric service provided by the Company in its MPS and L&P service areas. The proposed rates are designed to produce an additional $69.2 million in gross annual electric revenues excluding gross receipts, sales, franchise, and occupational taxes in the Company's MPS service area, a 20.3% increase over existing revenues, and $9.4 million in additional gross annual electric revenues in the Company's L&P service area, exclusive of gross receipts, sales, franchise, and occupational taxes, a 9.6% increase.

Thereafter, on May 27, 2005, Aquila filed with the Commission certain other proposed tariff sheets designed to implement a general rate increase for retail steam heat service provided by the Company in its L&P service area. The proposed steam heat service rates are designed to produce an additional $5 million in gross annual steam heat revenues excluding gross receipts, sales, franchise, and occupational taxes in Aquila's L&P service area, a 44.3% increase.

The need for the requested electric rate increase results primarily from higher fuel costs and new investments that Aquila has made to serve the demand of the Company's customers. The cost of both coal and natural gas, the fuels used to operate

the Company's generating facilities, has continued to increase since Aquila's last rate adjustment in 2004. Also, the Company has made significant investment in plant, including new generation facilities in its MPS service territory, to support customer growth. (Empson Direct, pp. 2 – 3)[1] The steam rate increase is also driven by higher fuel costs and the elimination of an existing steam rate subsidy. (Williams Steam Direct, p. 2)

On May 31, the Commission suspended the proposed electric service tariff sheets until April 21, 2006 and on June 1, suspended the proposed steam heat service tariffs until April 24, 2006.

By its orders issued in both cases on July 21, 2005, the Commission, among other things, established as the test year for these cases the 12 months ending December 31, 2004, updated and adjusted for known and measurable changes through June 30, 2005. A true-up was ordered to include all major changes to revenue, expenses, rate base and capital structure occurring through October 31, 2005.

Various parties intervened in these proceedings. Prepared testimony has been filed and local public hearings conducted, all in accordance with the established procedural schedules. In addition, the parties have identified a List of Issues to be presented to the Commission for determination involving both cases.

The procedural schedules established by the Commission in both cases directed the parties to file prehearing briefs on January 3, 2006. On December 28, 2005, the Commission extended the due date to January 10, 2006. Aquila is herein filing a single prehearing brief for both the electric and steam cases. The brief addresses issues and

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[1] All references herein are to Case No. ER – 2005 – 0436, unless otherwise stated.

follows the format of the List of Issues previously filed by the Staff on December 22, 2005 in both cases. The brief clearly designates whether the issue is related to the electric case, steam case, or both.

I. Rate of Return

1. Return on Common Equity (Electric and Steam)

Issue Description: What return on common equity should be used for determining Aquila's rate of return?

Aquila Position: Aquila should be authorized to earn a return of at least 11.50 % on its common equity.

It is Aquila's position that it should be authorized to earn a return of at least 11.5 percent on its common equity. Staff recommends an ROE of 8.5 to 9.5 percent, Public Counsel recommends an ROE of 9.95 percent, and the FEA parties recommend an ROE of 9.8 percent, the mid-point of Mr. Gorman's 9.3 to 10.3 range. (Hadaway Rebuttal, p. 1)

The cost of equity is the rate of return that common stockholders expect on their capital commensurate with the risk they take and the returns that might be available from other similar investments. The return on equity is not directly observable and must be estimated or inferred from capital market data and trading activity. (Hadaway Direct, p. 22; Hadaway Direct, p. 23, HR – 2005 – 0450) To properly estimate the cost of equity for a utility, one must apply informed judgment about the relative risks of the company in question and utilize knowledge of the risk and expected rate of return characteristics of other available investments.

The recommendations of Mr. Murray, Dr. Johnson, and Mr. Gorman are well below the mainstream of recent ROEs allowed by other regulatory commissions in this

country.[2] Aquila will have to compete against other enterprises, including electric utilities, to raise the capital needed to meet its capital requirements and continue to provide safe and adequate service in Missouri. Given the low ROE recommendations of Staff and the intervenors and the extensive upcoming capital requirements being faced by Aquila's MPS and L&P operating divisions, a reasonableness check is especially important in this proceeding. Additionally, any cost of equity recommendation should reflect certain industry-specific and company-specific factors.

Current expectations for utility stocks are negative based on projections for higher interest rates, as explained by Dr. Hadaway and as expressed in the Value Line Investment Survey. According to Dr. Hadaway, in this environment of increased interest rates, the traditional Discounted Cash Flow ("DCF") model does not produce reasonable cost of capital estimates. To varying extents, all utilities are affected by market uncertainties and changes affecting the energy industry. Because of MPS's and L&P's unique construction needs,[3] which in turn drive increased capital investment needs, it is essential for MPS and L&P to improve their financial condition and have a sound utility earnings base to support their capital investment requirements.

Dr. Hadaway's Testimony

Dr. Hadaway's ROE recommendation for Aquila properly reflects industry-specific and company-specific factors and is premised upon the fair rate of return

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[2] Although this Commission has stated that it will not set an ROE for a Missouri utility based on returns authorized by other regulatory bodies, this Commission has stated that the national average ROE is an indicator of the capital market in which Missouri utilities will have to compete for capital and that it will consider the reasonableness of an ROE recommendation in light of findings and decisions of other regulators. *See*, Report and Order, Case No. ER – 2004 – 0570, The Empire District Electric Company.

[3] The capital requirements for the two divisions are projected to be $850-$900 million cumulatively from the end of 2004 through 2010. This level will have the impact of increasing net plant by approximately 81 percent over the same period, a level that is significantly in excess of the reference company projections. (Hadaway Direct, p. 37)

principles established by the United States Supreme Court in *Federal Power Commission v. Hope Natural Gas Company*, 320 US 591 (1944), and *Bluefield Waterworks v. Public Service Commission,* 262 US 679 (1923). As the Commission is aware, the U.S. Supreme Court has held that the return authorized a utility by a regulatory body should be "commensurate with returns on investments in other enterprises having corresponding risks." *Hope*, 320 US at 603. In addition, the return should be "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." (*Id.)*

The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally. *Bluefield,* 262 US at 693. Dr. Hadaway explained that "(i)f a utility earns its market cost of equity, neither its stockholders nor its customers should be disadvantaged." (Hadaway Direct, p. 27; Hadaway Direct, p. 28, HR – 2005 – 0450)

Given the principles of *Hope* and *Bluefield*, Dr. Hadaway used several methods to determine the appropriate ROE and overall rates of return for Aquila's two Missouri operating divisions. Per Dr. Hadaway, models that employ market-based data for comparable utilities are most widely used in the industry, and there are three general categories of models: comparable earnings methods, risk premium methods, and DCF methods. (Hadaway Direct, p. 27; Hadaway Direct, p. 28, HR – 2005 – 0450) Dr.

Hadaway applied his chosen methods and the underlying economic models to an investment grade company reference group of similarly situated electric utilities selected from the Value Line Investment Survey. To be included in the reference group, a company must have at least a BBB-/Baa3 bond rating, must derive at least 70 percent of revenues from regulated utility sales,[4] must have consistent financial records not affected by recent mergers or restructuring, and must have a consistent dividend record with no recent dividend cuts. (Hadaway Direct, pp. 38 – 39; Hadaway Direct, pp. 39 – 40, HR – 2005 – 0450)

In summary, Dr. Hadaway's ROE estimate is based on alternative versions of the DCF model and was confirmed by a risk premium analysis and a review of projected interest rates and economic conditions. The DCF model is widely used in regulatory proceedings. According to Dr. Hadaway, it has a sound basis in theory and has the advantage of simplicity. In essence, the DCF model results in an ROE estimate that is the sum of the expected dividend yield and the expected long-term dividend (or price) growth rate.

To perform his DCF analysis, Dr. Hadaway used the average of high and low stock prices for each company in his reference group for January, February, and March of 2005. He explained that a reasonably current price consistent with present market conditions should be used instead of average or "spot" stock prices. Price must be representative of current market conditions and free from undue influence of unusual

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[4] "Application of the minimum 70 percent regulated utility revenues filter results in a group average percentage of revenues from regulated utility sales of 86 percent, which helps to assure that non-regulated activities are not a significant influence for the group." (Hadaway Direct, p. 39, ln. 1 – 4)

circumstances, because the cost of equity is a current and forward-looking concept. (Hadaway Direct, p. 40; Hadaway Direct, p. 41, HR – 2005 – 0450)

Dr. Hadaway applied three versions of the DCF model to estimate an appropriate ROE for MPS and L&P: the constant growth version of the model, the non-constant growth two-stage model, and a modified constant growth approach with the growth rate strictly proxied by the 6.6 percent long-term Gross Domestic Product growth rate. (Hadaway Direct, p. 40; Hadaway Direct, pp 41 – 42, HR – 2005 – 0450) Dr. Hadaway did not apply the DCF model directly to Aquila, because the Company does not currently pay dividends to its shareholders. Additionally, it would be inappropriate to use diverse "parent" financial data of the Company to set the required rates of return for the two operating divisions.

Dr. Hadaway's reference group analysis indicates a DCF ROE range of 10.6 to 11.1 percent.[5] To test his DCF results, Dr. Hadaway conducted a risk-premium analysis based on ROEs allowed by state regulators relative to Moody's utility debt costs. He also included Standard & Poor's ("S&P") forecasted higher interest rates for the coming year. His data shows that risk premiums are smaller when interest rates are high and larger when interest rates are low. According to Dr. Hadaway, with lower interest rates, as has been the case in recent years, allowed regulatory risk premiums have generally been in the three to four percent range. Dr. Hadaway employed the use of a regression analysis to confirm the inverse relationship between risk premiums and interest rates

[5] In total, however, Dr. Hadaway's DCF calculations produced an ROE range of 9.5 to 11.1 percent. The 9.5 percent figure resulted from the traditional constant growth DCF, but the result "is not consistent with risk premium checks of reasonableness or other consensus economic forecasts for higher interest rates." Consequently, Dr. Hadaway did not include that result in his estimated DCF range. (Hadaway Direct, p. 39, ln. 5 – 10) "Because the traditional Constant Growth DCF model result is more than 100 basis points below any of the other models that result fails a basic test of reasonableness and is therefore excluded from the estimated DCF range." (Hadaway Direct, p. 44, ln. 30 – 32)

and established that the appropriate current equity risk premium is 4.25 percent. When added to the projected single-A utility debt cost of 6.7 percent, a ROE estimate of 11 percent results. Other risk premium studies indicate ROEs are as high as 11.8 percent. According to Dr. Hadaway, the risk premium approach adds a useful perspective for judging requirements, given the current market and utility industry conditions. (Hadaway Direct, pp. 42 – 43) Taking all of his results into consideration, Dr. Hadaway estimates the fair cost of equity for his reference group companies at 11 percent.

Based on his DCF and risk premium results, and given the current market, industry, and company-specific factors appropriate for the case, Dr. Hadaway estimates the fair cost of equity for MPS and L&P at 11.5 percent. To reflect the higher utility risk profile of the operating divisions, the ROE was increased by 50 basis points relative to the 11.0 percent cost of equity estimate for the reference group. Although the reference group is the appropriate starting point for estimating ROE, the reference group ROE is lower than the fair cost of equity for Aquila's operating divisions. MPS and L&P face considerably higher construction and operating risks than the average company in the reference group. (Hadaway Direct, p. 4, ln. 19 – 22; Hadaway Direct, p. 5, ln. 17 – 18, HR – 2005 – 0450)

Given the unique circumstances of the divisions, the Commission should add an ROE increment or adjustment to the reference group result to account for MPS's and L&P's higher risks. This risk adjustment is not related to Aquila's relatively weak financial condition which resulted from Aquila's financial losses. The operating divisions' specific risks and the need for the above-described risk adjustment stem from the higher construction and operating requirements which the divisions face. (Hadaway

Direct p. 5, ln. 8 – 11; Hadaway Direct, p. 6, ln. 3 – 6, HR – 2005 – 0450) There are also other less easily quantified risk factors for the divisions such as smaller size. (*Id.* p. 6, ln. 4 – 5; p. 6, ln. 21 – 22, HR – 2005 – 0450) Dr. Hadaway's chosen methodology, given the current economic, market, and electric utility industry conditions, provides an appropriate approach for estimating each operating division's cost of equity capital.

Testimony of Other Witnesses

Little or no weight should be given to the ROE testimony offered by Staff witness Murray. His chosen methodology – and his resulting recommendation – simply do not meet the basic checks of reasonableness. The same is true for the testimony offered by Mr. Gorman and Dr. Johnson. The recommendations of these witnesses do not satisfy the principles of *Hope* and *Bluefield*. In particular, the witnesses have given little or no consideration to the returns authorized by other commissions (Hadaway Rebuttal, p. 4, ln. 3 – 13; p. 5, ln. 4 – 16, HR – 2005 – 0450), have ignored the requirement that an ROE be sufficient to ensure confidence in the financial integrity of a utility (Hadaway Rebuttal, p. 5, ln. 4 – 12; p. 6, ln. 6 – 14, HR – 2005 – 0450),[6] and have offered ROE recommendations which are too low for MPS and L&P to attain a strong investment grade bond rating. (Hadaway Rebuttal, p. 5, ln. 20 – 22; p. 6, ln. 22, p. 7, ln. 1 – 2, HR –2005 – 0450)

The ROE recommendations offered by Mr. Murray over the past five years have been consistently below the lowest allowed rates of return authorized by other

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[6] Additionally, the low recommendations, if adopted, would weaken the financial condition of MPS and L&P. "Such adverse consequences would be particularly inappropriate given the Company's efforts to pay down debt and restore its' financial condition. Sound financial condition is essential if Aquila is to finance its large construction commitments on reasonable financial terms." (Hadaway Rebuttal, p. 9, ln. 1 – 8)

regulatory commissions in this country. In fact, in two recent Commission cases in which Mr. Murray testified, this Commission determined that the ROE should be 1.48 to 2.21 percent higher that Mr. Murray's midpoint recommendations.[7] Following suit, Mr. Murray's ROE recommendation for Aquila is by far the lowest of any of the ROE witnesses in this case and is outside the mainstream of allowed ROEs.

As is explained by Dr. Hadaway, Staff witness Murray's ROE recommendations are unreasonably low due to Mr. Murray's reliance on the constant growth version of the DCF model with growth rates apparently based entirely on analysts' near-term three-to-five year estimates. Under present market conditions with low near-term growth rates and with interest rates expected to rise, Mr. Murray's constant growth results are below the reasonable range. Mr. Murray fails to give consideration to either consensus expectations for higher interest rates during the coming year or to the potentially negative financial integrity impact of his recommendations. Additionally, Mr. Murray fails to perform a meaningful market-based risk premium analysis to check the reasonableness of his DCF results.

Growth Rates and the DCF Model

The witnesses disagree as to the growth rates to be used in the DCF model and the role that higher projected interest rates should play in estimating ROE. All witnesses except Dr. Hadaway used growth rates which produced unreasonably low DCF estimates. Mr. Murray and Mr. Gorman relied on analysts' low near-term forecasts, and Dr. Johnson relied on historical growth rates that had been diminished by

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[7] An ROE of 10.5 percent was authorized for Missouri Gas Energy in Commission Case No. GR – 2004 – 0209, and the midpoint of Mr. Murray's ROE recommendation was 9.02 percent. An ROE of 11 percent was authorized for The Empire District Electric Company in Commission Case No. ER – 2004 – 0570, and the midpoint of Mr. Murray's ROE recommendation was 8.79 percent.

the electric industry's recent turmoil and restructuring. These chosen growth rates likely bear no relationship to investors' long-term expectations. These witnesses have given no weight to overall economic growth or to any other long-term growth forecasts. This is particularly problematic because the DCF analyses performed by Mr. Murray, Dr. Johnson, and Mr. Gorman were based on the constant growth version of the DCF model. With the constant growth DCF model, a basic assumption is that the growth term "g" must equal investors' expectations for the *long-term* future. Dr. Hadaway explained:

> Rather than attempt to meet this requirement, however, Mr. Murray and Mr. Gorman use only 3-to-5-year analysts' earnings projections and, worse, Dr. Johnson relies entirely on historical growth rates that are negatively influenced by electric utility industry events. Under current market conditions, these methods produce incorrect estimates of long-term growth. (Hadaway Rebuttal, p. 7, ln. 9 – 13; p. 8, ln. 11 – 15, HR – 2005 – 0450)

The DCF growth rates are likely so far apart in this case due to Mr. Murray, Mr. Gorman, and Dr. Johnson missing a key point: "*long-term* growth expectations as required in the DCF model should not change greatly from year to year." (Hadaway Rebuttal, p. 8, ln. 2 – 3; p. 9, ln. 5 – 6, HR – 2005 – 0450) The ROE recommendations would be significantly higher if the witnesses "employed a more reasonable assumption that long-term growth rates will be more stable than the short-term growth projections." (Hadaway Rebuttal, p. 8, ln. 10 –12; p. 9, ln. 13 – 14, HR – 2005 – 0450)

Financial Integrity Test

Pursuant to the mandates of Hope and Bluefield, an ROE must be sufficient to ensure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. Dr. Hadaway relies upon the Hope and Bluefield standards in

making his recommendations in this case. However, "had the other parties performed a financial integrity analysis, they would have found that their recommendations are inadequate." (Hadaway Rebuttal, p. 5, ln. 6 –12; p. 6, ln. 12 – 14, HR – 2005 – 0450) In his rebuttal testimony, Dr. Hadaway observes that the ROE recommendations of the other parties would weaken rather than support the financial condition of Aquila's MPS and L&P operating divisions. (Hadaway Rebuttal, p. 9, ln. 3 – 4; p. 10, ln. 5 – 6, HR – 2005 – 0450)

Because of the construction demands on MPS and L&P for the next five years, it is of paramount importance for Aquila that it be able to raise capital on terms comparable to that of its peer companies. In a recent case involving Kansas City Power & Light Company ("KCPL"), the Commission approved the collection of an "additional amortization amount" which was deemed necessary to preserve two out of three S&P credit ratios at a level no lower than the "lower level of the top third" of the BBB targets as set by S&P.[8] Similarly, it is of extreme importance that Aquila be allowed to attain credit metrics at least in the mid-BBB range in order to raise necessary capital on terms comparable to that of its peer companies.

Dr. Hadaway and Aquila point to Case No. EO – 2005 – 0329 not as precedent or binding authority, but simply to provide the Commission with an example of the circumstances and conditions in which Aquila must compete for capital. One of Aquila's competitors in the capital markets is KCPL, an electric utility subject to this Commission's jurisdiction, and the Commission, given KCPL's heavy construction

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[8] *See*, Commission Case No. EO – 2005 – 0329, Stipulation and Agreement.

program, recognized the importance of KCPL's financial integrity relative to its credit ratios.

Using Mr. Gorman's proposed capital structure and recommended ROE for Aquila in the case at hand, the required financial metrics for an investment grade rating are barely met, and using Dr. Johnson's proposed capital structure and ROE, only one of the required financial metrics is barely met. (Hadaway Rebuttal, p. 11, ln. 20 – 21 and 7 – 9; p. 25, ln. 7 – 9; p. 22, ln. 11 – 12, HR – 2005 – 0450) Using Staff witness Murray's proposed capital structure and the upper end of his recommended ROE range, only two of the required financial metrics are barely met. "Such results are not adequate to demonstrate that there is reasonable support for MPS and L&P financial integrity." (Hadaway Rebuttal, p. 10, ln.13 – 16; p. 11, ln. 18 – 19, HR – 2005 – 0450) The ROE recommendations of Mr. Murray, Dr. Johnson, and Mr. Gorman are not sufficient to ensure the confidence in the financial integrity of Aquila so as to maintain its credit and attract capital. Thus, the recommendations of these witnesses do not satisfy the standards of *Hope* and *Bluefield.*

2. Capital Structure (Electric and Steam)

Issue Description: What capital structure should be used for determining Aquila's rate of return?

Aquila Position: The appropriate capital structure to use in calculating Aquila's cost of capital is a capital structure based on the capital structures of a group of 29 investment grade companies, an approach which comports with the principles of the *Hope* and *Bluefield* cases, and is as follows:

Common Equity	51.80 %
Long Term Debt	48.20 %

The appropriate capital structure to use in calculating Aquila's cost of capital is common equity of 48.2 percent and debt of 51.8 percent. The following tables reflect Aquila's requested capital structure components and the resulting overall rates of returns for the two divisions:

Missouri Public Service (MPS)

Capital Components	Ratio	Cost	Weighted Cost
Debt	51.8%	6.7%	3.47%
Common Equity	48.2%	11.5%	5.54%
TOTAL	100.0%		9.01%

St. Joseph Light & Power (L&P)

Capital Components	Ratio	Cost	Weighted Cost
Debt	51.8%	7.96%	4.12%
Common Equity	48.2%	11.5%	5.54%
TOTAL	100.0%		9.67%

The Company is requesting a capital structure based on the 2004 capital structure percentages of a group of 29 investment grade companies – the reference group used by Dr. Hadaway to estimate the appropriate ROE for Aquila. (Hadaway Direct, p. 8, ln. 12 – 27; p. 9, ln. 21 – 27, p. 10, ln. 1 – 9, HR – 2005 – 0450) This request conforms with the principles of *Hope* and *Bluefield* in that use of the requested hypothetical capital structure will match the financial risk of the reference group to the estimated ROE and resulting overall rates of return for MPS and L&P. It is also consistent with Aquila's internal capital assignment process discussed in the Cost of Debt section hereof. Pursuant to its capital assignment policy, Aquila has consistently

assigned 47.5 percent equity and 52.5 percent debt to its electric utility operating divisions. (Hadaway Direct, p. 9, ln. 6 – 8; p. 10, ln. 1 – 3, HR – 2005 – 0450)

Staff witness Murray recommends a capital structure of 57.53 percent debt and 42.47 percent equity based on the Company's capital structure updated through the true-up period ending October 31, 2005. Public Counsel witness Johnson recommends a capital structure of 67.3 percent debt and 32.7 percent equity based on the consolidated capital structure for the Company as of December 31, 2004. FEA witness Gorman recommends a capital structure of 55 percent debt and 45 percent equity based on the average capital structure of a selected group taken from the September 2005 C.A. Turner Utility Report.[9] (Hadaway Rebuttal, p. 2, ln. 2 – 10; p. 3, ln. 9 – 17, HR – 2005 – 0450)

There are significant problems with the capital structure recommendations of Mr. Murray, Dr. Johnson, and Mr. Gorman. For example, Dr. Johnson's recommendation essentially ignores all of the progress that Aquila has made to improve its equity ratio in 2005. Using data from 2004 is in sharp contrast with the direction the Company has been taking in recent months to improve its equity position. "Dr. Johnson's recommendation is not reasonable given [the] tangible improvement that the Company has made in shoring up its financial condition." (Hadaway Rebuttal, p. 19, ln. 1 – 3; p. 19, ln. 1 – 3, HR – 2005 – 0450) Further, by Order of July 21, 2005, the Commission held that the test year in these cases should be the 12-month period ending December 31, 2004, adjusted and updated for known and measurable changes through June 30,

[9] Mr. Gorman and Dr. Hadaway used the same proxy groups to estimate capital structure and ROE, but Dr. Hadaway explained that Mr. Gorman's capital structure differs because the C.A. Turner publication relied upon by Mr. Gorman includes short-term debt in its capital structure amounts. Value Line, which was used by Dr. Hadaway, does not. (Hadaway Rebuttal, p. 2, ln. 11 — 14)

2005. The Commission also held that there should be a true-up through October 31, 2005 for purposes of updating certain changes including capital structure. Public Counsel and Dr. Johnson, however, appear to have disregarded these orders and the current data provided by Aquila.

Additionally, Dr. Johnson's capital structure recommendation is not consistent with his ROE analysis, in that he has created a mismatch by using an ROE from his comparable group but then recommending an equity ratio which is dramatically lower than the group's average (48.2 percent for year-end 2004 and 52.8 percent when projected for the next three to five years) "The capital structure recommendation must be consistent with the comparable group ROE analysis or a risk adjustment is necessary." (Hadaway Rebuttal, p. 19, ln. 4 –12; p. 19, ln. 4 – 12, HR – 2005 – 0450) An upward adjustment to the ROE is necessary to account for the additional risk, but Dr. Johnson made no such adjustment.

There are also problems with Mr. Gorman's capital structure recommendation. Mr. Gorman overstates the debt portion by including short-term debt. Short-term debt should not be reflected in Aquila's capital structure percentages for ratemaking purposes, because short-term debt is not a part of Aquila's permanent capital base. By including short-term debt, Mr. Gorman unfairly shifts lower short-term debt costs to capital. This "virtually guarantees that the Company will not be able to earn its authorized rate of return." If short-term debt were removed from Dr. Gorman's data, his capital structure recommendation would be the same as Dr. Hadaway's recommendation offered by Aquila.

In evaluating the requested capital structure, Dr. Hadaway considered bond rating and optimal capital structure issues and prepared an analysis of each division's financial condition under alternative assumed outcomes from this Commission case. (Hadaway Direct, p. 14, ln. 17 – 19; p. 15, ln. 7 – 9, HR – 2005 – 0450) As Dr. Hadaway explained, "The relationship between bond ratings (risk) and the cost of capital is a fundamental capital market principle. Specific factors for each company, such as operating risks and debt and equity percentages (financial risk) determine a company's total risk. . . . More debt and less equity, for any level of operating risk, will result in a lower bond rating and higher interest costs for debt." (Hadaway Direct, p. 11, ln. 6 – 17; p. 12, ln. 1 – 12, HR – 2005 – 0450)

Dr. Hadaway's calculations demonstrate that the requested hypothetical capital structure is essential for an investment grade bond rating. Rate case outcomes based on Aquila's consolidated corporate capital structure produce financial ratios well below those required for an investment grade rating. Dr. Hadaway explained that such "results are not consistent with using an investment grade reference group to estimate ROE or using investment grade debt costs to calculate the allowed overall rate of return." He added, "Such a mismatched approach would produce results that violate the *Hope* and *Bluefield* requirements." (Hadaway Direct, p. 15, ln. 3 – 6; p. 15, ln. 16 – 19, HR – 2005 – 0450)

In the event this Commission uses Aquila's consolidated corporate structure for setting rates, it is imperative that the authorized ROE be raised to account for the additional financial risk caused by higher financial leverage resulting from the increased debt. To be consistent with the principles established by the United States Supreme

Court, a tradeoff must be reflected in the overall rate of return. According to Dr. Hadaway, if Aquila's consolidated capital structure is used, the authorized ROE would have to be raised to about 15 percent to keep the divisions' revenue levels consistent. Regulators have the responsibility to ensure that the overall effect of a rate decision is just and reasonable – both for customers and the utility. This requires focus on the reasonableness of the "end result." Staff witness Murray, however, criticizes Dr. Hadaway for an "end-result oriented cost of common equity recommendation of 11.50 percent." (Murray Rebuttal, p. 10, ln. 7 – 8) The "end result" principle is reflected in the *Hope* decision: "(t)he question is whether that order "viewed in its entirety" meets the requirements of the Act. Under the statutory standard of 'just and reasonable' . . . it is the result reached not the method employed which is controlling." Hope, 320 US at 602. In judging the "end result," it is the impact of a rate order on a company's financial integrity, balanced against the customers' interest in maintaining reasonable rates, that must be evaluated. (*Id.* at 605)

3. Cost of Debt (Electric and Steam)

Issue Description: What cost of debt should be used for determining Aquila's rate of return?

Aquila Position: Aquila Networks-MPS cost of debt is 6.70%. Aquila Networks-L&P cost of debt is 7.96%. If the Commission adopts Aquila's corporate capital structure for purposes of these cases then Aquila agrees with the Staff cost of debt calculation which is 7.445%.

The cost of debt for the MPS division is 6.7 percent, and the cost of debt for the LP division is 7.96 percent. These figures result from Aquila's internal capital assignment process whereby the Company assigns capital to its operating divisions on an as needed basis. The cost of debt for each division reflects the average cost rates

for issues assigned to each division as of December 31, 2004. The debt issues assigned to each division have been assigned at "investment grade" rates per the Company's capital assignment policy designed to protect its ratepayers from non-regulated business activities.

Public Counsel witness Dr. Johnson testified that "(t)he cost of debt that has been proposed by the Company is reasonable for rate making purposes . . . (t)he resulting cost rates are reasonable for use with my recommended capital structure, and thus I recommend their acceptance." (Johnson Direct, p. 5, ln. 26 – 27, p. 6, ln. 21 – 22)

II. Rate Base Issues

4. Generation Resources (Electric)

Issue Description: What are the prudent types and amounts of generation resources to include in Aquila Networks-MPS's rate base?

Aquila Position: Aquila's Networks-MPS current generation resource mix is prudent and should be included in rate base.

It is the Company's position that the current generation resource mix for Aquila Networks-MPS is prudent and should be included in rate base. There is no need to increase revenue requirement as proposed by Staff in this case on the premise of an alternative supply mix.

There is a divergence of opinion between the Company and Staff as to the nature of the prudent types and amounts of generation resources, namely the

Company's proposed use of purchased capacity to meet a relatively small portion of its future needs versus the Staff's argument for self-built generation capacity.[10]

Generation Mix

The resource mix for Aquila Networks-MPS consists of three coal fired steam units, an 8% share in each of three coal fired steam units, four gas/#2 fuel oil fired turbines, three gas fired combustion turbines, one oil fired combustion turbine, as well as energy from an ownership share (0.12 MW) of wind generation. (Boehm Direct, pp. 3 – 4) MPS also has purchase power contracts which include long-term purchases as well as a purchase tolling agreement. (Boehm Direct, p. 4)

Despite Staff witness Lena Mantle's suggestion in her direct testimony that Aquila should have built additional combustion turbines, the fact is that the current Missouri Electric (Aquila Networks-MPS and L&P) resource plan 2006 Total System capacity is forecasted at 2,123 MW (2,128 net 5MW of sale) which will be met with 81.4% (1,733 MW) of existing generation capacity, and 18.6% (395 MW) of capacity purchases. (Boehm Rebuttal, p. 2)

Cost of Capacity – Using Known and Measurable v. "Phantom" Estimates

In this case, the Staff has offered an adjustment allegedly designed to include in revenue requirement the costs the Staff has determined are necessary to meet Aquila Networks-MPS' capacity shortfall. (Schallenberg Direct, p. 5, referring to S-23.9) Staff's adjustment would increase the Company's revenue requirement proposal for

[10] The generation capacity at issue here is a mere 200 MWs, essentially representing the reserve margin required by the Southwest Power Pool ("SPP").

capacity cost by approximately $5 million.[11] **The Company does not believe that this adjustment is appropriate.** (Korte Rebuttal, p. 3)

As part of the Company's capacity procurement, the Company engaged in the construction of an additional 315 MW of generation in order to replace an expiring 500 MW purchase power contract and to meet additional load. The Company procured the remainder of its capacity needs by entering into two purchase power contracts, one nine year contract for 75 MW and the other, a one year contract for 200 MW. Utilization of a mix between power purchases and self-built generation allows the Company to take advantage of the current competitive purchase power market, while also meeting long-term capacity planning objectives. While Staff argues that meeting capacity requirements, including capacity reserves, through a 100% self-build approach may result in a lower cost over thirty years, such a conclusion must be based on many assumptions for which Staff has provided no analysis supporting its claim. To illustrate the strength of the "buyer's market" for purchase power, the initial filing of the Company for Project X compared to the one-year contract to which it entered into is evidence of this strength. In this case, with regard to ratemaking treatment for the Project X, the Company in its initial filing requested a demand charge, including transmission, of $6.50/KW-MO for a total of $15.6 million per year, based on a contract quantity of 200 MW per year. (Appril Direct, p. 5, ln. 1 – 3) The one-year purchase power contract with ** [redacted] ** representing a ** [redacted] ** difference. Therefore, the Company's use of a one-year purchase power contract in this

[11] As determined by comparing Staff's accounting schedules.

case allows it to take advantage of a very attractive current market rate and, at worst, delays any perceived impact of self-built generation by only one year.

If an adjustment were deemed by the Commission to be appropriate, the Commission should use the known and measurable costs from the South Harper Project. As to any proposed adjustment, the Company's position is that if an adjustment is used, the known and measurable costs of the South Harper power station that is now in operation are the best cost proxy for determining additional generation capacity in this case, and that the cost estimates offered by Staff are merely "estimates" provided by a Staff witness who lacks experience with turbine valuation, the cost of which represents the largest portion of the generation capacity cost "estimate" provided by Staff.[12]

The Company's approach, of using known and measurable costs, is one that is sound, and takes into the account solid evidence or actual experience, not phantom hypothetical's or "estimates", as to what type of generation resources are prudent. The Company believes that the purchase of capacity, as opposed to building generation, during this "buyers" market is not only the most prudent choice, but one which will produce the lowest overall revenue requirement for Aquila's customers, based upon the Company's cost estimate for building generation capacity.

The Staff's generation hypothetical capacity addition, as well as the cost of that resource, is an unreliable approach and is not based on sound business practices, in

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[12] Staff Witness Schallenberg is a certified public accountant. Witness Schallenberg in his direct testimony sets out his "various areas of responsibilities," none of which include training, experience or background as an appraiser of turbines. The Company does not discount Witness Schallenberg's years of regulatory experience, but does question his ability to provide a cost estimate, where the primary cost associated with the estimate is the cost of a combustion turbine, as well as the costs associated with modification, transportation, installation as well as delivery.

that it relies upon an estimate of an estimate[13], which has been put together by individuals whom are not experts necessarily in the area they are estimating, namely turbine valuation. The Staff believes that the Commission should adopt in this case an adjustment for the cost structure which is at best speculative, and relies upon estimates which are not achievable. Staff's witness concedes that the cost estimate it is presenting to the Commission is just **"a matter of judgment."** (Schallenberg Direct, p.7, ln. 14) The Staff suggestion would have the Commission make an adjustment in this case by hypothecating a generation mix based on unreliable and unsound estimates that do not reflect the Company's actual cost of generation in its portfolio.

Ultimately, the Staff's recommendation on this point is nothing more than speculation, based on estimated estimates used by the Staff in valuing the cost of building generation, all the while inexplicably overlooking the **known and measurable** installed cost of the 315 MW South Harper Project[14], which the Company believes is the best available proxy for capacity costs in this case if the Commission were to make an adjustment. It makes little sense to concoct a phantom generation resource to serve as a cost proxy when the South Harper Project is known and measurable.

The Company specifically disagrees with the Staff's recommendation as to the adjustment in that the Staff bases its entire cost estimate on the "premise of adding [ ] capacity at an existing site." (Schallenberg Direct, p. 5) While Aquila's South Harper site was constructed to accommodate additional capacity, the mere existence of this

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[13] Staff Witness Schallenberg in his surrebuttal testimony stated that he created an estimate, which has as its foundation the estimate provided by Staff Witness Featherstone.

[14] In Case No. EO – 2005 – 0156, Aquila agreed to a turbine valuation of $66.7 million for the South Harper combustion turbines for purposes of a Stipulation and Agreement, and believes that any proxy use of South Harper for generation valuation purposes should reflect a fair market value, and not an amount reflective of a compromise for settlement purposes.

site, does not necessarily make it the most prudent site for new construction of new generation capacity. Despite Staff witness Schallenberg's statement that there is a "cost advantage(s) to utilizing an existing site," (Schallenberg Surrebuttal, p. 5) he provides nothing to support his assertion, and clearly fails to consider other relevant factors which exist with respect to evaluating "cost advantages" at the South Harper facility which could include varying transportation costs for turbine delivery to the South Harper location,[15] further community opposition to construction,[16] possible air emissions permitting considerations and additional questions regarding legal authority to build at this location.

The Company's cost estimates include land costs for both turbines and transmission equipment, a fact which Staff disregards altogether even though they acknowledge that the existing site might not be used. (Featherstone Surrebuttal, p. 45) Staff's estimates to install a combustion turbine facility are inadequate not only from an evidentiary standpoint, but also based upon common sense. Witness Korte for the Company in his rebuttal testimony points out that Staff witness Schallenberg's adjustments to capacity costs are "not supported by any facts or comparison data" (Korte Rebuttal, p. 3) further highlighting the Staff's questionable record on this issue. Furthermore, the enormous range, between the Company's cost estimate and the Staff's cost estimate demonstrates the highly questionable conclusion of Staff's

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[15] Staff Witness Featherstone in his surrebuttal testimony, p. 54 identified turbines in locations as varied as Houston, Texas, U.S.A. and Germany. Staff witness Schallenberg in his surrebuttal testimony provides details as to how he arrived at the estimated cost of generation capacity, and details specific adjustments he has made, including AFUDC, construction costs, transmission upgrades and common plant modifications, no allowances have been made for transportation costs in delivery of turbines. (*See* Schallenberg Surrebuttal, p. 5, ln. 18 – 23, p. 6, ln. 1 – 2) (See Featherstone Surrebuttal, p. 41, ln. 7 – 8, wherein transportation of turbines is considered a relevant cost factor)

[16] Staff witness Featherstone recognized "opposition" to the Camp Branch site as a factor in locating generation at South Harper. (Featherstone Surrebuttal, p. 41, ln. 15 – 16).

adjustment. (Korte Rebuttal, p. 3) The Company does not believe that an adjustment is appropriate in this case, but would agree with witness Schallenberg's statement that "using the best information available" would be an appropriate means of determining an alternative capacity cost. (Korte Rebuttal, p. 3, Schallenberg Direct, p. 7)

Looking specifically at the Staff's approach to determining capacity costs, Staff witness Schallenberg, as well as witness Featherstone, in evaluating turbine values grossly overestimate the turbine market by inappropriately attributing the offering price for the sale of a turbine with market value. Just like the homeowner that puts their house on the market at an advertised price, the resulting sale is not necessarily equal to that price, instead, the price actually paid is what would constitute a fair market value. Additionally, the offering prices considered by Staff in this case, do not necessarily include or take into account additional costs associated with procuring the generation resources, such as the location of the product, necessary modifications, unique installation costs, lags or time delays associated with completion of the sale and delivery, among other things.

Gas Turbine World is one resource in which Staff indicated it had "seen offers made by turbine manufacturers to another Missouri utility" to sell (See Featherstone Surrebuttal, p. 56) Looking at *Gas Turbine World* is much like looking at the *Kelly Bluebook* for the price of a used car. While you might be in the market for a 1995 Honda Accord, and the Bluebook provides a price, the market realities are that you cannot be assured that you will even be able to locate a 1995 Honda Accord, when you need it, let alone that it will be an acceptable make, model, color, include the features

which you want, while also not being a vehicle which was previously misused, wrecked, poorly maintained or repaired.

Thus, using *Gas Turbine World* alone as the authority for valuation of generation costs is fundamentally flawed. Staff's analysis, and associated cost assignment, fails to take into account that what is listed is still available on the market, that the price stated may not increase due to product demand, modification, transportation, warranty, upgrades, or that the seller will complete the transaction within the time necessary. It would be like relying upon the classified ads in your local newspaper for the purchase of an important Christmas gift. A utility could no more expect that the representations in *Gas Turbine World* are any more than just representations, of the offering prices for sale in the market, and are not necessarily indicative of actual value, cost, availability, or condition.

Transmission from Distant Generation and Relocation of Generation Resources

In addition to the valuation considered by Staff in developing a cost proxy the Staff has suggested that the Company could have procured generation capacity currently located in Illinois and transmitted this power, and as such, this out of state generation could have served the additional 200MW of capacity which Aquila Networks MPS required. Assuming that the assets considered by Staff in their testimony consist of the 750 MW of combined capacity currently located in Illinois at Raccoon Creek and Goose Creek, it is Company witness Korte's opinion that these generation resources would "not be appropriate" for Aquila MPS and L&P in that these generation resources are not located within the MPS and L&P system. (Korte Rebuttal, p. 5) According to

Witness Korte, Aquila would need to secure, at additional cost, transmission from the generation to MPS and/or L&P or join the MISO RTO and determine whether either facility was capable of being designated as a network resource. (Korte Rebuttal, p. 5) (emphasis added)

While Staff in rebuttal testimony suggested that Racoon Creek and Goose Creek were appropriate, the transmission issue was clearly overlooked, as well as the risks and uncertainties in evaluating the question of Aquila's participation in the MISO RTO. After the Company raised the transmission issue in rebuttal testimony, the Staff's case diverted into a suggestion that the Company could instead transport the Illinois turbines to another location. (Featherstone Surrebuttal, p. 54; Schallenberg Surrebuttal, p. 4) In Staff's surrebuttal testimony the concerns raised about transmission are at least identified, but are just as flawed as in their final analysis.

Staff suggests that simply purchasing the generation capacity in Illinois, unbolting it from the ground, loading it up and moving it across southern Illinois, and across the entire State of Missouri, should be considered by the Company, without giving any sort of meaningful consideration to transportation and delivery costs. The Staff in its testimony references the relocation of other turbines by Aquila as an example of moving or relocating resources, but the example falls short in analysis, in that the transport of turbines from the Aquila facility at Ralph Green, to South Harper, Missouri encompasses approximately 15 miles, a far cry from the additional cost for moving the resources from southern Illinois all the way to western Missouri.

The mobility question suggested by Staff begs further evaluation, as seen in the Rolls-Royce power venture offer, wherein turbines located in Houston and Germany

were offered to Aquila. (Featherstone Surrebuttal, p. 54) Again, transportation costs and the difficulties in transportation and delivery were not given relevant consideration.

It is, however, important to note that Staff concedes that the Rolls-Royce offer represented a higher cost in relation to the other turbine information Staff reviewed, **which solidly supports the Company's position that the Staff's turbine valuations are understated.** This deficiency in Staff's analysis is in addition to the fact that the Staff has failed to adequately consider buying opportunities which currently exist in the purchase power market, as well as numerous cost considerations. These include availability of appropriate turbines, transportation, retrofitting, siting costs, delivery timing, as well as possible construction and transmission costs if capacity were located outside Missouri.

The overall result in this case is that Aquila has prudent generation resources. The Company's resource plan is heavily reliant on owned generation while also providing Aquila with the opportunity to take advantage of the now existing "buyers market" for PPA's (Boehm Rebuttal, p. 2) and as such the Company's cost for rate base should be accepted. The Company believes that there should be no adjustment, as suggested by Staff, but should an adjustment be adopted by the Commission it should be based upon the known and measurable costs at South Harper. On this issue the Commission should determine that Aquila's analysis is appropriate and that the Company's position is prudent under the facts and evidence as presented.

5. South Harper (Electric)

Issue Description: What costs related to the South Harper facility, if any, should be included in Aquila Networks-MPS's rate base?

Aquila Position: The South Harper power plant investment should be included in rate base.

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

AFUDC should begin November 2004 and end August 11, 2005, which is the date the plant met the Staff in-service criteria. The AFUDC rate utilized by Aquila is in accordance with the FERC requirements.

This issue has its origins in Section 393.135, RSMo (2000) which provides, essentially, that an electrical corporation may not include in rates the costs associated with any existing or new facility or other property before same is "fully operational and used for service." The statute doesn't define the terms[17]. As a consequence, in the past, the Staff has come up with certain plant specific "in-service" criteria on a case by case basis and the utility has attempted to meet these standards.

Setting aside for a minute the issue as to whether the Staff or any other party for that matter may dictate, through "criteria," what is meant by the statutory language "fully operational and used for service," in this case the issue arises because the Staff seeks to impose <u>two</u> different sets of criteria to determine the one in-service date with respect to the same plant. (Rooney Rebuttal, p. 24)

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[17] Aquila submits that Section 393.135 RSMo (2000) is so vague and indefinite as to deprive the Company of fair and reasonable notice of what is meant by the terms "fully operational and used for service" and the application of said terms as proposed by the Staff herein would deprive Aquila of its property without due process of law in violation of Missouri Constitution Article 1, Section 10 and the United States Constitution Amendment 14, Section 1 and would constitute the taking of private property of Aquila for public use without just compensation in violation of Missouri Constitution Article 1, Section 26.

The plant involved is Aquila's South Harper facility consisting of three combustion turbines. In this case, the Staff's Engineering Department has proposed one set of "in-service" criteria and the Staff's Accounting Department has proposed its own "in-service" criteria. The key distinction is that the Staff's accounting in-service criteria would declare each unit in-service virtually the first date it generates electricity, whereas the Staff's engineering method would not allow the units to be declared in-service (or used and useful) until all in-service criteria are achieved. (*Id.* p. 25)

In this case, the Company complied with the criteria published by the Staff's engineering department, which considers all appropriate performance criteria so that no further construction or testing remains that could interfere with the ability of the plant to be dedicated to and used for reliable utility service. (Rooney Rebuttal, p. 27) This makes sense because, if anything, "fully operational and used for service" are engineering and not accounting terms. The Staff's accounting criteria, on the other hand, overlooks the importance of key performance criteria, and oversimplifies the process by simply relying upon generation of electricity to equate "in-service." In other words, the accounting approach ignores the "fully operational and used for service" standard as set out in Section 393.135 RSMo (2000)

In-service means that the project is no longer considered Construction Work in Progress and as such concluding that electricity is being generated for sale does not qualify a plant as in-service pursuant to FERC Electric Plant Instruction 3.

The Company's position is that August 11, 2005, should be the in-service date and not the staggered dates suggested by the Staff accountants. This approach is

consistent with Staff's engineering in-service criteria and does not correlate to the mere production of electricity.

The Commission should not allow the Staff to utilize different criteria for the same plant. To pick and choose alternative in-service dates for different issues is fundamentally unfair and creates a lack of regulatory certainty. The Commission needs to provide guidance by selecting one in-service criteria or the other (accounting in-service or engineering in-service) - otherwise, parties would be incentives to argue for one or the other or both, under the same circumstances and facts. This very situation is highlighted in the surrebuttal testimony of Staff witness Featherstone wherein he has indicated that the second set of in-service criteria (engineering in-service) was developed because Staff was unhappy with the Company's application of the accepted in-service criteria (accounting in-service).

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

The cost of test power net of revenue received selling the power used at South Harper through August 11, 2005, should be capitalized. The Company's South Harper facility met the Staff's engineering in-service criteria on August 11, 2005, and as such, the test power costs should coincide with that the August 11, 2005 in-service date.

See discussion at Section 5.a. regarding "in-service criteria."

The Staff suggests instead that the "commercial operation date" should be used, which is the date supplied by Staff's accounting department, which overlooks the fact that the three power units at South Harper were not used and useful until their in-service date which is August 11, 2005, using the engineering in-service criteria. The

Company's position is that the cost of test power net of revenue received from selling the power used at South Harper through August 11, 2005 should be capitalized.

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

Yes. The fees and professional services payments made to the City of Peculiar regarding Chapter 100 financing should be included in rate base.

The Commission should approve rate base treatment of Aquila's Chapter 100 financing arrangement with the City of Peculiar.[18] The amounts include South Harper Facility costs for payments made to and benefiting the city. The costs for inclusion in the rate base amount to up front fees of $927,000, on June 30, 2005. (Rooney Rebuttal, p. 2) Commission staff agrees with Aquila in including the up-front fees in the rate base as a cost of the plant. (*Id.* at 3)

The Chapter 100 arrangement provides a mechanism to abate property taxes. (*Id.)* The benefits of the arrangement will be enjoyed by Aquila's rate payers for the next 30 years. (*Id.* at 2). The expected tax abatement is $25 million over 30 years in return for cost of less than $1 million up front and additional costs of $7.3 million over 30 years. (*Id.* at 3, 4).

Consistent with the Commission affording the costs rate-base treatment, Aquila includes the savings from the Chapter 100 financing arrangement in this proceeding as well. (Rooney Rebuttal, p. 3) Aquila's proposal incorporates the financial benefits

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[18] Legal fes associated with legal challenges to Chapter 100 financing are distinguishable from fees in the regular course of business, which would include those fees associated with Chapter 100 financing.

obtained from entering into the Chapter 100 arrangement with the city. The benefits include a reduction in property taxes Aquila receives in return for costs paid by Aquila to the City of Peculiar. Because the rate proposal includes both the financial outlay and the corresponding savings for Aquila's rate payers, the Commission should accept Aquila's up front payment as part of the rate base.

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

Aquila has settled with Staff what items should be included in rate base relating to various legal, consulting and other costs. Public Counsel is taking issue with additional items including the cost of the extension of the berm and trees on top of the berm which costs Aquila believes should be included in rate base.

Aquila believes that landscaping around a power plant should be considered as part of the cost of building a power plant. Building a berm and planting trees to reduce noise of the plant to provide relief for surrounding residents is not an abnormal cost. Building a power plant without any noise abatement programs would be imprudent. The Company believes the Commission would take issue if a plant was built and no consideration for noise issues were addressed.

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

Aquila believes the South Harper is used and useful and should be included in rate base. The current investment in South Harper is the best proxy for the plant so no alternative amount is needed.

Aquila believes the South Harper facility is used and useful and should be included in rate base. If the costs related to South Harper are not included in Aquila's rate base, the question then becomes one of how the cost of service should be calculated, for example, what proxy should be used. First, the Company believes that the costs for South Harper should be included in rate base, but should the costs not be included, South Harper is the only "proxy" for cost of service which the Commission should consider here. (*See*, section 4 discussing South Harper as the appropriate proxy, if a proxy is used) The Commission should not adopt an estimate from Staff which contemplates phantom generation units and hypothetical plant, and instead should rely upon what is known and measurable by using South Harper as the proxy.

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

Aquila believes the fair market value of the involved assets to be $70,796,890. For purposes of this rate proceeding, Aquila has introduced in its Aquila Networks-MPS rate base for these assets the sum of $66,760,000.

The Company believes that the fair market value for the plant investment at South Harper, namely three combustion turbines, is $70,796,890, which is the valuation of these assets currently reflected on the books of MPS. (Williams Surrebuttal, p. 17, ln. 1 – 3). This amount is significantly less than the original cost of $78,716,233[19]. (Williams Surrebuttal Testimony, p. 17, ln. 5 – 6 Aquila has agreed to include a lower amount in the rate base, namely $66,760,000 versus $70,796,850, because, the

[19] The three South Harper combustion turbines were originally purchased by Aquila Equipment, LLC., "("AEQ") a merchant affiliate of Aquila, Inc., and transferred to Aquila Networks – MPS.

Company as a party to the Stipulation and Agreement in Case No. EO – 2005 – 0156 agreed to a settlement transfer valuation for turbines and related equipment of $66,760,000 in order to put the transfer valuation behind the Company. (Williams Surrebuttal, p. 20, ln. 7 – 9) The Staff agrees that $66,760,000 should be included in rate base. OPC has accepted the $66,760,000 valuation on the condition that Aquila accept that amount in rate base.

6. AAO's (Electric)

Issue Description: Should the unamortized balance of the accounting authority orders the Commission issued for the Rebuild and Western Coal Conversion of Aquila's Sibley generating facility be included in Aquila Networks-MPS's rate base?

Aquila Position: The unamortized AAO balances relating to the Rebuild and Western Coal Conversion at the Sibley power plant should be included in rate base.

The unamortized balance of the Sibley Rebuild and the Sibley Western Coal Conversion Accounting Authority Orders should be included in Aquila Networks – MPS rate base as has been previously authorized by the Commission. The Commission granted three Accounting Authority Orders ("AAOs") to Aquila authorizing the Company to keep approved costs on its books for potential recovery in a rate case. (Phillip Williams Rebuttal, p. 2) The Commission issued the AAOs in order to permit Aquila to defer specific costs (outside of a rate case) with an opportunity to subsequently recover the costs through rates, as opposed to requiring the utility to expense these costs in the current period. (Williams Rebuttal, p. 15) The deferral of costs lessened the impact of regulatory lag, and encouraged the Company to take actions which this Commission

termed "innovative" in order to reduce costs to its customers. (Williams Surrebuttal, p. ln. 3 – 4)

The Commission issued AAOs to Aquila to provide authority for deferring depreciation expenses, property taxes, and carrying costs for two major projects at Aquila's Sibley generating station. The approvals to defer and recover the costs were initially granted by the Commission in Case Nos. EO – 90 –114 and EO – 91 – 358 and reauthorized in Case Nos. ER – 90 – 101 and ER – 93 – 37. (Phillip Williams Rebuttal, p. 2)

One project, the Capacity Life Extension (Sibley Rebuild Project), Case No. ER – 90 – 101, (Phillip Williams Direct, p. 19), Case No. EO – 90 – 114, (Williams Rebuttal, p.16) extended the life of the three Sibley generating units by 20 years, eliminating the need to build another power plant or find alternative sources of energy. (Williams Rebuttal, p.16) The second, the Western Coal Conversion Project, Case No. ER – 93 – 37 (Phillip Williams Direct, p. 19), Case No. EO – 91 – 358 (Williams Rebuttal, p.16), significantly reduced sulfur dioxide ("SO2") emissions at the Sibley Generating Station as required by federal Clean Air Act Amendments.

The Sibley Rebuild Project and the Sibley Western Coal Conversion Project were extraordinary construction projects undertaken by Aquila to provide a continuation of adequate service. (Phillip Williams Rebuttal, p. 5) The projects represent major capitol additions to plant in service as opposed to extraordinary maintenance expenditures from some extraordinary event like an ice storm. The Commission has previously found that Aquila's approach to these projects were innovative and resulted in substantial saving to customers. (Williams Surrebuttal, p. 3 – 4) In this proceeding, the

Commission Staff supports including in rate base the test year amortization for both the Sibley Rebuild and the Sibley Western Coal Conversion deferrals. (Phillip Williams Direct, p. 20)

In opposition to the position taken by Aquila and the Staff, the Public Counsel recommends disallowing the unamortized deferred balances of the projects from rate base, despite the Commission's previous decisions in Case Nos. ER – 90 – 101, EO – 91 – 247, and ER – 93 – 37 allowing the unamortized balance of the Sibley Rebuild and the Sibley Western Coal Conversion AAOs in the rate base. (Phillip Williams Surrebuttal, p. 22) (citing Robertson Rebuttal, p. 5)

In support of its position, the Public Counsel relies on the 1998 Missouri Gas Energy ("MGE") natural gas rate case, Case No. GR – 98 – 140, in which the Commission reversed its earlier decisions allowing rate based treatment of an unamortized balance of an MGE service line replacement program. The MGE decision can be distinguished from the facts in the present case. MGE sought to significantly accelerate the amortization period initially seeking to accelerate the timeframe to 3 years. In the 1998 case, MGE affirmatively proposed to reduce a 20 year amortization period to a 10 year amortization period. While the Commission allowed the reduced amortization period, the Commission recognized that MGE would recover the amortized amount of the service line replacement program in a reduced period of 10 years rather than the original 20 year period. In the present matter, Aquila has no similar request to accelerate the amortization period. Rather, Aquila is consistent with its positions in the previous Commission AAOs.

The argument of the Public Counsel is also inconsistent with the Commission's previous determinations and policies. Public Counsel's position relates to the deferral of costs over time. Because the utility is given a guarantee on the "return of" deferred expenses, Public Counsel indicates that the utility should not be provided with a more immediate "return on" those amounts. Public Counsel also argues against the deferral of costs to lessen the impact of regulatory lag. (Williams Rebuttal, p. 17) (citing Robertson Direct, p. 16 – 18)

The promised return of an investment is not a compelling reason for receiving no return on its investment. (Williams Rebuttal, p.17) This policy rationale is particularly true in the present case where the projects last over an extended timeframe. The Sibley Rebuild and Western Coal Conversion Projects were started three years before they were in service. Cash funds were expended before there was any opportunity to recover the costs. (*Id.*) During this time, Aquila shareholders experienced three years of regulatory lag, receiving no return "of" or "on" their investment. (*Id.*)

Utilities properly authorized by Commission AAOs should be in a position to rely on those grants of authority in the actions taken by the company. In the present case, the Commission has already issued AAOs related to the Sibley Rebuild and Western Coal Conversion Projects. Furthermore, the facts underlying the previous decisions regarding the Sibley Rebuild and Western Coal Conversion Projects remain the same. Each project required significant expenditures over a significant period of time.

The AAO authority granted to Aquila on the Sibley Rebuild and Western Coal Conversion Projects is consistent with the Commission's position on deferral of expenses. The Commission followed its position that lessening regulatory lag by

deferring costs is not a reasonable goal unless the costs are associated with an extraordinary event. (Williams Rebuttal, p. 19) (citing Case Nos. EO – 91 – 358 and EO – 91 – 360) The deferred costs included in the AAOs for the life extension of Sibley should be treated in the same way as other capital costs and afforded rate base treatment. (Phillip Williams Rebuttal, p. 5)

7. Deferred Taxes - AAO (Electric)

Issue Description Should deferred income taxes associated with the Sibley and Ice Storm accounting authority orders be determined and applied as an offset to Aquila Network-MPS's rate base?

Aquila Position: If the unamortized balance is included in rate base then deferred taxes should be included as an offset to rate base. If the balance is excluded from rate base i.e. ice storm then the associated deferred taxes should not be included as an offset to rate base.

Deferred expense balances and the related deferred taxes should be treated consistently in the rate base. The ice storm AAO authorizes deferral of the ice storm expenses removing those expenses from regulated cost of service and placing them instead on the balance sheet as an asset. (Rooney Surrebuttal, p.19) The AAO change creates a difference between the expenses in cost of service and the expenses in the tax return. The AAO treatment gives rise to the deferred income tax liability but no additional cash is received from rate payers. (*Id.*)

Analysis by the Internal Revenue Service ("IRS") supports Aquila's position. The IRS provides that the treatment of the rate base, deferred taxes, depreciation, and tax expense for ratemaking purposes should all be handled consistently. (Rooney Surrebuttal, p. 22) With respect to items subject to normalization, such as plant balances and depreciation, the IRS requires a consistent methodology. (*Id.)* The Public

Counsel promotes an inconsistent approach to the rate base calculation. The Public Counsel proposes to exclude from rate base ice storm moneys advanced by Aquila, while including a rate base reduction for the deferred taxes created by the ice storm AAO. (Rooney Surrebuttal, p. 14)

Rate base reductions generally occur for two reasons: (1) either the rate payer has advanced money to the company in advance of the company spending it; or (2) the rate payer is paying the company a return on an asset and the reduction is intended to reflect the company's net cash investment in that asset. (Rooney Surrebuttal, p. 13) In the case of the Ice Storm AAO: (1) Aquila spent the money in advance of the recovery; and (2) the Public Counsel has not included the ice storm asset in the rate base. (*Id.*)

The methodology proposed by Public Counsel is flawed for a number of reasons. As noted above, it is inconsistent to reduce rate base calculations for the deferred taxes while denying the same treatment for the underlying expenditure as a deferred asset. Second, a rate base reduction denies a return on funds already advanced by Aquila. (Rooney Surrebuttal, p. 16) Third, the methodology proposes a rate base deduction where no funds have been advanced by rate payers. Fourth, by inappropriately including a rate base deduction where no funds have been advanced by the rate payers, the utility would not be in a position to recover the actual amounts it was allowed to defer. (*Id.*)

Aquila seeks a consistent position from the Commission regarding the Company's deferred ice storm amortization under an AAO Aquila's deferred expense balances and the related deferred taxes should both be included in the rate base calculation.

8. Deferred Tax Balances: (Electric and Steam)

Issue Description: Should certain deferred tax timing differences be included in the accumulated deferred tax balances (added/deducted) from plant in service in the determination of rate base?

Should deferred tax debit balances related to non-rate base accruals and reserves be included in the accumulated deferred income tax balances deducted from plant in service in the determination of Aquila Networks-MPS's and Aquila Networks-L&P's rate bases?

Aquila Position: No. The deferred taxes relating to the timing differences have already been included in the cash working capital calculation.

Adjustment of specific deferred tax balances as proposed by Staff and AARP should not be made. The liabilities giving rise to the timing differences proposed to be removed from the accumulated deferred income tax balance are reflected in the cash working capital calculation. In fact, Staff's cash working capital calculation reduces the rate by nearly $20 million for the net impact of these items. (Rooney Surrebutal, p. 12) AARP and Staff propose to entirely remove accumulated deferred income tax balances related to allocated costs, employee incentives, maintenance accruals, and some employment benefits, from the calculation of the rate base. (Rooney Surrebuttal, p. 11) The Commission should reject the proposed adjustments related to accumulated deferred income taxes because it is incorrectly premised on the assumption that all the related liabilities are excluded from the rate base calculation. (Rooney Surrebuttal, p. 12) The related liabilities were not excluded, but instead as previously stated are reflected in the cash working capital calculation which offsets rate base.

9. Accounts Receivable Program – (Electric)

Issue Description: Should customer accounts receivable be treated as being sold for purposes of determining Aquila Network-MPS's and Aquila Networks-L&P's cash working capital included in rate base?

Aquila Position: No. Aquila does not sell MPS and L&P customer account receivables under the plan that Staff used to make the associated adjustment.

An accounts receivable sales program should not be included in the cash working capital included in rate base in that Aquila does not sell accounts receivable. The Staff includes Aquila's original accounts receivable program as though it was still available to Aquila. (Williams Rebuttal, p. 5) It is not.

Staff incorrectly assumes that Aquila maintains an accounts receivable program and utilized the program during the test year. (Williams Rebuttal, p. 3) Aquila does not participate in such a program where a company sells its receivables at a discount to a financial institution. (*Id.*) This arrangement creates legal and structural requirements which make the arrangement prohibitively costly as a means of short-term financing. (*Id.* at 4) Aquila discontinued the program in 2002. (*Id.* at 5)

To avoid the pitfalls of account receivable programs, Aquila secured a $150 million line of credit as a short term financing arrangement. Accounts receivable are pledged as collateral against any credit accepted, rather than being sold outright. (*Id.* at 4) This arrangement carries lower costs than other methods of short-term financing, due to its self liquidity. (*Id.*) The purpose for securing the short-term credit is to bridge the period between permanent financing or to meet seasonal needs. (*Id.* at 6)

The positions furthered by Staff on the accounts receivable program are inconsistent. On one hand, Aquila is criticized for the loss of the original accounts receivable program as a detriment to Aquila and its customers. (*Id.* at 5) On the other hand, the Staff uses the program's entire short-term financing as permanent financing

and assumes it to be outstanding for the test year and into the future. (*Id.* at 6) Partly in response to the criticism by Staff, Aquila re-established its accounts receivable program which was previously terminated. However, no borrowing took place during the test year. Staff has never imputed in rate proceedings for other Missouri utilities the impacts of a hypothetical accounts receivable financing program. Imputing hypothetical accounts receivable for Aquila would penalizing Aquila for its response to Staff and seems unfair and inappropriate. (*Id.* at 7)

10. 20 West 9th: (Electric and Steam)

Issue Description: What cost should be included in Aquila Networks-MPS's and Aquila Networks-L&P's rate bases for Aquila's 20 West 9th headquarters/annex?

Aquila Position: Aquila believes all the 20 West 9th headquarters/annex costs should be included in rate base.

The Company asserts that all rate base and expense costs in connection with Aquila's 20 West 9th Headquarters/Annex should be recovered in rates. Aquila has configured its office space at 20 West 9th so as to create a positive work environment and provide suitable work space for all supporting personnel. Aquila's current space utilization goal is about 280 useable square feet per occupant. (Empson Rebuttal, p. 4) This meets a standard of approximately the 50th percentile of both the 1997 and 2002 International Facilities Management Association ("IFMA") studies. (*Id.*)

The configuration results in 477 workstations in the Headquarters/Annex. (Empson Rebuttal, p. 4) Just 47 of the 477 work stations are vacant. (*Id.)* This results in a 9.9% vacancy rate. According to the IFMA, the average workstation utilization rate

for headquarters facilities is 87% or a 13% vacancy rate. (*Id.* at 5) Aquila's 9.9% vacancy rate is reasonable. (*Id.*)

While the Public Counsel uses the same IFMA studies provided by Aquila in its analysis (Robertson Direct, p. 8), the Public Counsel incorrectly calculates the building space in finding that the cost of maintaining and operating the headquarters is excessive. The Public Counsel witness, Ted Robertson, fails to include in his assessment both: (1) current space utilization calculations; and (2) the number of employees, including full time consultants, contract employees and part-time employees, who work in the building.

Public Counsel used the planned capacity, as opposed to the current employee capacity, in its calculation of the current space usage. (Robertson Direct, p. 8) Aquila revised its capacity from the planned capacity using the IFMA studies. (Empson Rebuttal, p. 2) The original planned capacity was inadequate in that it was based on an aggressive space utilization plan configured in "bullpen" areas. It was creating a negative work environment. (*Id.* at pp. 2 – 3)

Public Counsel calculations also failed to include all personnel working at the headquarters building. The Public Counsel numbers did not incorporate full time consultants, contract employees, or employees that work part time in the building, although they may have office space elsewhere. (Empson Rebuttal, p. 5) An IFMA report provides that 45% of surveyed companies provide workstations for periodic users. The average size of the workstations is 91 square feet. Aquila provides an average workstation for periodic users of just 63 square feet. (*Id.*)

Aquila's space configuration is consistent with industry office occupancy norms as provided by IFMA. (Empson Rebuttal, p. 6) Aquila uses its headquarters office space in a manner that simply offers a productive work environment. The involved costs should be recovered through rates.

11. SO_2: Emissions Costs (Electric)

Issue Description: What level of SO2 emission costs should be included in rate base?

Aquila Position: Aquila agrees with the Staff position to use a 13 month average of SO2 costs to be used in rate base.

Aquila and Staff agree on an adjustment for Aquila's purchases of rights to emit Sulfur Dioxide ("SO2") from its fossil fuel plants. (Braun Direct, p. 15) Aquila is required to obtain SO2 emission allowances for its fossil fuel plants by federal law and the federal Environmental Protection Agency ("EPA") The SO2 adjustment is based on a calculation of SO2 emission allowances required for Aquila's fossil fuel plants associated with MPS and L& P. (*Id.*)

Annually, EPA makes a certain number of emission allowances available for each operating plant. (Klote Direct, p. 6) Aquila is normally required to purchase additional allowances for each plant to meet EPA requirements. (*Id.*) The adjustment for SO2 emission allowances is based on a thirteen-month average of the SO2 emission allowance inventory. (Braun Direct, p. 15)

Aquila calculates the emission allowances required for each plant. The forecast numbers for MPS are obtained by using the plant production level and the blend of coal needed to produce energy. (Klote Direct, p.6) The calculation of the adjustment includes taking the annual forecast numbers of emission allowances needed and

subtracting the free allowances issued by EPA for each plant for the year. (*Id.*) The remaining required emission allowances are multiplied by the projected unit cost per allowance of $700. This number is obtained from Argus Air Daily and subsequently compared to the amount booked in FERC Account 509 for the test year ending on December 31, 2004. (*Id.* at p. 6 – 7.)

The forecast numbers for L&P were obtained using the same methodology. (*Id.* at 7) In addition to two generating facilities, L&P has a purchase power contract in which L&P is obligated to provide enough emission allowances to meet the power generation needs of a third facility. (*Id.* at 7)

The adjustment for SO2 emission allowances is based upon federal requirements and the availability of the allowances to Aquila. The amount of the adjustment required for Aquila's fossil fuel plants associated with MPS (1,090,518) and L&P (573,845) is reasonable and fully supported by the record.

III. Expense Issues

12. SO2: Emissions Costs (Electric)

Issue Description: What level of SO2 emission costs should be included in expense?

Aquila Position: Aquila agrees with Staff position that 19,874 SO2 allowances for MPS and 8,262 SO2 allowances for L&P are appropriate levels for Aquila.

Aquila's expenses for its fossil fuel plants include continuous purchases of Sulfur Dioxide ("SO2") emission allowances. (Braun Direct, p.15) As noted previously, Aquila is required to obtain these SO2 emission allowances for its fossil fuel plants by federal law and the federal Environmental Protection Agency ("EPA").

The SO2 expense is calculated using projections of the SO2 emission allowances required for Aquila's fossil fuel plants associated with both MPS and L& P. (*Id.)* The utility expense calculation must necessarily include several broad-ranging variables. A few of these significant variables include: the availability and cost of the SO2 emission allowances and the availability and cost of different qualities of coal.

Staff and Aquila are in agreement on the expense of purchasing the SO2 emission allowances to meet Aquila's needs. Witness Graham Vesely testified that the Commission staff reached agreement with Aquila when Aquila accepted the position originally developed by the Commission staff. (Vesely Surrebuttal, p.14)

The Public Counsel conducted calculations utilizing a methodology with similarities to Aquila's calculations. (Robertson Direct, pp. 33 – 34) The similarities include beginning with annual emission allowances required, subtracting free allocations from the federal EPA, and multiplying by a $700 per emission allowance as proposed by Aquila. (*Id.* at 33) The Public Counsel, however, confounds its own methodology by inputting flawed variables and adjustments.

Overall, the Public Counsel's calculations fail to consider unknown variables in calculating the expenses of SO2 emission allowances. This is remarkable, considering the variety of unknowns in determining a set price for the cost of the emission allowances on the open market and in the potential amount of emissions which might occur.

Among other inputting failures in calculating the expense of SO2 emission allowances, the Public Counsel ignores present facts regarding the Sibley facility. The Public Counsel refuses to analyze the need for additional emission allowances due to

an unusual situation arising from a low sulfur contract. (Robertson Rebuttal, p.23) The situation led to the company filing a lawsuit. The Public Counsel ignores the need to estimate increased SO2 emission allowances due to higher sulfur content coal than the contract would provide. (*Id*) The Public Counsel prefers to wear blinders and calculate an estimate of emission allowances limited to the allowances required in recent years -- under a coal contract which is no longer in effect.

Finally, the Public Counsel would disallow as excessive Aquila's efforts to reduce the costs of acquiring additional SO2 emission allowances. (Robertson Rebuttal, p. 24). These efforts include SO2 emissions allowance trading activities, such as purchases, sales, swaps and potentially lower booked prices for emission allowances. (*Id.*)

Aquila demonstrates the most reasonable calculation of the emission allowances required for each plant. The forecast numbers for MPS are obtained by using the plant production level and the blend of coal needed to produce energy. (Klote Direct, p.6) The calculation of the adjustment includes taking the annual forecast numbers of emission allowances needed and subtracting the free allowances issued by EPA for each plant for the year. (*Id.*) The remaining required emission allowances are multiplied by the projected unit cost per allowance of $700. This number is obtained from Argus Air Daily and subsequently compared to the amount booked in FERC Account 509 for the test year ending on December 31, 2004. (*Id.* at pp. 6 – 7).

The forecast numbers for L&P were obtained using the same methodology. (*Id.* at 7) In addition to two generating facilities, L&P has a purchase power contract in which L&P is obligated to provide enough emission allowances to meet the power generation needs of a third facility. (*Id.* at 7)

The expense for SO2 emission allowances is founded upon federal requirements. It must be calculated using a method for determining: the availability and cost of emission allowances; as well as the cost, quality and availability of coal to Aquila. Aquila's methodology is sound. The annualized for SO2 emission allowances for Aquila's fossil fuel plants associated with MPS (2,986,042) and L& P (1,489,511) are projections that Aquila, the Commission staff and the record fully support.

13. Generation Resources: (Electric)

Issue Description: What are the prudent types and amounts of generation resources for determining fuel and purchased power expense for Aquila Networks-MPS and Aquila Networks-L&P?

Aquila Position: Aquila's Networks – MPS and L&P current generation resource mix is prudent for dispatching Aquila load and should be included in calculating fuel costs for this case.

See discussion set out at Section 4.

14. Spot Market (Electric and Steam)

Issue Description: How should prices for power Aquila purchases on the spot market be determined?

Aquila Position: Aquila utilized the national and regional market data from Global Energy Decisions and used the MIDAS Gold analysis package to determine spot market prices.

The Company utilized the national and regional market data from Global Energy Decisions ("GED"), and used the MIDAS Gold analysis package to determine spot market prices. The MIDAS Gold database has as its source the current GED Energy Velocity database. (Okenfuss Direct, p. 4) The MIDAS Gold database contains unit specific operating data on every operating plant within NERC. (Okenfuss Direct, p. 4) This operating data includes, for example, unit capacity, heat rate, fuel type, variable

O&M costs, and fixed plant costs, much of which GED compiles from published resources. (Okenfuss Direct, p. 4)

The MIDAS Gold dataset also includes regional loads. (Okenfuss Direct, p. 4) Information regarding regional loads and 10-year forecasts is collected, and GED then breaks down present load and growth by market area. (Okenfuss Direct, p. 4) The MIDAS Gold dataset uses this information to simulate the load growth of all regions and market areas in NERC, and the Company does not modify this information in the production of the spot market price curve for power. (Okenfuss Direct, p. 4)

In determining which fuel costs to include in the power price determination, the methods used by the Company concern only the fuels that have a material impact on the ultimate market price for power, and not with those having minimal impact. (Okenfuss Direct, pp. 4 – 5) Further, in estimating primary fuel source forward prices, because fuel assumptions vary with the fuel being considered, the methods used for determining the cost of each primary energy source are considered separately, which results in a more accurate determination of cost. (Okenfuss Direct, p. 5)

Similarly, the MIDAS Gold "multi-area" mode of analysis results in a more comprehensive and accurate development of power prices. (Okenfuss Direct, p. 6) In this analysis, all regions of the country are condensed into market areas, each with a load profile and a set of generation resources. (Okenfuss Direct, p. 7) The market areas are connected by a series of transmission lines, each subject to a transmission constraint. (Okenfuss Direct, p. 7) Price differences in market areas connect with an unconstrained transmission path, and will cause the model to assume a power flow between the two areas. (Okenfuss Direct, p. 7) The effect will be to lower the cost in

the high price area and increase the cost in the low cost area, as this assumed power flow increases until the two market prices have equilibrated at an identical level or the transmission line has reached its limit. (Okenfuss Direct, p. 7)

Under the analysis used by the Company, prices are not only developed for the Southwest Power Pool NERC region, but simultaneously for all regions within the model study. (Okenfuss Direct, p. 7) Specifically, the Midwest model produces power market forward prices for the market areas in the Southwest Power Pool, Mid-Continent Area Power Pool, Mid-American Interconnected Network, and the Southeastern Electric Reliability Council NERC regions. (Okenfuss Direct, p. 7)

In light of the above, the Company's utilization of the national and regional market data from GED, and its use of the MIDAS Gold analysis package to determine spot market prices, results in a more comprehensive and accurate determination of prices.

15. Purchased Power: (Electric and Steam)

Issue Description: How should prices for power based on purchased power contracts be determined?

Aquila Position: Aquila believes that the actual charges set out in the signed purchased power contracts for purchased power should be used to determine the prices to be included in rates.

Refer also to the discussion set out in section 4 herein.

As explained by Aquila witnesses Mike Apprill and Jerry Boehm, the MPS division has long-term purchases sourced from Sunflower NPPD's Cooper Nuclear Station and the Gray County Wind Farm in west Kansas (Apprill Direct, p. 2, ln. 19 – 20; Boehm Direct, p. 4, ln. 4 – 7) The L&P division has long-term purchases sources from

NPPD's Gerald Gentleman Station and the Gray County Wind Farm in western Kansas (Apprill Direct, p. 3, ln. 1 – 2) Additionally, a new purchased power contract for 200 megawatts is included in this case. The contract began in September of 2005, and the project is identified as Project X. Coupled with the NPPD Cooper Nuclear Station purchase and the South Harper generating facility, the Project X purchase is designed to replace the Aries purchase, provide for anticipated load growth, and mitigate the need for additional short-term summer season purchases. (*Id.*, ln. 6 – 10)

The resources derived from the above-described purchased power contracts were not all used during the test period for this case. There were changes to the resource mix which were made in consideration of expiring contracts and generation under construction. (Boehm Direct, p. 5, ln. 1 – 3) The test case and the forecast resources for 2005 differ in that additional capacity has been secured for 2005 as part of a contingency plan, a one-year purchase power agreement with the Sunflower Electric Cooperative has been acquired to hedge against the Project X agreement, and a purchase of 225 MW of the Crossroads peaking facility provides capacity against possible construction delays for South Harper. (Boehm Direct, p. 6, ln. 1 – 5)

16. Coal Prices: (Electric and Steam)

Issue Description: On what prices should Aquila's coal fuel expense be based in setting rates?

Aquila Position: Aquila believes that the actual charges set out in the signed coal contracts should be used to determine the prices to be included in rates.

The Company's position is that the prices set out in actual contracts for coal should be used to calculate prices for use in determining rates. (HR – 2005 – 0450,

Boehm Rebuttal, p. 3, ln. 20 – 21) Instead, the Staff has suggested that the Company be denied recovery of the C.W. Mining Contract, unless the Company meets a long list of subjective criteria. There is simply no justification for the Commission to penalize the Company by adjusting coal costs based upon the alleged breach of the C.W. Mining contract, by C.W. Mining. (Korte Rebuttal, p. 8, ln. 2) This approach overlooks the standard of **known and measurable**, that the Company entered into the contract with C.W. Mining at a time when it was the best cost, preferred supplier bid and that the Company is not a breaching party. Now Staff would essentially use "hindsight regulation" to penalize the Company by reflecting a hypothetical coal cost. (Korte Rebuttal, p. 8, ln. 5 – 8)

The contract prices identified by the Company in this case have not been endorsed by the Staff in that the Staff is recommending that the pricing from the C.W. Mining contract be used to determine recovery (Korte Rebuttal, p. 6, ln. 9 – 10), even though it is a contract from which Aquila no longer receives coal. C.W. Mining has attempted to terminate the contract based on alleged force majeure events and, thus, has ceased to supply coal. (*Id.)* Accordingly, Aquila has been forced to enter into a new contract in order to obtain the necessary coal.

The Staff recognizes, along with the Company, that the costs associated with replacing the C.W. Mining contract are higher. However, this in and of itself "cannot be a reason to deny inclusion of the replacement costs in rates." (ER – 2005 – 0436, Korte Rebuttal, p. 6. ln. 9 – 10; HR – 2005 – 0436, Boehm Rebuttal p. 4, ln. 1 – 2; p. 4, ln. 1 – 2, HR – 2005 – 0450) The treatment of coal costs in this rate case should be determined based upon **known and measurable costs.** (ER – 2005 – 0436, Boehm

Direct, p. 16, ln. 17 – 19) Aquila does not support including coal costs based on a supplier by whom Aquila is no longer supplied. (Boehm Rebuttal, p. 3, ln. 15; p. 3, ln. 12 – 15, HR – 2005 – 0450) Rather, the actual costs that Aquila will incur in the period for which these rates are being determined and in effect should be those which are included in the cost of service. The contract, which replaced the C.W. Mining Contract, and any other costs related to it should be included in the cost of service in this case. (ER – 2005 – 0426, Boehm, p. 18, ln. 21 – 22, p. 17, ln. 1 – 5)

The reliance by Staff on pricing from the C.W. Mining contract underestimates the costs of coal which Aquila knows it will incur by approximately $6.2 million and as such is inappropriate in this case and as such the Commission should use known and measurable costs.

Lastly, the parties have pointed out that Aquila has initiated litigation against C.W. Mining to seek damages for its alleged breach of its coal contract with Aquila. Should this litigation result in damages being paid to Aquila, Aquila would propose to treat those changes as extraordinary gain and flow them back to customers through an amortization. A similar approach was used by this Commission in the past to flow back damages received by Missouri Public Service Company as a result of lawsuits against Westinghouse and Peabody Coal Company. *In the Matter of Missouri Public Service Company*, 25 Mo. P.S.C. (N.S.) 139, 148 - 153 (Case No. ER-82-39)(June 21, 1982).

17. Natural Gas Prices (Electric and Steam)

Issue Description: On what prices should Aquila's natural gas expense be based in setting rates?

Aquila Position: Aquila utilized the 3 month rolling average, (Oct 1 to Dec 31, 2004) 12 month strip NYMEX future prices for 2006 in its initial filing. This price was $6.571. Updating the 3 month rolling average to June 1 to

August 31, 2005 pre Katrina NYMEX future prices for 2006 calculates an annual price of $8.42.

The New York Mercantile Exchange ("NYMEX") futures method of predicting natural gas prices, which is used by the Company, is an accurate and comprehensive method that provides a more complete view of the actual prices the Company will face in the marketplace.

Staff asserts that the Company's historical cost of natural gas in June 2005 is the accurate indicator of natural gas prices. (Hyneman Direct, p. 7, ln. 2 – 4) The selection by Staff of June 2005 as the month to determine natural gas prices is arbitrary. (Korte Rebuttal, p. 12, ln. 5 – 9; p. 6, ln. 4 – 7 , HR – 2005 – 0450); Boehm Surrebuttal, p. 5, ln. 1 – 3) Historically, June is generally the month that natural gas prices are at the lowest. (Korte Rebuttal, p. 12, ln. 12 – 13; p. 6, ln. 10 – 11, HR – 2005 – 0450) Arbitrarily selecting a historically low-priced natural gas month introduces a bias into the results of the production cost model, which lowers the estimated costs for operating the Company's electric service business. (Korte Rebuttal, p. 12, ln. 14 – 17; p. 6, ln. 12 – 15, HR – 2005 – 0450) The way to mitigate this bias is to use a more comprehensive model that incorporates a more complete view of the actual marketplace. (Korte Rebuttal, p. 13, ln. 1 – 4; p. 6, ln. 21 – 22; p. 7, ln. 1 – 2, HR – 2005 – 0450)

The Company offers this more comprehensive and accurate model. The Company proposes the use of the NYMEX futures method for price determination. (Boehm Direct, p. 10, ln. 12 – 14) "The company has averaged the NYMEX futures market price for the 2006 calendar year that occurred in the last three months of 2004. These prices are known and represent actual market transactions for natural gas in that

time period." (Boehm Direct, p. 10, ln. 14 – 16) This method has been proven to be accurate in determining the actual prices the Company will face in the market. (Boehm Direct, p. 10, ln. 17 – 21) Further, the Company's use of NYMEX futures average gas prices prices has been confirmed by publicly available independent studies. (Boehm Direct, p. 11, ln. 10 – 14) Because the Company is hedging natural gas costs, present day NYMEX prices more accurately reflect the prices the Company will pay. (Boehm Surrebuttal, p. 4, ln. 15 – 18; p. 3, ln. 6 – 9, HR – 2005 – 0450)

Compared with Staff's proposal, the Company's NYMEX futures method of determining natural gas prices is a more accurate and comprehensive method that provides a more complete view of the actual prices the Company will face at the time rates are in effect.

18. Fuel Oil Prices: (Electric and Steam)

Issue Description: On what price should Aquila's fuel oil in expense be based in setting rates?

Aquila Position: Aquila believes current market price for fuel oil is the appropriate price to use for setting rates.

This Commission should use the current market price for fuel oil in setting the rates in this proceeding. Staff, however, uses the single last transaction entered into by Aquila as the market price ($1.6414 per gallon). This transaction occurred on November 4, 2004 – over one year ago. As such, Aquila cannot support this method of price determination. (Korte Rebuttal, p. 13, ln. 5 – 10) The method chosen by Staff is arbitrary and is based on the "barest minimum of market based information." (Korte Rebuttal, p. 13, ln. 10 – 11) The prevailing price for fuel oil has changed dramatically since November 4, 2004. In fact, there was a 25 percent increase in price between

November 4, 2004 and November 4, 2005. This is a concern because the relatively low price of oil can impact the production cost model. (Korte Rebuttal, p. 13, ln 12 – 21) The Commission simply cannot rely upon a price from over a year ago when more current and more accurate data is available. To replace supply used during December 2005, Aquila purchased on January 3, 2006 high and low-sulfur fuel oil for Greenwood and Lake Road at delivered prices of $1.9920 and $2.0385 per gallon, respectively.

19. 20 West 9th: (Electric and Steam)

Issue Description: What expense for Aquila's 20 West 9th headquarters/annex should be used in setting Aquila Networks-MPS's and Aquila Networks-L&P's rates?

Aquila Position: Aquila believes all the 20 West 9th headquarters/annex costs should be included in expense.

All proposed costs of Aquila's 20 West 9th Headquarters/Annex Adjustment should be included in expense. Aquila proposes a configuration of office space that creates a positive work environment and provides work space for all supporting personnel. Aquila's current space utilization goal is about 280 useable square feet per occupant. (Empson Rebuttal, p. 4) This meets a standard of approximately the 50th percentile of both the 1997 and 2002 International Facilities Management Association ("IFMA") studies. (*Id.*)

The proposed configuration results in 477 workstations in the Headquarters/Annex. (Empson Rebuttal., p. 4) Just 47 of the 477 work stations are vacant. (*Id.*) This results in a 9.9% vacancy rate. According to the IFMA, the average workstation utilization rate for headquarters facilities is 87% or a 13% vacancy rate. (*Id.* at 5) Aquila's 9.9% vacancy rate is reasonable. (*Id.*)

While the Public Counsel uses the same IFMA studies provided by Aquila in its analysis (Robertson Direct, p. 8), the Public Counsel incorrectly calculates the building space in finding that the cost of maintaining and operating the headquarters is excessive. The Public Counsel witness, Ted Robertson, fails to include in his assessment both: (1) current space utilization calculations; and (2) the number of employees, including full time consultants, contract employees and part-time employees, who work in the building.

Public Counsel used the planned capacity, as opposed to the current employee capacity, in its calculation of the current space usage. (Robertson Direct, p. 8) Aquila revised its capacity from the planned capacity using the IFMA studies. (Empson Rebuttal, p. 2) The original planned capacity was inadequate in that it was based on an aggressive space utilization plan configured in "bullpen" areas. It was creating a negative work environment. (*Id.* at p. 2 – 3)

Public Counsel's calculations also failed to include all personnel working at the headquarters building. The Public Counsel's numbers did not incorporate full time consultants, contract employees, or employees that work part time in the building, although they may have office space elsewhere. (Empson Rebuttal, p. 5) An IFMA report provides that 45% of surveyed companies provide workstations for periodic users. The average size of the workstations is 91 square feet. Aquila provides an average workstation for periodic users of just 63 square feet. (*Id.*) Aquila's space configuration is consistent with industry office occupancy norms as provided by IFMA. (Empson Rebuttal, p. 6) Aquila proposes to use the headquarters office space in a manner that simply offers a productive work environment.

20. SERP: (Electric and Steam)

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

Aquila Position: Yes. Without the SERP program, executives would lose retirement benefits under limitations imposed by the IRS code that apply to qualified retirement programs that are in place at Aquila.

The Company's expenses associated with its Supplementary Executive Retirement Plan ("SERP") should be recovered in rates. IRS rules limit the amount of salary that can be used in benefit formulas of the Company's qualified retirement programs, which, over time, results in a reduction of benefits for higher paid executives. (Beyer Rebuttal, p. 2, ln. 5 – 16; p. 2, ln. 5 – 16; HR – 2005 – 0450) The purpose of the Company's SERP is to restore these benefits to higher compensated employees whose benefits are reduced due to the IRS maximum salary benefits. (Beyer Rebuttal, p. 3, ln. 5 – 7; p. 3, ln. 5 – 7, HR – 2005 – 0450)

While the Company's SERP does have change in control provisions that define the circumstances by which control of the Company may occur, these provisions do not create an expense unless the Company's control changes. (Beyer Rebuttal, p. 3, ln. 14 – 19; p. 4, ln. 3 – 4; p. 3, ln. 14 – 19; p. 4, ln. 3 – 4, HR – 2005 – 0450) Further, in the event of a change in control, executives are not provided greater benefits, (Beyer Rebuttal, p. 4, ln. 12 – 13; p. 4, ln. 12 – 13, HR –2005 – 0450), and, contrary to the assertion of Staff, senior executives have not received base pay increases or bonus income that would apply to the SERP. (Beyer Rebuttal, p. 5, ln. 12 – 14; p. 5, ln. 12 – 14, HR – 2005 – 0450)

Staff has approved rate recovery of SERP expenses in the past under rationale that is equally applicable in this case. (Hyneman Surrebuttal, p. 20, ln. 16 – 17, 21 – 23) The Missouri portion of SERP expense for basic benefits is $791,256. (Beyer Rebuttal, p. 6, ln. 8 – 9; p. 6, ln. 8 – 9, HR –2005 – 0450) Because this expense is directly attributable to basic benefits that restore benefits lost due to IRS salary limits, the $791,256 should be included in the cost of service. (Beyer Rebuttal, p. 6, ln. 9 – 11; p. 6, ln. 9 – 11, HR – 2005 – 0450)

21. L&P Transition Costs (Electric and Steam)

Issue Description: Are the transition costs of the merger of St. Joseph Light & Power Company with Aquila an expense Aquila should recover from Aquila Networks-MPS and Aquila Networks-L&P ratepayers?

Aquila Position: Yes. The cost to achieve the merger such as computer system development, benefit plans combined, etc should be included in rates as long as adequate savings have been met to off-set those costs.

The Commission should approve recovery in rates the $671,030 of annual jurisdictional amortization of costs to achieve the Company's merger with St. Joseph Light and Power ("SJLP") The costs of the merger in this case were approximately $18 million. (Rooney Rebuttal, p. 10, ln. 17 – 18) The Company has excluded certain costs from its request based on challenges by Staff and has voluntarily adjusted its request for costs to comply with the position of Staff. (Rooney Rebuttal, p. 11, ln. 9 – 11, 18 – 20)

Public Counsel objects to the Company's request, alleging that the Company agreed to never seek recovery of these costs. Aquila, however, made no such agreement. (Rooney Surrebuttal, p. 4, ln. 8 – 12) The Company did agree to not seek recovery of the acquisition premium "through the merger savings sharing mechanism

proposed in Case No. ER – 2004 – 0034." (Rooney Surrebuttal, p. 4, ln. 14 – 26; p. 5, ln. 1 - 2) The acquisition premium does not include the costs to achieve the merger, as there is a distinction between costs paid to the seller and other costs incurred. (Rooney Surrebuttal, p. 5, ln. 8 – 10; p. 8, ln. 6 – 22) Further, while Public Counsel asserts that the Company had no basis to defer the costs on its books, the Company did have a basis for its accounting in the USoA, which allows amounts to be deferred and recorded where there is no order and uncertainty exists. (Rooney Surrebuttal, p. 9, ln. 9 – 17; p. 3, ln. 11 - 14) The Commission expressed its intent to defer a ruling on the final disposition of these costs until a later rate case, thereby making the disposition of the costs to achieve the merger uncertain. (Rooney Surrebuttal, p. 9, ln. 18 – 21; p. 10, ln. 1 – 4)

The costs of the merger sought to be recovered in rates in this proceeding are far outweighed by the savings and benefit to the ratepayers resulting from the merger. (Rooney Rebuttal, p. 8, ln. 6 – 8; p. 10, ln. 6 – 8) The largest benefit is in joint dispatch savings, which are estimated by the Company to be approximately $11.2 million per year. (Rooney Rebuttal, p. 8, ln. 22; p. 9, ln. 1) In addition to the joint dispatch savings and the several broad categories of savings identified by Company witness Vern Siemek in Case No. ER-2004-0034, there are other savings including the termination of executive officers, who had total annual salaries in excess of $800,000, and the termination of two non-officer employees, who had total annual salaries in excess of $1,500,000. (Rooney Rebuttal, p. 9, ln. 4 – 12) In terms of comparing these benefits to the costs, "it is more than ten times likely that adequate savings exist to justify recovery of the costs to achieve the merger." (Rooney Surrebuttal, p. 4, ln. 3 – 5) In light of the

foregoing, the Commission should approve the Company's request for recovery of the jurisdictional amortization of costs to achieve the Company's merger with SJLP.

22. FAS 106 Funding: (Electric and Steam)

Issue Description: How should Aquila's FAS 106 funding deficiency, if any, be addressed in this case?
Alternative, how should Aquila's FAS 106 funding deficiency be addressed?

Aquila Position: There is no FAS 106 "funding deficiency."

The Company's position is that there is no FAS 106 "funding deficiency" and as such, there is nothing for the Commission to address with regard to this issue. The Company does however agree with Staff that an additional annual funding requirement of $1,447,631 will be required starting with the effective date of rates set in this case if the Staff's recommended recovery for the St. Joseph Light & Power merger transition costs is adopted by the Commission. The transition costs, recommended for recovery, include $1,477, 631, amortized over 10 years, related to a FAS 106 curtailment in 2001 for the L&P division.

The Commission has now pending before it a complaint in Case No. EC – 2006 – 0171[20], wherein the Office of the Public Counsel alleges that the Company, pursuant to Section 386.315 RSMo 2000, has failed to fund the Voluntary Employee Beneficiary Association ("VEBA") trust. The Company, in its Answer and Notice of Satisfaction, has

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[20] *See* Complaint, Case No. EC – 20061 – 71, October 14, 2005. See also, Public Counsel's Response to Staff's Initial Response to Complaint, October 20, 2005, wherein the Office of the Public Counsel acknowledged that the prayer for relief contained in Case No. EC – 2006 – 0171 requested that the Commission "direct its general counsel to seek criminal penalties pursuant to Section 286.580 [*sic*]", that the Staff pointed out in its Initial Response to Complaint that the Commission's General Counsel does not have authority to conduct criminal prosecution and seek criminal penalties pursuant to Section 286.580 [*sic*], to which the Office of the Public Counsel agreed with the Staff that the Commission's General Counsel does not have the authority to conduct criminal prosecutions.

stated that it has, at all times relevant to the complaint, utilized an independent external funding mechanism that restrict disbursements only for qualified retiree benefits as required by Section 386.315 RSMo 2000; Section 386.315 RSMo 2000, does not address the contribution of funds to an independent external funding mechanism, but rather addresses the disbursement of funds from the funding mechanism; and Aquila has established an independent funding mechanism, a VEBA trust. Aquila has also funded the same to the extent that contributions have been included in rates, has not made any unlawful disbursements from said trust and in all other respects has fully complied with Section 386.315 RSMo. In answering the Complaint in Case No. EC – 2006 – 0171, the Company denied that Aquila has a FAS 106 funding "deficiency",[21] is the same position the Company takes in this case. Consequently, the Commission should not in any way treat this issue as if a "deficiency" exists.

23. FAS 106 Funding: (Electric and Steam)

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

Alternatively,

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

Aquila Position: No. The expected earnings would have decreased any funding which would off-set the computations of the time value of money.

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[21] See Answer and Notice of Satisfaction, Aquila, November 15, 2005, paragraphs 2, and 6.

Any computation of a FAS 106 funding deficiency, if any, should not include the time value of delay in any contributions to the fund in that the expected earnings would have decreased any funding would off-set the computations of the time value of money.

OPEB expense adjustments discussed in the testimony in this case are not a corollary for "deficiency" and as such should not be confused on this issue. Staff and the Company have agreed that the pro forma reduction of $208,747 to the MPS test year OPEB expense and the pro forma reduction of $282,480 to the L&P test year OPEB expense originally proposed by Mr. Traxler should be lowered to $117,560 and $163,565 respectively. (Winterman Surrebuttal, p. 2, ln. 1 – 4) These expense figures are based on the understanding that, in actuarial practice, the determination of annual FAS 106 expense does not include an expected return on current year contributions in the current year's expense. (Winterman Surrebuttal, p. 2, ln. 6 – 8) (emphasis added) This agreement by the Company, does not admit the existence a "deficiency" but rather agrees with a proposed method of adjustment for this expense.

There is a question here as to whether the time value of money was considered by the Staff in reaching its conclusion. The Company's proffered testimony supports that any impact would be immaterial. (Winterman Surrebuttal, p. 2, ln. 12 – 14) Company witness Winterman's surrebuttal testimony is reflective of an analysis of expenses. The testimony provided by Company witness Winterman merely indicates that he believes that the Staff, in its analysis, did consider the time value of money, and that the Staff in discussions with Aquila on this matter determined that the impact, if any, would be immaterial. (Winterman Surrebuttal, p. 2, ln. 13 – 14)

A simple example would begin with an assumption that Aquila had a $100 funding deficiency in 2003, while using a 7% expected return on assets. During 2004, this $100 would be expected to return or earn $7. From a funding perspective, one would assume that Aquila would need to contribute $107, if this deficiency would be made up in the following year. However, the expected return would also reduce the 2004 FAS 106 expenses by this same $7, resulting in a lower contribution in 2004. (Winterman Surrebuttal, p. 3, ln. 4 - 9) Witness Winterman explained that the Company's actuary, Hewitt, calculated the impact of "not funding the direct MPS and L&P VEBAs for 2003 – 2005." (*Id.* p. 3, ln. 10 – 11.) (Winterman Surrebuttal, p. 3, ln. 10 – 15)

The Company maintains that it is not required to make contributions to the fund at any particular point in time, and consequently, no "funding deficiency" exists. However, Company Witness Winterman concludes that the data and analysis as to time value of any alleged delay demonstrate that a "deficiency" would have an immaterial impact.

24. South Harper Expenses (Electric)

Issue Description: What expenses related to the South Harper facility should Aquila recover from Aquila Networks-MPS's ratepayers?

Aquila Position: The expenses related to the South Harper facility should be included in rates.

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

Yes. Chapter 100 financing is the least cost option to the customers.

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

If PILOT payments are disallowed then the associated property taxes should be included in expense for this case.

c. Fees: Should the amortization of costs of fee and professional services payments Aquila made to or for the benefit of the City of Peculiar for Aquila to enter into a Chapter100 financing arrangement with the City of Peculiar in connection with the South Harper facility be included as an expense Aquila recovers from Aquila Networks-MPS's ratepayers?

Yes. The costs of fees and professional services payments made to the City of Peculiar regarding Chapter 100 financing should be included in rates.

Aquila proposes to recover all costs of making payments for the South Harper Facility in a Chapter 100 financing arrangement with the City of Peculiar. Aquila's participation in this Chapter 100 program benefits both the city and Aquila rate payers.

Aquila incurred the Chapter 100 costs as a cost of service in order to achieve savings for the rate payer. (Rooney Rebuttal, p. 3) Aquila participates in a Chapter 100 financing arrangement with the City of Peculiar that results in significant savings for Aquila rate payers. The Chapter 100 arrangement operates to abate property taxes. (*Id.)* The benefits of the arrangement will be enjoyed by Aquila's rate payers for the next 30 years. (*Id.* at 2) The expected tax abatement is $25 million over 30 years in return for cost of less than $1 million up front and additional costs of $7.3 million over 30 years. (*Id.* at 3)

Chapter 100 provides benefits to customers. If Aquila had not incurred the costs of issue, the customer benefits could not have been achieved.

Aquila' proposal includes the costs as well as the benefits of the Chapter 100 program. The benefits include a reduction in property taxes Aquila receives. The costs include ongoing payments in lieu of taxes ("PILOT") to be made by Aquila in the financing arrangement with the City of Peculiar. (*Id.* at 5) Because the rate proposal includes both the financial outlay and the corresponding savings for Aquila's rate payers, the Commission should authorize Aquila to include this obligation in Aquila's ratemaking process.

Each cost of the Chapter 100 financing arrangement is incurred to achieve savings for the ratepayer. Denial of recovery would result in a dampening of any future use of Chapter 100 bonds if utilities are penalized through nonrecovery of the costs necessary to achieve the significant benefits. Aquila should be authorized to recover all costs of making payments to the City of Peculiar for the significant savings the Chapter 100 financing arrangement generates.

25. Corporate Restructuring: (Electric and Steam)

Issue Description: Should there be a disallowance of corporate restructuring expenses for Aquila Networks-MPS and Aquila Networks-L&P and, if so, in what amount?

Aquila Position: No. Corporate restructuring expenses are no longer an issue between Staff and Aquila.

Corporate restructuring expenses need not be addressed in this rate case. Aquila excluded costs associated with restructuring from its request prior to filing its case. (Williams Surrebuttal, p.10 – 11) The Staff proposed an adjustment duplicative of the Aquila position which reclassified 50% of costs associated with nine selected corporate departments to Aquila's restructuring activities. (*Id.)* Aquila and Staff agree

that the corporate restructuring costs are no longer an issue. (Williams Surrebuttal, p. 10)

In opposition to the position of Aquila and the Staff, AARP takes a unique position requesting further reductions of corporate costs. (*Id.*) AARP does concede that the elimination of 50% of expenses by specific corporate departments is reasonable. AARP provides no substantiated starting point for further reductions. (*Id.*) The position of AARP to make broad reductions across the board to Aquila's corporate organization without further examination is not supported by the role of many corporate departments, some of which were involved in the restructuring effort and some which were not. (*Id.*) at 11-12. In addition, Aquila has very few restructuring activities to complete. (*Id.* at 12.)

Aquila is committed to the responsibility of restoring financial stability without adversely impacting its customers. (Williams Surrebuttal, p. 10) It is Aquila's position that the costs of restructuring activities should not be borne by its utility customers. (*Id.*) To fulfill this commitment, Aquila's corporate accounting personnel carefully reviewed invoices and costs allocated to the utility operations to ensure that restructuring costs would be retained at the corporate level. (*Id.* at 11) During the test year, Aquila made the determination to retain the amount of payroll and nonpayroll costs associated with restructuring activities. The amount Aquila retained equaled $23.9 million. Aquila accepted the responsibility to track and remove the cost of restructuring activities. No further adjustments proposed solely by AARP are supported.

26. Low Income Weatherization Assistance: (Electric)

Issue Description: Should an amount for low-income customer weatherization and assistance programs be included in Aquila Networks-MPS's and Aquila Networks-L&P's cost of service? If so, what amount should be

included, how should it be funded, which programs should be included, and what kind of review should be ordered by the Commission?

Aquila Position: As long as the costs for the involved programs are added to the current cost of service then Aquila is not opposed to the programs.

In her direct testimony, witness Anita Randolph of the Missouri Department of Natural Resources ("MDNR") recommends instituting a number of programs and/or expenditures that she believes will benefit low-income, residential and commercial customers. (Daunis Rebuttal, p. 2, ln. 6 – 7) While the Company is willing to discuss each recommendation with MDNR and any other interested party, because there are costs associated with each recommended program, a clear determination of cost recovery and cost assignment should be made. (Daunis Rebuttal, p. 3, ln. 7 – 10)

Further, in response to Staff witness Lena Mantle's testimony regarding Staff's position on MDNR's proposals, Company witness Matthew Daunis testified that demand side resources must be considered on an equivalent basis with supply side resources. (Daunis Surrebuttal, p. 2, ln. 21 – 22; p. 3, ln. 1 – 4) Staff and MDNR's proposal that the costs of certain programs be split 50/50 between ratepayers and shareholders "is inconsistent with the directive to consider demand side resources on an equivalent basis with supply side resources, and fails to allow the Company an opportunity to recover its costs and earn a return on its investment that is comparable to that which it would earn on a supply side resource." (Daunis Surrebuttal, p. 10, ln. 9 – 12) Demand side programs must be funded by a mechanism meeting these criteria. (Daunis Surrebuttal, p. 10, ln. 13) A Commission order that program be implemented and funded with "shareholder" dollars would be confiscatory and a taking in violation of the U.S. and Missouri Constitutions.

27. DSM: Demand Side Management (Electric)

Issue Description: Should an amount for energy efficiency services to residential and commercial customers be included in Aquila Networks-MPS's and Aquila Networks-L&P's cost of service? If so, what amount should be included, how should it be funded, which programs should be included, and what kind of review should be ordered by the Commission?

Aquila Position: As long as the costs for the involved programs are added to the current cost of service then Aquila is not opposed to the programs.

See discussion set out at section 26.

IV. Class Cost of Service/Rate Design

28. Rate Design/Cost of Service (Electric):

Issue Description: How should the Commission determine what, if any, shifts in class revenues for Aquila Networks-MPS and Aquila Networks-L&P should be made in this case?

Aquila Position: Aquila proposes an across the board increase in rates, with exceptions for lighting mounting option and the Cogeneration Purchase Schedule, and consolidation of the Economic Development Rider.

In Case No. EO – 2002 – 384, now pending before the Commission, the question of class cost of service has been litigated and submitted for decision. Aquila firmly stands behind the recommendations and positions it set out in that case, and specifically in the Direct, Rebuttal and Surrebutal testimony of J. Matt Tracy (ER – 2005 – 0436, J. Matt Tracy Rebuttal p. 3, ln. 13 – 15) It should be noted that the Company filed no Direct Testimony in cases ER – 2005 – 0436 or HR – 2005 – 0450 in that the issue of class cost of service had specifically been set out in a separate docket, with the purpose of solely considering class cost of service in **that docket.**[22]

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[22] *See* Commission Case No. ER – 2001 – 672, wherein Case No. 2002 – 0384 was specifically **established to study, on a revenue neutral basis, Aquila's class cost-of service, to identify load characteristics and to develop revenue neutral shifts to properly balance class rates.** (Unanimous

The Company considers that the appropriate way to adjust class revenues for any revenue increase should be that which includes in its considerations the impact on all stakeholders of "**not** moving to the results of Aquila's COS ..." as litigated in Case No. EO – 2002 – 384. (*Id.* p. 4, ln. 19 – 21) The Company believes that the Commission should resolve the COS and rate design issues in the still open Case No. EO – 2002 – 384, and adopt all of the recommendations from Case No. EO-2002-384 of Aquila witnesses David L. Stowe in his direct, rebuttal and surrebutal testimony, and Charles R. Gray in his direct and surrebutal testimony. (*Id.* p. 5. ln. 14 – 19)

In this case, the Staff has made clear with its direct testimony that the results of the COS it filed in Case No. EO-2002-384 and this case "are quite different" (Watkins Direct, p. 3. ln. 8 – 10) and are incomplete. Staff witness Watkins concluded that the "Staff has not yet been able to determine the cause of these differences." (Watkins Direct, p. 3. ln. 10 – 11) The Staff's inability to explain the differences here should not prevent the Commission from issuing a decision in Case No. EO – 2002 – 384. The Staff, contrary to the August 23, 2005 Order of the Commission, is effectively asking the Commission to give it more time to study the differences, and in essence prolong even

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Stipulation and Agreement, Case No. ER – 2001 – 672, pgs. 5 – 6.) In Case No. ER – 2001 – 672, the Unanimous Stipulation and Agreement, included this spin-off docket for the purpose of review, on a "revenue-neutral basis" Aquila's class cost of service. Unanimous Stipulation and Agreement, Case No. ER – 2001 – 672. The purpose was to allow a more detailed analysis of *cost-causal* factors so that any imbalances could be identified and recommendations as to necessary changes advanced while allowing full consideration of the issues **without the overcast of contention present in the usual rate case as well as the usual time constraints**. Furthermore, the Commission reinforced this charge when it stated in the Order Regarding Consolidation and Procedural Schedule issued in this case on August 23, 2005, p. 7, that the underlying principle in cost of service is "matching costs to the customers who cause those costs." See also Order Approving Stipulation and Agreement, Case No. ER– 2001 – 672, February 28, 2002; Order Regarding Consolidation and Procedural Schedule, Case No. EO – 2002 – 384, August 23, 2005.

further, a decision concerning what has already been litigated in Case No. EO – 2002 – 384.

The Company continues to stand by its position in Case No. EO – 2002 – 0384, and suggests that the Commission adopt its COS study and implement the Company proposed rate design.

29. Rate Design/Cost-of-Service (Electric):

Issue Description: How should any revenue increase for Aquila Networks-MPS or Aquila Networks-L&P that results from this case be implemented in rates?

Aquila Position: Aquila proposes an across the board increase in rates, with exceptions for lighting mounting option and the Cogeneration Purchase Schedule, and consolidation of the Economic Development Rider.

Alternatively, to 28 and 29,

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

The Company has fully set out its position, and argument regarding section 29 in section 28.

V. Reliability Issues

30. Service Reliability (Steam):

Issue Description: Should Aquila be directed to study any alleged recent reliability problems on its steam system, identify solutions, and report its findings to the Commission and interested parties?

Aquila Position: No. Aquila's steam operations are reliable.

The Company has had no electric or steam service reliability issues. With regard to electric services, from January 2004 to June 2005, the Company reported to Staff the three most common reliability indices used by the electric industry. (Maloney Direct, p. 2, ln. 13-14; p. 3, ln. 10-11) These indices are SAIFI, which measures the number of

service interruptions per customer, SAIDI, which reflects the average interruption in minutes per total customers served for the period covered, and CAIDI, which also measures average interruption duration. (Maloney Direct, p. 2, ln. 18 – 23; p. 3, ln. 1 – 4)

Staff did not identify any long-term trends in the data reported by the Company for the above period that should be of concern to the Commission. (Maloney Direct, p. 3, ln. 12 – 14) Witness Erin L. Maloney for Staff did note that there were spikes in the Company's date for January 2005 due to an ice storm that caused numerous outages and for June and July 2004 due to thunderstorms that caused several outages, as well. (Maloney Direct, p. 3, ln. 18 – 19; p. 4, ln. 1 – 3) Witness Maloney indicated that the spikes are shown in the Company's indices because the Company chooses to not adjust its data for abnormal weather. (Maloney Direct, p. 4, ln. 3 – 4; p. 3, ln. 19 -21) Witness Maloney did not testify that the Company's reporting was inappropriate, but she did state that an adjustment to the data for abnormal weather provides a better reflection of the operation of the system under normal conditions. (Maloney Direct, p. 4, ln. 9 – 12)

Similarly, there are no concerns regarding the steam services provided by the Company. In response to prepared comments by Terry McClatchey of AG Processing, Witness Glenn P. Keefe testified that with regard to the three types of steam that the Company provides to AG Processing, year to date through September, out of 393,120 minutes possible, steam availability for the 850 pound service is 99.8%; steam availability for the AGP 1 service is 99.9%; and steam availability for the AGP 2 service is 99.9%. (Keefe Surrebuttal, p. 2, ln. 21, HR –2005 – 0450) Witness Keefe testified

that these are excellent steam reliability numbers. (Keefe Surrebuttal, p. 3, ln. 3 – 4, HR – 2005 – 0450) AG Processing senior vice president of corporate and member relations, Mike Maranell, expressed similar satisfaction with the Company's services. With regard to a $55 million expansion at their St. Joseph facility, Mr., Maranell was quoted by the press as follows: "One of the reasons AGP decided to build at the St. Joseph facility is the relationship with the local utility. We've had a long-term relationship that's been very good. One of the things our plant requires is a lot of energy." (Keefe Surrebuttal, p. 3, ln. 8 – 14, HR – 2005 – 0450)

In light of the above, there is no indication that there is any data which supports steam and electric service reliability and therefore the Commission should conclude that Aquila's steam operations are reliable.

31. System Resource Study and Plan (Steam)

Issue Description: Should Aquila be directed to perform a study of steam production resources to include the results of the reliability review and to identify economical alternatives for the provision of steam service, and report its findings to the Commission and interested parties?

Aquila Position: Aquila is currently studying alternatives for its steam production resources and will discuss the results with the Commission and interested parties upon its completion.

The Company has indicated that it is currently studying this particular issue and that it is willing to discuss the results with the Commission and interested parties, however, the Company does not believe that the Company should be directed to perform such a study which would thereby require it to incur additional cost and expense.

VI. Fuel Cost Recovery

32. IEC: (Electric and Steam)

Issue Description: If the Commission adopts an interim energy charge, how should it be structured?

- **a.** What natural gas costs/prices should be included in the charge? What coal costs/prices should be included in the charge
- **b.** What purchased power costs/prices should be included in the charge?
- **c.** What SO_2 emission credits should be included in the charge?
  - (i) Should Aquila be required to use pet coke as a fuel to reduce SO_2 emissions?
- **d.** Should the IEC be established and trued-up on a divisional basis (for MPS and for L&P separately) or on a unified basis (MPS and L&P combined?
- **e.** Additional items to consider include treatment of off-system sales and hedging program cost/benefits.

Aquila Position: Aquila is open to discussions to determine the appropriate structure of an IEC in the context of a settlement with all the parties in the case.

Aquila recommends that the Commission establish rates in this case utilizing fuel and purchased power costs that are reasonably expected to be in place at the time the rates established in this proceeding will be in effect. (Williams Surrebuttal, p. 24, ln. 12 – 14) In other words, the Commission should utilize the "traditional" ratemaking approach of including all fuel costs in "base" rates without utilizing an interim energy charge ("IEC") for any fuel adjustment charge ("FAC") The Company, however, is willing to continue discussions to determine the appropriate structure of an IEC in the context of a settlement on this issue with all the parties in the case. (*See*, Aquila's Statement of Position on Issues, items #31 and #32.)

As explained in the Rebuttal Testimony of Aquila witness Dennis Williams, the initial position of the Company was that if requested by the Company the Commission may authorize Aquila to implement a FAC or IEC in this case. (Williams Rebuttal, p. 9, ln. 4 – 6.) After the review of the rebuttal testimony of Staff witness Featherstone, however, the Company concluded that the different viewpoints concerning the lawfulness of any FAC that might be approved by the Commission in this case would create an unacceptable risk of litigation associated with the implementation of a FAC. Thus, Aquila has abandoned its request to use an FAC in this case. (Williams Surrebuttal, p. 22, ln. 4 – 5, 7, 9 – 23, p. 23, ln. 1 – 6) The Company also believes that the same litigation risk applies to an IEC. (*Id.* at ln. 9) Even though Aquila has in the past utilized an IEC (as a result of it being unopposed by any party in its last rate case), it has concluded, that, a unanimous agreement among all the parties in this case with respect to an IEC is unlikely. Therefore, any IEC that might be authorized by the Commission would be subject to challenge. (*Id.* at ln. 11 – 15.)

In light of the fact that the Commission is without the authority to impose a FAC or IEC on Aquila without the Company's consent, and because Aquila is not requesting an FAC, and will accept an IEC only if all parties consent, there is no need to further brief this issue except to note those points associated with litigation risk including the cost of litigation, potential constraints on cash flow, possible adverse views by ratings agencies, all of which would serve to offset the strides toward improved credit ratings that Aquila has made to date. (Williams Surrebuttal, p. 23, ln. 1 – 6)

33. IEC Rate Design: (Electric and Steam)

Issue Description: If the Commission adopts an interim energy charge, how should the cost of the charge be allocated to customer classes in setting rates?

a. How should natural gas costs be allocated to customer classes?
b. How should coal costs be allocated to customer classes?
c. How should purchased power costs be allocated to customer classes?
d. How should SO_2 emission credits be allocated to customer classes?
e. How should off-system sales and hedging program cost/benefits be allocated to customer classes?

Aquila Position: Aquila is open to discussions to determine the appropriate structure of an IEC in the context of a settlement with all the parties in the case.

See discussion at section 32.

VII. Analysis of Fuel Options

34. Fuel: (Electric and Steam)

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

Aquila Position: Aquila has considered different fuel alternatives for Sibley and Lake Road but pet coke would create additional costs because of its SO2 emissions and operating issues.

The Company should not be required to use or explore the use of petroleum coke in its operations because the Company has used it in the past and ceased use because of increased problems of handling the fuel, increased risk of forced outages and increased cost due to sulfur dioxide allowances. Witness Sharon Hennings for AG Processing, Inc. testified that the Company should explore the replacement of the coke it currently uses with petroleum coke. (Hennings Direct, p. 7, ln. 21 – 22) Witness Hennings' rationale for switching to petroleum coke primarily focuses on her assertion

that using a blend of petroleum coke is less costly, and is, therefore, a way to reduce fuel cost. (Hennings Surrebuttal, p. 1, ln. 9 – 12)

In response to Witness Hennings' direct testimony, Company witness, Glenn Keefe testified that, while the Company used petroleum coke in the past, it ceased using it for several reasons. (Keefe Rebuttal, p. 4, ln. 16 – 17, p. 4, ln. 16 – 17, HR – 2005 –0450) First, there were increased problems of handling the fuel, and there were increased risks of forced outages. (Keefe Rebuttal, p. 5, ln. 1; p. 5, ln 1, HR – 2005 – 0450) Witness Keefe stated the Company experienced difficulties in unloading and handling the fuel to the boiler, and that any errors in blending had the potential to cause overheating of tube metal in the cyclone burner. (Keefe Rebuttal, p. 4, ln. 20 – 21; p. 4, ln 20 – 21, HR – 2005 – 0450) These issues introduced the risk of forced outages. (Keefe Rebuttal, p. 4, ln. 21 – 22; p. 4, ln 21 – 22, HR – 2005 – 0450)

Second, the Company ceased using petroleum coke because of the increased cost due to the cost of sulfur dioxide allowances. (Keefe Rebuttal, p. 5, ln. 2; p. 5, ln 2, HR – 2005 – 0450) Contrary to the position of Witness Hennings, there is a direct correlation between the sulfur in the fuel and sulfur dioxide produced by the combustion process. (Keefe Rebuttal, p. 3, ln. 16; p. 3, ln 16, HR – 2005 – 0450) While the Company's coal fired units have electrostatic precipitators to control emissions, the precipitators do not remove the gaseous sulfur dioxide produced in the combustion process. (Keefe Rebuttal, p. 4, ln. 17 – 22; p. 3, ln 17 – 22, HR – 2005 – 0450) Because of these factors, a cost should be assigned based on the increased sulfur dioxide that is generated. (Keefe Rebuttal, p. 4, ln. 3 – 5; p. 4, ln. 3 – 5, HR – 2005 – 0450)

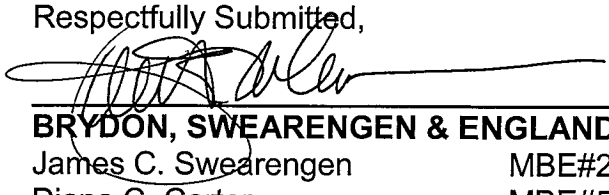
To elaborate, the sulfur content of petroleum coke is more than fifteen times higher than the Company's predominant fuel source. (Keefe Rebuttal, p. 4, ln. 5 – 6; p. 4, ln. 5 – 6, HR – 2005 – 0450) According to Witness Keefe's calculation factoring in the cost for sulfur dioxide allowances, the delivered price of petroleum coke is $6.02 per million Btu, as opposed to Witness Hennings' calculation of $0.88 per million Btu. (Keefe Rebuttal, p. 4, ln. 7 – 10; p. 4, ln. 7 - 10, HR – 2005 – 0450) This large variance is the result of the erroneous omission of additional costs in sulfur dioxide allowances for Witness Hennings' calculation. (Keefe Rebuttal, p. 4, ln. 10 – 11, p. 4, ln. 10 – 11, HR – 2005 – 0450) In light of the need to include sulfur dioxide allowance costs in determining the price of petroleum coke and as indicated in the above figures, it is not a low cost alternative fuel. (Keefe Rebuttal, p. 4, ln. 14 – 15; p. 4, ln. 14 – 15, HR – 2005 – 0450)

In summary, there are no benefits to be gained by the Company switching from its current fuel source to petroleum coke, as the use of petroleum coke results in increased problems in handling the fuel, increased risk of forced outages, and increased costs. (Keefe Rebuttal, p. 4, ln. 23; p. 5, ln. 1 – 2; p. 4, ln. 23; p. 5, ln. 1 – 2, HR – 2005 – 0450)

CONCLUSION

The Commission should find and rule in favor of Aquila on all contested issues.

Respectfully Submitted,



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