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Users' Association and
Ag Processing Inc a Cooperative
[with St. Joseph Industrial Group]
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Aquila Networks-MPS and Aquila Networks-L&P

Case No. ER-2007-0004

Prepared Surrebuttal Testimony of

Donald Johnstone



On behalf of

Sedalia Industrial Energy Users' Association
and
Ag Processing Inc a Cooperative
[with St. Joseph Industrial Group]

March 2007

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Before the
Missouri Public Service Commission

Aquila Networks-MPS and Aquila Networks-L&P

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Prepared Surrebuttal Testimony of Donald Johnstone

1 **Q PLEASE STATE YOUR NAME AND ADDRESS.**

2 A My name is Donald Johnstone, and I reside at 384 Black Hawk Drive, Lake
3 Ozark, Missouri, 65049. My qualifications and experience are set forth as
4 Attachment A to my direct testimony that was filed on January 18, 2007.

5 **Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

6 A My purpose is to respond to the Rebuttal testimonies of Mr. Williams of Aquila
7 and Mr. Featherstone of the Staff in regard to the matters of fuel recovery
8 under either an IEC or a FAC.

1 **SUMMARY**

2 **Q PLEASE SUMMARIZE YOUR TESTIMONY.**

3 **A** My testimony may be summarized as follows:

4 ➤ The FAC proposal of Aquila is an undesirable alternative to traditional rate
5 mechanisms.

6 ➤ The IEC proposal of Staff is an undesirable alternative to traditional rate
7 mechanisms.

8 ➤ If there is to be a rate adjustment mechanism, a collaborative approach has
9 the advantage of allowing the parties to develop a mechanism which would
10 be more likely to accommodate the competing interests of the parties.

11 ➤ If a mechanism is approved in spite of the opposition, I recommend the FAC
12 attached to my rebuttal testimony as superior to the FAC proposed by
13 Aquila or the IEC proposed by Staff.

14 ➤ Consumer protections must be a part of any rate adjustment mechanism.

15 **Q PLEASE PROVIDE A SHORT OVERVIEW OF THE STAFF IEC PROPOSAL.**

16 **A** Staff proposes an IEC that would raise rates to a level higher than the test year
17 costs as adjusted in this case. There would be an as yet undefined floor and
18 ceiling for the recovery of fuel costs. (Note: Staff provides some indication of
19 the floor (\$6 / MMBtu for gas and \$55 per MWh for purchased power) and the
20 ceiling (\$9 / MMBtu for gas and \$90 / MWh for purchased power). Staff doesn't
21 translate this into overall rate levels. The ceiling accommodates gas prices 50%
22 above the floor and purchased power prices 64% above the floor. In this Case,
23 rates would be implemented at the ceiling price level.

1 **Q DO YOU HAVE ANY COMMENT ON THE STAFF IEC PROPOSAL?**

2 The effect is for customers to pay high costs (the ceiling) up front, based
3 on a forecast that exceeds the most likely estimate of future fuel costs.
4 Indeed the costs in rates charged will not even reach the prudence review if
5 the actual costs are less than the ceiling. The costs simply may not be incurred
6 at all. This stands in contrast to base rates that reflect test year conditions
7 with adjustments to normalize and to reflect known and measurable changes.
8 It also stands in contrast to a fuel adjustment that under Missouri rules will
9 operate on historical costs. While the IEC proposal in this case was developed
10 by Staff, Mr. Featherstone states that IECs have been developed in the past
11 pursuant to collaborative processes.

12 **Q HAS THERE BEEN A COLLABORATIVE PROCESS IN THIS PROCEEDING?**

13 A The nonutility parties have all contributed to the alternative FAC introduced as
14 a part of my rebuttal testimony. Once that was accomplished Aquila was
15 given the document, but has declined to participate in any substantive
16 collaborative discussions, either before the alternative FAC was submitted in
17 my rebuttal testimony or at any time since. Nor have there been any
18 collaborative discussions among all the parties in the matter of the IEC.

19 **Q IS A COLLABORATIVE PROCESS A POSSIBILITY IN THIS PROCEEDING?**

20 A Yes. Given the many difficult and complex issues and diversity of interests
21 surrounding the fuel cost recovery issues, a collaborative approach certainly

1 has merit - if parties are willing. The nonutility parties have taken a major
2 step in contributing to the FAC attached to my rebuttal. A collaborative
3 approach is not a possibility, however, if Aquila declines to come to the table
4 or if the parties simply cannot agree. Hence a Commission decision may be
5 necessary.

6 **Q WHAT IS YOUR POSITION WITH REGARD TO AN IEC FOR THE RECOVERY OF**
7 **FUEL AND PURCHASED POWER COSTS?**

8 **A** As reflected in my direct testimony, I do not believe Aquila has shown
9 sufficient basis to change from traditional rate regulation. Similarly, I find no
10 proof of need for an IEC from Staff. In addition, the specific IEC proposal of
11 Staff suffers from a number of defects.

12 First, cost recovery for fuel and purchased power does not require
13 inflated rates based on high side forecasts (a ceiling). Another concern is the
14 reduced incentive to low cost efficient operation due to the provision of 100%
15 recovery between the floor and ceiling (subject to the prudence review). For
16 these and other reasons that will be developed more fully below, I oppose the
17 Staff IEC proposal.

18 **NEED FOR A IEC**

19 **Q HOW DOES AQUILA DESCRIBE ITS DESIRE FOR AN IEC?**

20 **A** While Aquila cites its recent history of fuel and purchased power costs and its
21 several rate cases, it offers no support for an IEC. Instead, it has opposed an

1 IEC as not responsive to its perceived problem because it fails to guarantee
2 100% recovery of all its fuel and purchased power costs.

3 **Q HAS STAFF OFFERED PROOF OF NEED FOR AN IEC?**

4 **A** No. By my understanding of the testimony Staff has described the operation of
5 an IEC and explained its preference for that approach.

6 **APPROVAL STANDARD**

7 **Q WHAT STANDARD DID YOU RECOMMEND FOR THE COMMISSION IN**
8 **DETERMINING WHETHER OR NOT TO APPROVE A PROPOSAL FOR AN FAC?**

9 **A** As stated in my earlier testimony, I recommend a standard of “acute need” for
10 a FAC.

11 **Q SHOULD A DIFFERENT STANDARD APPLY FOR AN IEC?**

12 **A** No. I recommend the same standard for an IEC. The departure from base rates
13 addresses the same costs and depending on the structure of any IEC or any FAC,
14 can create similar deficiencies as a rate mechanism. Also, while not an
15 attorney, I see no substantive distinction between a FAC and an IEC pursuant to
16 Senate Bill 179. I recommend application of the same standard to either
17 adjustment mechanism.

INCENTIVE TO OPERATE EFFICIENTLY

Q SHOULD AN IEC UNDER ANY CIRCUMSTANCES PASS THROUGH 100 PERCENT OF THE VARIATIONS IN FUEL AND PURCHASED POWER COSTS TO CUSTOMERS?

A First, I should note that the IEC at least limits the 100% pass through to a cost range. However, within the range the 100% pass through will eliminate the incentive to Aquila - whether costs are above or below the rate case level. An alternative approach that constitutes better regulatory policy would maintain a substantial measure of the traditional incentive. A simple solution for this issue is to implement a sharing mechanism for the variations in costs that will occur under any IEC.

Q DID STAFF PROPOSE A SHARING MECHANISM AS A PART OF ITS IEC?

A Yes and no. Staff proposes all or nothing sharing. Within the forecast range Staff proposes 100% pass through to consumers (subject to a prudence review) and outside of the range the effect is base rate treatment - no sharing.

PRUDENCE REVIEWS DO NOT INCENT LOW COST

Q DOES THE AFTER-THE-FACT PRUDENCE REVIEW THAT IS A PART OF THE STAFF IEC ELIMINATE THE NEED FOR A MORE DIRECT FINANCIAL INCENTIVE?

A No, it does not. The prudence review adds nothing that does not already exist. It has always been a responsibility of Aquila to prove prudence before being allowed to pass along any changes in cost through higher rates. Since the rates

1 would be set at a higher interim level under the IEC, it follows that the
2 responsibility for a prudence review must follow along with the IEC rate.
3 However, the benefits of the prudence review are diminished as compared to
4 traditional regulation because the higher rates would already be in effect and
5 the prudence review in the context of the IEC would be after the fact. Under
6 the Staff IEC, the customers will provide revenues to cover the possibility of
7 higher costs long before any costs are incurred and the long before the
8 prudence review.

9 **Q UNDER THE TRADITIONAL APPROACH TO REGULATION IN MISSOURI, IS THERE**
10 **AN IMPORTANT INCENTIVE TO HOLD COST TO A MINIMUM AND TO OPERATE**
11 **THE UTILITY IN AN EFFICIENT MANNER?**

12 **A** Yes, there is. Under traditional regulation, once the rates are set, Aquila's
13 financial returns will always be better if it operates efficiently and in a least-
14 cost manner. That is not the result under the Staff IEC proposal. The only
15 requirement for the utility to recover the subject costs within the range is to
16 pass the prudence review, which has moved from before the fact to after the
17 fact.

18 In a rate case, Aquila would have to prepare and defend its filing.
19 However, under the Staff IEC, rather than approaching the Commission with a
20 case in which it is expected to prove its costs in consideration of all relevant
21 factors, there is a subtle shift to reliance on the Staff of the Commission to

1 routinely ferret out any imprudence. One could only hope that State resources
2 would be available and adequate to the task at hand.

3 **Q IS IT POSSIBLE TO INTRODUCE A SUBSTANTIAL MEASURE OF THE**
4 **TRADITIONAL INCENTIVES INTO THE STAFF IEC?**

5 **A** Yes. The simple solution is to share the impact of variations in costs. While I
6 do not support the IEC approach, a financial incentive could be maintained by
7 allowing only 50 percent of the variations in fuel and purchased power to be
8 considered for pass-through under the IEC. The other 50 percent would
9 continue to be recovered pursuant to traditional regulation.

10 **Q IS AQUILA DENIED AN OPPORTUNITY TO RECOVER ALL OF ITS COST AND TO**
11 **EARN A FAIR RETURN IN CONJUNCTION WITH A SHARING MECHANISM?**

12 **A** No. The most obvious evidence of this is the 50/50 sharing that is proposed by
13 Aquila in conjunction with its off-system sales margins.

14 **Q ARE UTILITIES IN GENERAL AND AQUILA IN PARTICULAR PROVIDED AN**
15 **OPPORTUNITY TO RECOVERY ALL OF THEIR COSTS IN THE CONTEXT OF BASE**
16 **RATE REGULATION -- IN THE ABSENCE OF AN IEC OR A FAC?**

17 **A** Yes, and that would continue under any FAC in which some of the cost
18 variation are tracked while some would continue to receive base rate
19 treatment.

20 Just as always has been the case, once base rates are set, revenues will
21 be collected pursuant to the sale of electricity, and the utility's financial

1 returns will depend upon its ability to operate efficiently and in a low-cost
2 fashion. That is exactly the situation that will continue with respect to the
3 50 percent of the cost variations that will not pass through to consumers under
4 a sharing mechanism.

5 **CONSUMER PROTECTIONS**

6 **Q IS IT POSSIBLE TO ADD CONSUMER PROTECTIONS TO AN IEC?**

7 **A** Yes, in theory it is possible. Staff proposes an upper limit on cost recovery and
8 the after the fact prudence review. Others are possible.

9 **Q CAN A 50/50 SHARING MECHANISM BE ADDED TO AN IEC AS A CONSUMER**
10 **PROTECTION?**

11 **A** Yes. It would provide a continuing incentive for Aquila to operate in an
12 efficient manner that will minimize cost when it is within the range of
13 recovery. Therefore, in this important respect, it is reasonable to characterize
14 a 50/50 sharing as a consumer protection.

15 **Q PLEASE EXPLAIN WHY PERFORMANCE STANDARDS ARE A CONSUMER**
16 **PROTECTION.**

17 **A** Under traditional base rate regulation, Aquila bears the brunt of the additional
18 costs when there is an outage in one of its lower cost base load generating
19 units. The additional costs that I am referring to in particular are the fuel and
20 purchased power costs that are incurred when any low-cost generation is
21 replaced with higher cost generation during the period of an outage. It is a

1 consumer protection to continue to address such replacement power costs in
2 the context of traditional regulation instead of in any IEC. Indeed, the primary
3 motivations for Aquila's proposed FAC and Staff's proposed IEC are the changes
4 in the prices of fuel and purchased power. Accepting that as the goal, it is
5 simply an unnecessary side effect that Aquila could coincidentally be provided
6 with 100% replacement power cost recovery in the IEC - at least up to the
7 ceiling built into rates.

8 In effect, IEC recovery of the cost of replacement power can amount to
9 outage insurance for Aquila. There is no reason for consumers to provide such
10 insurance. If such insurance is a good idea, it should be purchased by Aquila
11 and addressed in the context of base rate proceedings.

12 **Q DOES THE IEC OTHERWISE OPERATE IN A WAY TO LIMIT THE COST OF ANY**
13 **REPLACEMENT POWER?**

14 **A** Yes. The ceiling on cost recovery limits the exposure. Thus the necessity for
15 performance standards will depend to some extent on the range of fuel and
16 purchased power costs eligible for recovery under an IEC. If the range is
17 significant the need for performance standards would continue. If the range is
18 narrow, the need is reduced.

1 Q DO YOU HAVE A SPECIFIC RECOMMENDATION FOR A PERFORMANCE
2 STANDARD FOR THE COAL-FIRED GENERATION OF AQUILA?

3 A Yes. In my rebuttal, I offered a performance standard in the context of a FAC.
4 Such a standard should also be considered in the context of any IEC. Of course,
5 a normal level of outages (both forced and scheduled) would be built into any
6 performance standards, so the effect on cost recovery for Aquila would be to
7 provide incentives for performance while providing for a normal level of cost
8 recovery. At the same time the standard would limit the automatic pass
9 through of all replacement power costs. Mitigation of Rate Volatility

10 Q DOES THE IEC PROPOSAL OF STAFF MITIGATE THE VOLATILITY OF RETAIL
11 RATES?

12 A Yes. The number of rate changes will be limited and in that sense volatility is
13 mitigated. However it does so by imposing an extra increase up front based on
14 the possibility of higher costs during the IEC term. Higher rates for a period of
15 years, based on the possibility of higher costs occurring at some time during
16 the period, is a dubious approach to volatility mitigation.

17 Q IS IT POSSIBLE TO CHANGE THE DESIGN TO INCORPORATE FEATURES THAT
18 WILL REDUCE THE NEGATIVE AFFECTS OF AN IEC ON RETAIL CUSTOMERS?

19 A It is possible to reduce some negative effects, but it is impossible to change the
20 effect of higher rates that are based on only the possibility of higher costs. For
21 that is the essence of the IEC concept.

1 **DEMONSTRATION OF NEED**

2 Q HAVE STAFF OR AQUILA MADE ANY SHOWING OF ACUTE NEED?

3 A Neither have demonstrated the effect of variations in fuel and purchased
4 power costs on the financial results of Aquila.

5 Q IS THERE ANY DOUBT THAT HIGHER FUEL AND PURCHASED POWER COSTS
6 WILL TEND TO REDUCE EARNINGS?

7 A No.

8 Q IS THERE ANY DOUBT THAT LOWER FUEL AND PURCHASED POWER COSTS
9 WILL TEND TO INCREASE EARNINGS?

10 A No.

11 Q DOESN'T THAT DEMONSTRATE NEED?

12 A No. That merely demonstrates the reality faced by any business. The real
13 questions are: how large is the problem?, is a solution needed?, and if so, what
14 is the best solution? Neither Aquila nor Staff has provided any quantification of
15 the financial impact of variations in fuel costs on Aquila. Nor is the impact on
16 ratepayers illustrated or demonstrated.

17 Q DO YOU THINK IT APPROPRIATE FOR THE COMMISSION TO APPROVE A
18 CHANGE SO IMPORTANT AS AN IEC OR A FAC IN THE ABSENCE OF ANY
19 FINANCIAL DATA THAT QUANTITATIVELY DEMONSTRATES THE NEED?

20 A No.

1 Q HAVE STAFF OR AQUILA DEMONSTRATED OR QUANTIFIED THE FINANCIAL
2 CONSEQUENCE OF NOT IMPLEMENTING AN IEC OR A FAC?

3 A No.

4 Q CAN YOU RECOMMEND THAT THE COMMISSION APPROVE A CHANGE SO
5 IMPORTANT AS AN IEC OR A FAC IN THE ABSENCE OF ANY IMPACT DATA?

6 A No. Instead, any party seeking to implement an IEC or a FAC should 1) back up
7 the claim of need with financial statistics and 2) an illustration of the potential
8 impact on retail rates.

9 Q I UNDERSTAND THAT YOU ARE NOT ADVOCATING AN IEC OR A FAC, BUT CAN
10 YOU PROVIDE ANY ILLUSTRATION?

11 A I asked for rate impact data from Aquila and Aquila did not provide it. I intend
12 to request information from the Staff in regard to the IEC possibility discussed
13 by Mr. Featherstone.

14 Q DOES THIS CONCLUDE YOUR TESTIMONY?

15 A Yes.