

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

In the Matter of a Management Audit of	)	
Aquila, Inc. d/b/a Aquila Networks-MPS	)	Case No. EO-2006-0356
and Aquila Networks-L&P	)	

**PUBLIC COUNSEL’S RESPONSE TO MANAGEMENT AUDIT**

COMES NOW the Office of the Public Counsel and for its Response to Management Audit states as follows:

1. The Staff of the Commission has completed a thorough and exhaustive review of the issues it set out to cover. The review undertaken by Staff was, by design and by agreement, a limited one. On the ten issues identified, Staff investigated whether the actions of Aquila, Inc.<sup>1</sup> with respect to these issues had caused “quantifiable detriment to Aquila’s Missouri customers.” With this limited goal, and with respect to these limited issues, Staff concludes no such detriment occurred. But equally important is Staff’s conclusion that “without question, the attention of Aquila’s management has been diverted to problematic concerns....”

2. Staff did an admirable job of investigating and reporting on the issues, and Public Counsel will not argue with its methods or specific conclusions. But Public Counsel believes that Staff’s recommendations are too limited. There are six specific recommendations, found in the report at the end of several of the chapters:

- Review present incentive compensation programs to determine that they are serving as a cost effective motivation to employees.
- Review and utilize methodologies to fully determine, define and document the total amount of executive compensation.

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<sup>1</sup> Within the time covered by the report, Aquila, Inc. has had other names and other corporate structures. This response will use the name “Aquila” to refer to all of them.

- Re-examine the Company's staffing levels, staff responsibilities and attendant executive compensation levels to ensure such compensation is commensurate with executive responsibilities.
- Adjust executive compensation levels based upon the results of the examination.
- Give adequate consideration to all available options when planning for future capacity requirements that will ensure the development of cost-effective decisions.
- Provide advance notice to the Commission prior to investing in future unregulated activities along with documentation of all known and potential impacts those activities may have on Aquila's Missouri utility customers. Include in the Company's notice to the Commission all plans the Company has to ensure that Aquila's Missouri customers will not be negatively impacted by investing in future unregulated activities.

Every one of these recommendations is directed to Aquila; none are directed at the Commission. In other words, Staff concludes that the Commission does not need to take any action based on the results of Staff's management audit.

3. Public Counsel does not agree with this conclusion. There are several actions the Commission should take, some concrete and immediate, and some more general and long-term.

4. With respect to executive compensation (Chapter 4), Staff notes that it was not able to find an Aquila case in the last fifteen years in which executive compensation was addressed in testimony. Public Counsel is investigating executive compensation in the currently pending Aquila rate case (ER-2007-0004), and intends to file testimony on the issue. As an immediate and concrete action, the Commission should carefully consider the evidence in that rate case on the issue of executive compensation, keeping in mind that Aquila bears the burden of proof to show that the level of compensation is just and reasonable.

5. With respect to Aquila's decisions concerning the Aries and the South Harper facilities (Chapters 7 and 8), Public Counsel suggests that the Commission should take actions both concrete and immediate as well as general and long-term. The specific costs associated with the South Harper facility may very well be at issue in Case No. ER-2007-0004; Public Counsel is investigating South Harper costs in the context of that case, and expects to file testimony. The specific costs associated with Aries may be at issue in future rate cases.

In general, Staff expresses concern that “[d]excisions to rely heavily on purchase [*sic*] power contracts and natural gas-fired generation have some of the greatest potential for negative effects.” Many of those decisions have taken place over the last ten years while the Commission's Integrated Resource Planning rules have been held in abeyance. In the long-term, the Commission should carefully scrutinize Aquila's resource planning, particularly in light of its heavy reliance on natural gas-fired generation. The Commission should continue to require compliance with its IRP rules, should not allow decade-long lapses in IRP filings, and should not (if it proceeds with a re-write of those rules) weaken the Commission's oversight of utilities' planning processes.

More immediately, Aquila has an IRP filing due in February 2007 – its first in many years. Given the concerns raised by Staff in its management audit, the Commission should pay particular attention to whether Aquila's planning decisions have been made, and are now being made, with the long-term interests of Aquila's Missouri ratepayers in mind, or whether the focus is on maximizing shareholder wealth.

6. In general terms, while Staff does not recommend that the Commission take specific actions, Staff does not give Aquila a glowing report card – far from it. Staff's summary is that:

The Staff has reached the general conclusion that while, without question, the attention of Aquila's management has been diverted to problematic concerns created by its pursuit of unregulated business activities, the Staff has not documented quantifiable detriment to Aquila's Missouri customers. The Staff concludes that Aquila has provided little if any service quality or rate making protections to its Missouri customers, but instead is of the opinion that the efforts of multiple state and federal regulatory bodies with various authorities have provided appropriate protections to date.

Until such time as Aquila provides evidence to the contrary, in setting rates for Aquila's Missouri customers, the Commission should keep in mind Aquila's lack of attention to those customers and its failure to provide protections for those customers. This is particularly important when the Commission is deliberating on the appropriate return on equity for Aquila. Whether or not specific adjustments to return on equity are offered in Aquila rate cases, the Commission is always faced with a range of proposed returns. If the Commission considers factors beyond the mathematical calculations provided by analyses such as Discounted Cash Flow or Risk Premium, then Aquila's lack of attention to its Missouri customers and failure to protect those customers are factors that the Commission should definitely consider.

7. Insofar as this particular case goes, Public Counsel does not propose that the Commission take any action against Aquila to account for Aquila's management failures. Public Counsel does request that the Commission order Aquila to comply with

the six specific Staff recommendations in the report, and for the first four<sup>2</sup> to file a report in this case within six months on the results. For the last two,<sup>3</sup> Public Counsel requests that the Commission order Aquila to comply with them on an ongoing basis.

**WHEREFORE,** Public Counsel respectfully submits this response to the Management Audit filed by the Staff of the Commission on October 31, 2006.

Respectfully submitted,

OFFICE OF THE Public Counsel

**/s/ Lewis R. Mills, Jr.**

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<sup>2</sup> (1) Review present incentive compensation programs to determine that they are serving as a cost effective motivation to employees; (2) Review and utilize methodologies to fully determine, define and document the total amount of executive compensation; (3) Re-examine the Company's staffing levels, staff responsibilities and attendant executive compensation levels to ensure such compensation is commensurate with executive responsibilities; and (4) Adjust executive compensation levels based upon the results of the examination.

<sup>3</sup> (5) Give adequate consideration to all available options when planning for future capacity requirements that will ensure the development of cost-effective decisions; and (6) Provide advance notice to the Commission prior to investing in future unregulated activities along with documentation of all known and potential impacts those activities may have on Aquila's Missouri utility customers. Include in the Company's notice to the Commission all plans the Company has to ensure that Aquila's Missouri customers will not be negatively impacted by investing in future unregulated activities.

**CERTIFICATE OF SERVICE**

I hereby certify that copies of the foregoing have been mailed, emailed or hand-delivered to the following this 30<sup>th</sup> day of November 2006:

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