

Exhibit No.:

Issues: Fuel Adjustment Clause

Witness: Steve Fetter

Sponsoring Party: Aquila Networks-MPS
& L&P

Case No.: ER-2007-0004

Before the Public Service Commission
of the State of Missouri

Rebuttal Testimony

of

Steve Fetter

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ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
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**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
REBUTTAL TESTIMONY OF STEVEN M. FETTER
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
CASE NO. ER-2007-0004**

1 **I. INTRODUCTION AND BACKGROUND**

2 Q. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.

3 A. My name is Steven M. Fetter. I am President of Regulation UnFettered. My
4 business address is 1489 W. Warm Springs Rd., Suite 110, Henderson, NV
5 89014.

6 Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

7 A. I am testifying on behalf of Aquila, Inc., which I shall refer to as “Aquila” or the
8 “Company”.

9 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

10 A. I am President of Regulation UnFettered, a utility advisory firm I started in April
11 2002. Prior to that, I was employed by Fitch, Inc. (“Fitch”), a credit rating agency
12 based in New York and London. Prior to that, I served as Chairman of the
13 Michigan Public Service Commission (“Michigan PSC”).

14 Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

15 A. I graduated with high honors from the University of Michigan with an A.B. in
16 Communications in 1974. I graduated from the University of Michigan Law
17 School with a J.D. in 1979.

18 Q. PLEASE BRIEFLY DESCRIBE YOUR ROLE AS PRESIDENT OF
19 REGULATION UNFETTERED.

1 A. I formed a utility advisory firm to use my financial, regulatory, legislative, and
2 legal expertise to aid the deliberations of regulators, legislative bodies, and the
3 courts, and to assist them in evaluating regulatory issues. My clients include
4 investor-owned and municipal electric, natural gas and water utilities, state public
5 utility commissions and consumer advocates, non-utility energy suppliers,
6 international financial services and consulting firms, and investors.

7 Q. WHAT WAS YOUR ROLE DURING YOUR EMPLOYMENT WITH FITCH?

8 A. I was Group Head and Managing Director of the Global Power Group within
9 Fitch. In that role, I served as group manager of the combined 18-person New
10 York and Chicago utility team and was also responsible for interpreting the
11 impact of regulatory and legislative developments on utility credit ratings. In
12 April 2002, I left Fitch to start Regulation UnFettered, a utility advisory firm.

13 Q. HOW LONG WERE YOU EMPLOYED BY FITCH?

14 A. I was employed by Fitch from October 1993 until April 2002. In addition, Fitch
15 retained me as a consultant for a period of approximately six months shortly after
16 I resigned.

17 Q. HOW DOES YOUR EXPERIENCE RELATE TO YOUR TESTIMONY IN
18 THIS PROCEEDING?

19 A. My experience as a Commissioner on the Michigan PSC and my subsequent
20 professional experience analyzing the U.S. electric and natural gas sectors – in
21 jurisdictions involved in restructuring activity as well as those still following a
22 traditional regulated path – have given me solid insight into the importance of a
23 regulator's role in both setting rates and also determining appropriate terms and

1 conditions of service for all regulated utilities. These are the factors that enter
2 into the process of utility credit analysis and formulation of individual company
3 credit ratings. It is a well-established fact that a utility's credit ratings have a
4 significant impact as to whether that utility will be able to raise capital on a timely
5 basis and upon favorable terms.

6 Q. HAVE YOU PREVIOUSLY SPONSORED TESTIMONY BEFORE
7 REGULATORY AND LEGISLATIVE BODIES?

8 A. Since 1990, I have on numerous occasions testified before the U.S. Senate, the
9 U.S. House of Representatives, the Federal Energy Regulatory Commission, and
10 various state legislative and regulatory bodies on the subjects of credit risk within
11 the utility sector, electric and natural gas utility restructuring, fuel and other
12 energy adjustment mechanisms, utility securitization bonds, and nuclear energy.
13 On the topic involved in this case, I have previously testified on the issue of fuel
14 and purchased power cost recovery mechanisms ("FACs") in several proceedings,
15 most notably when the Missouri Legislature was considering Senate Bill 179.
16 That bill was ultimately enacted into law authorizing the use of such mechanisms
17 upon request of a Missouri electric utility within the context of a rate proceeding,
18 if approved therein by the MPSC. I have also testified on the subject of FACs on
19 behalf of PSI Energy in Cause No. 42200 before the Indiana Utility Regulatory
20 Commission, Arizona Public Service Company ("APS") in Docket Nos. E-
21 01345A-03-0437 and E-01345A-06-0009 before the Arizona Corporation
22 Commission, and Entergy Arkansas, Inc. in Docket No. 05-116-U/06-055-U
23 before the Arkansas Public Service Commission.

1 My full educational and professional background is presented in Schedule SMF-1.

2 **II. EXECUTIVE SUMMARY**

3 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

4 A. I have reviewed the direct testimony of the following individuals and will rebut
5 their views related to the subjects I have noted:

6 a) Donald Johnstone, testifying on behalf of Sedalia Industrial Energy
7 Users' Assn. and Ag Processing Inc.;

8 b) Ronald Binz, testifying on behalf of AARP;

9 c) Ryan Kind, testifying on behalf of the Office of Public Counsel,
10 do not support adoption of an FAC in this proceeding, a position with
11 which I disagree;

12 d) Russell Trippensee, testifying on behalf of the Office of Public
13 Counsel, indicates that adoption of an FAC would make Aquila's
14 business operations virtually risk-free (at p. 8), a proposition that I
15 disagree with and, as I show below, the rating agencies would
16 question; and, finally,

17 e) Cary Featherstone, testifying on behalf of the Missouri Public Service
18 Commission ("MPSC" or "Commission") Staff, supports use of an
19 interim energy charge ("IEC") rather than an FAC, a policy choice
20 with which I also disagree.

21 In rebutting the positions taken by these witnesses in their respective
22 direct testimonies and in discussing why I believe adoption of an FAC for Aquila
23 is the appropriate policy action for the MPSC to take in this proceeding, I will

1 contrast the intervenor/staff testimony view that an FAC would not be in the
2 public interest (notwithstanding the fact that Aquila's proposal tracks the intent of
3 Senate Bill 179) with the positive experiences that I have had with an FAC as a
4 regulator in Michigan and the acceptance that the concept has received in a large
5 majority of other states across the United States. I conclude by explaining why I
6 believe that the positive attributes of FACs make that mechanism preferable to an
7 IEC (which is also permissible under Senate Bill 179) as a means of providing
8 timely cost recovery for fuel and purchased power expenditures.

9

10 **III. MESSRS. JOHNSTONE, BINZ AND KIND ARE MISGUIDED IN THEIR**
11 **ATTACKS ON THE CONCEPT OF FACS**

12 Q. DO YOU BELIEVE THAT THE STAFF, PUBLIC COUNSEL, AND
13 INTERVENOR WITNESSES WHO HAVE FILED TESTIMONY ON THE FAC
14 ARE MISGUIDED WHEN THEY ARGUE THAT FACS ARE NOT
15 WARRANTED, AND IF SO WHY?

16 A. Yes, and to do so I would like to point out the positive attributes of FACs that
17 these witnesses ignore. For example, virtually every integrated electric utility has
18 a need for both the procurement of fuel to fire its power plants and purchased
19 power to deal with the peaks and valleys of electricity supply needed to serve its
20 core regulated customers. Both utilities and regulators agree that overbuilding
21 would place too large a financial burden on regulated customers while a paucity
22 of internal electricity supply would jeopardize the ongoing ability to provide
23 reliable utility service to those same customers. Purchased power helps to fill the
24 gap between a regulated utility's internal generation capacity and the fluctuating

1 needs of its core customers. In addition, with the advent of competitive wholesale
2 markets, a utility has the option of buying from the market when the market
3 purchase price is less than the cost of self-generation.

4 Q. THE TESTIMONY IN OPPOSITION TO FACS IN THIS CASE CRITICIZES
5 THE “AUTOMATIC” NATURE OF FACS AND OFFERS UP VARIOUS
6 SHARING MECHANISMS AS PREFERABLE ALTERNATIVES. WOULD
7 YOU AGREE WITH THAT ASSESSMENT?

8 A. No I would not. First, let me describe how an appropriately-structured FAC
9 operates: The concept of an FAC is to allow recovery of fuel or purchased power
10 costs without a utility having to go through all of the procedural steps and time
11 required for a traditional rate case. Utility companies and their customers benefit
12 from the saving of costs of the regulatory process as well as a decrease in
13 regulatory uncertainty that is a major concern of both equity and debt investors.
14 Of course, regulatory commissions also benefit from the decrease in the frequency
15 and complexity of contested cases; and, as discussed below, with FACs being the
16 prevailing norm across the United States, customers benefit from the greater
17 investor interest that accompanies the presence of FACs within a particular
18 jurisdiction. As regulatory uncertainty decreases, investors are more willing to
19 commit funds to a utility at reasonable cost, and this translates into lower rates for
20 customers. I note, however, that while the intent of FACs is to provide a means
21 by which a utility can recover fuel and purchased power costs without undue
22 process or time lag, it is still incumbent upon the utility to have expended those

1 funds in a prudent manner – and a properly-structured FAC will include a means
2 to ensure this result.

3 Q. THE OPPOSITION CONTENDS THAT AQUILA’S PROPOSED FAC
4 CREATES A DISINCENTIVE FOR THE COMPANY TO ACT IN A
5 PRUDENT MANNER WITH RESPECT TO ITS FUEL AND PURCHASED
6 POWER DECISIONS. DO YOU AGREE WITH THAT CONTENTION?

7 A. No I do not.

8 Q PLEASE EXPLAIN.

9 A. Both Mr. Johnstone and Mr. Binz decry the automatic nature of an FAC. Mr.
10 Johnstone describes it as “100% of any cost increases or decreases are passed thru
11 to ratepayers under the more or less automatic operation of the clause.”
12 (Johnstone at p. 10) Mr. Binz says that “regulators should avoid using
13 ‘automatic’ cost adjustment mechanisms for rate regulated companies.” (Binz at
14 p. 6). If what they are saying about the automatic nature of an FAC were true in
15 this instance, I would not support such a mechanism.

16 Fortunately, what they are saying is not the case here. Both of those
17 witnesses call for incentives of some kind to ensure that Aquila will carry on its
18 fuel and power supply procurement in an appropriate manner, while each of them
19 ignores the greatest hammer of all – a review of the prudence of the Company’s
20 resource procurement activities by the Commission with the ability to disallow
21 imprudent expenditures. As I described earlier, I have served as chairman of a
22 commission that utilized a form of FAC – and, I am glad to be able to say that

1 while after-the-fact disallowances of fuel and power supply costs were rare, they
2 did serve to motivate appropriate behavior on the part of utility managers.

3 “Aha,” Johnstone and Binz would say – the automatic nature of your
4 mechanism passed virtually all of those costs through. But that was not the case
5 at all. Since the goal of the mechanism in Michigan was to only reimburse
6 utilities for their prudent expenditures, utilities communicated with commission
7 staff to ensure they were proceeding down the proper path. No need for 50-50
8 deals and forecasted levels locked into base rates, because the companies knew
9 they had an obligation to carry out those activities prudently – and when they
10 didn’t, they knew they would be subject to a financial disallowance. I have not
11 seen anywhere in the testimony of four of witnesses listed above that they accept
12 the concept that customers should pay 100% of the expenditures made prudently
13 by Aquila on their behalf in order to ensure an appropriate level of service quality.
14 Aquila receives no return on the expenditures it makes for fuel and purchased
15 power on behalf of its customers, and denial of legitimate operating expenses
16 would constitute illegal confiscation of utility assets. Thus, such fair cost
17 recovery should be the goal of regulators, not something they should flee from.

18 Q. WHAT ABOUT MR. JOHNSTONE’S CLAIMS THAT AN FAC CAN
19 PROVIDE “EARNINGS STABILITY” FOR AQUILA WHILE AT THE SAME
20 TIME PROTECTING RATEPAYERS IF FUEL AND PURCHASED POWER
21 COSTS DECLINE?

22 A. I actually agree with Mr. Johnstone’s statements that Aquila would prefer the
23 “[e]arnings stability” that an FAC would provide, and that in “the situation of

1 decreasing prices [an FAC] can also protect ratepayers if the base rates would
2 have otherwise remained higher than would be consistent with the return
3 appropriate for a regulated business.” (Johnstone at p. 5) This speaks of the
4 exactness that a properly-structured and administered FAC provides, as opposed
5 to the forecasted guesses at fuel factors to be plugged into base rates a year or two
6 or three before the fuel and purchased power expenditures are even to be made.

7 Q. WHAT IS YOUR OPINION OF MR. BINZ’S PROPOSAL TO INCLUDE A
8 PORTION OF FUEL AND PURCHASED POWER COSTS IN BASE RATES
9 AND TO RECOVER THE BALANCE THROUGH SOME SORT OF FAC?

10 A. I disagree with Mr. Binz when he elects to forgo the precision that accompanies a
11 properly-functioning FAC and instead proposes base rate treatment coupled with
12 a 50% pass-through FAC, which he acknowledges will mean that “the utility will
13 sometimes over recover, sometimes under recover, but at half the rate that
14 happens today.” (Binz at p. 19). That is the major flaw of the sharing mechanisms
15 put forward by FAC opponents in this case. They do not provide for full recovery
16 of prudent fuel and purchased power expenditures by Aquila on the upside, and
17 they do not treat customers fairly on the downside, since those customers will
18 have to pay more in rates than the actual costs prudently expended by the
19 Company.

20 Q. PLEASE SUMMARIZE YOUR OPINIONS REGARDING THE
21 TESTIMONIES OF MESSRS. JOHNSTONE AND BINZ THAT AN FAC
22 THAT ONLY RECOVERS PART OF AQUILA’S FUEL AND PURCHASED

1 POWER COSTS IS PREFERABLE TO THE FAC THAT THE COMPANY
2 HAS PROPOSED IN THIS CASE.

3 A. The vague statements about incentives and getting Aquila's attention are not good
4 enough for me. I have seen the benefits for both customers and utility
5 shareholders that come with a properly-structured FAC – not to mention or
6 underestimate the positive benefits that accompany ongoing informal interaction
7 between company managers and commission staff as they jointly seek a prudent
8 resource procurement path. I describe below my prior participation as a regulator
9 with FACs in Michigan. Based upon that experience, I can assure this
10 Commission that the positives of an FAC far exceed that which can be gained by
11 structuring any of the hybrid "sharing" systems that on their own terms admit that
12 the end result will never provide for an exact match between prudent actions and
13 corresponding cost recovery.

14 Q. YOUR LAST COMMENT INDICATES THAT WHAT YOU SAW AS THE
15 BENEFITS OF FACS WHEN YOU WERE A STATE REGULATOR
16 OUTWEIGH THOSE THAT MIGHT COME FROM OTHER ALTERNATIVE
17 STRUCTURES. CAN YOU POINT TO EXPERIENCE IN OTHER
18 JURISDICTIONS ACROSS THE U.S. THAT REFUTE THE POSITIONS
19 TAKEN BY MESSRS. JOHNSTONE AND BINZ?

20 A. Yes, I believe I can. Over the past thirty years, regulators and/or legislators in a
21 majority of the states have adopted some form of FAC suited to the characteristics
22 of the utilities located within their jurisdiction. Regulatory Research Associates
23 ("RRA"), a respected utility regulatory analysis company that provides

1 information to utility companies and the financial community,¹ puts the number of
2 states utilizing some form of FAC at 42. In addition, according to the American
3 Gas Association, 49 jurisdictions have purchased gas adjustment mechanisms
4 (“PGAs”) for gas utilities.² As RRA sums it up, utilities operating in jurisdictions
5 without FACs “have always been, and continue to be, at risk for fluctuations in
6 fuel and purchased power costs between rate cases.”³

7 One state that adheres to the view that FACs further public policy goals is
8 Indiana, a state which is viewed as having a very constructive regulatory
9 environment. Part of the reason for its positive reputation is that it has not only
10 utilized tracking mechanisms for fuel and power supply, it has also authorized
11 trackers for other costs that are variable, outside the direct control of the utility,
12 and highly variable from year-to-year, including costs related to environmental
13 compliance and independent system operator activities. I mentioned earlier my
14 involvement on behalf of PSI Energy, Inc. (“PSI”) in Cause No. 42200 before the
15 Indiana Utility Regulatory Commission. The Commission’s final order in that
16 case sums up well the benefits of FACs:

17 Sound regulatory policy supports the numerous regulatory
18 decisions, in Indiana and elsewhere, authorizing purchased power
19 trackers.... [A] utility should have a reasonable opportunity to
20 recover the prudently incurred costs associated with meeting its
21 obligation to provide adequate and reliable service to its
22 customers.... [T]racking mechanisms are appropriate regulatory
23 tools for reflecting costs that are volatile, substantial, and largely
24 outside of the control of the utility.... As this Commission has
25 previously stated, maintenance of credit quality is important both

¹ Regulatory Research Associates Regulatory Focus Special Report: “Fuel and Wholesale Power Cost Recovery, A State-By-State Review,” October 3, 2005.

² Email from Mr. Jay Copan, Senior Vice President, American Gas Association, May 19, 2006.

³ Regulatory Research Associates Regulatory Focus Special Report: “Fuel and Wholesale Power Cost Recovery, A State-By-State Review,” October 3, 2005 at 2.

1 for utilities and their customers. "Reduced credit quality will result
2 in higher debt costs which, in turn, will result in higher rates
3 charged customers in the future." [Citation omitted.]... As we have
4 previously recognized, rate adjustment mechanisms for fluctuating
5 costs such as fuel and purchased power are viewed positively by
6 rating agencies. ... We recognize that customers and shareholders
7 share an interest in PSI's achievement of necessary financing at
8 reasonable costs. We believe that the continuation of a purchased
9 power tracker for PSI should assist PSI in attracting capital on
10 reasonable terms and this, in turn, would also benefit customers. ...
11 To terminate PSI's tracker at this point in time would deprive PSI
12 of the opportunity to recover its prudently incurred costs of
13 providing service. This we will not do.⁴

14 Q. YOU MENTIONED THAT YOU HAD EXPERIENCE WITH FACs AND
15 PGAs DURING THE TIME THAT YOU SERVED AS A REGULATOR IN
16 MICHIGAN. PLEASE EXPLAIN YOUR EXPERIENCE AS IT RELATES
17 TO THE ARGUMENTS MADE BY MESSRS. JOHNSTONE AND BINZ.

18 A. Yes I did have experience with FACs when I was a utility regulator in Michigan.
19 When I served as chairman of the Michigan PSC, each year we went through
20 proceedings for each utility to set a plan for their proposed fuel and natural gas
21 procurement and power purchases from third-party providers. The plan the
22 Michigan PSC approved served as a before-the-fact prudence finding to provide
23 guidance to a utility as it dealt with these issues as the year went on. As issues
24 arose during the course of the year, communication between utility managers and
25 commission staff attempted to ensure that any actions beyond the terms of the
26 plan would still fall within a range of prudent behavior. At the conclusion of the
27 plan year, a reconciliation proceeding compared actual results with the approved

⁴ In the Matter of the Petition of PSI Energy, Inc. pursuant to the Commission's April 11, 2001 Order in Cause No. 41448-S1 and Ind. Code 8-1-2-42, for Authority to Extend and Expand PSI's Standard Contract Rider No. 67, to Allow Recovery of Certain Costs Associated with Wholesale Power Purchases Made by Petitioner to Meet its Retail Native Load Requirements, Beyond 2002 and in Months Outside of June through September, as necessary to Maintain Adequate Electricity Reserves, June 4, 2003 at 11-12, 14.

1 plan and made prudence findings on any differences that existed. The goal
2 throughout both processes was to assist utilities to prudently manage their fuel
3 and natural gas procurement and purchased power needs. And it is important to
4 emphasize: a prudence review of resource procurement activities taken where an
5 FAC exists is no different than the myriad prudence determinations that a
6 regulatory body makes within the context of a traditional rate case – the topics for
7 review under an FAC may be circumscribed, but a commission has total freedom
8 to decide how deeply it wishes to delve into any issues in dispute.

9 Q. YOU MENTIONED EARLIER THAT MR. TRIPPENSEE'S TESTIMONY
10 INDICATES THAT ADOPTION OF AN FAC FOR AQUILA WOULD MAKE
11 THE COMPANY'S BUSINESS OPERATIONS VIRTUALLY RISK-FREE.
12 BASED UPON YOUR EXPERIENCE AS HEAD OF THE UTILITY RATINGS
13 PRACTICE AT FITCH, CAN YOU COMMENT WHETHER YOU BELIEVE
14 THE FINANCIAL COMMUNITY WOULD AGREE WITH MR.
15 TRIPPENSEE'S ASSESSMENT?

16 A. Yes I can, and no, I do not believe investors and rating agencies would agree with
17 Mr. Trippensee's assessment. Consideration of fuel costs in a manner that lowers
18 uncertainty and risk represents the mainstream position on this issue across the
19 United States. Thus, the financial community takes the presence of an FAC as
20 virtually a given when comparing utilities across jurisdictions for possible
21 investment. Investors rely on the presence of such adjustment mechanisms to
22 protect themselves from the variability of fuel and purchased power costs that are
23 substantially outside the control of the affected utility, but which can have a

1 substantial impact on the financial profile of that utility, even when prudently
2 managed. Of course, fuel and power procurement is just one of a multitude of
3 risks that a regulated electric or gas utility faces in its day-to-day operations.
4 Thus, even with these mechanisms mitigating a portion of the risk and uncertainty
5 related to regulated utility's operations (and I note FACs relate to activities upon
6 which the utility does not receive a return), investors will still consider the
7 business risks that remain and compare them to utilities in other jurisdictions --
8 which likely operate under an FAC -- in determining where to direct their capital.
9 Accordingly, far from viewing an FAC as removing all risk from a utility targeted
10 for investment, investors more likely would see the absence of the protection that
11 an FAC provides as a negative element in a utility's credit and investment profile,
12 one which might eliminate it as a potential recipient of investor funds, or at least
13 raise the cost that would have to be paid for such needed capital.

14 Q. DO THE RATING AGENCIES CONCUR WITH YOUR OPINION?

15 A. I believe they do. S&P stated in November 2002 its opinion concerning the
16 importance of electric utilities having the opportunity to recover fuel and
17 purchased power expenses:

18 When assessing the importance of productive regulation to the
19 credit strength of an electric utility, something to consider is the
20 means by which the utility can expect to recover variable expenses,
21 particularly fuel and purchased-power expenses, which have highly
22 erratic unit costs. Recent, and in some cases, extreme volatility in
23 the U.S. wholesale electricity markets, as well as in the natural gas
24 markets, underscores this importance. It is no coincidence that
25 utilities with stronger fuel and power cost recovery mechanisms
26 typically enjoy loftier credit ratings.

27 S&P went on to comment upon the negative aspects of the absence of a FAC:

1 In jurisdictions where FACs have been prohibited, electric utilities
2 have always been subject to the uncertainties surrounding the
3 recovery of incurred fuel and purchased-power expenses. With
4 few exceptions, companies operating exclusively in these
5 jurisdictions have always had ratings below the industry average.⁵

6 Q. DO THE OTHER RATING AGENCIES SHARE S&P'S POSITIVE VIEWS
7 WITH REGARD TO FACs?

8 A. Yes they do. Moody's has commented upon the importance of FACs in
9 mitigating operating risk:

10 Cost Recovery Provisions: States have various policies with
11 respect to fuel and wholesale power cost recovery, and the recent
12 volatility in commodity prices have made these provisions
13 important elements of a utility's cost management capability. Such
14 provisions make it possible for utilities to quickly adjust rates in
15 the event of an unexpected hike in fuel costs. Although the
16 number of states permitting such recovery has declined,
17 particularly in those that have transitioned to a competitive market,
18 they remain critical risk mitigants to those utilities still operating in
19 regulated environments.⁶

20 Fitch has discussed the credit implications of the presence of FACs:

21 Fitch factors risks related to commodity price volatility into stress
22 cases related to each company's individual circumstances and asset
23 portfolios.... Potential risks for regulated distribution and
24 integrated utilities: ... Utilities with frozen tariffs or those without
25 the means to recover their higher fuel expense are most at risk.⁷

26 In February 2006, Fitch added these thoughts in a report discussing credit
27 implications of commodity cost recovery:

28 A utility's ability to weather a period of high and rising commodity
29 costs is influenced by many related factors, including the state's
30 market structure, rules regarding power procurement and the
31 utility's obligation to serve customers' energy needs, the utility's
32 resource mix relative to its load requirement, access to adequate

⁵ S&P Research: "Constructive Regulation For U.S. Utilities Is More Important Than Ever," November 14, 2002 at 1.

⁶ Moody's Global Credit Research: "Rating Methodology: Global Regulated Electric Utilities," March 2005 at 19.

⁷ Fitch Special Report: "Electric Fuels Outlook: The Fuels Dilemma," November 11, 2004 at 7.

1 liquidity and the state's regulatory/political environment. Within
2 this context, **effective and timely commodity cost-adjustment**
3 **mechanisms provide utilities with greater assurance of**
4 **ultimate recovery in a rising energy price environment.**
5 [Emphasis supplied.]⁸

6 Then in June 2006, Fitch re-emphasized the impact that timely recovery of fuel
7 and purchased energy expenses has on electric utility credit ratings:

8
9 Volatile and higher energy and fuel commodity prices represent a
10 challenge to electric utilities.... Given [the current] environment, Fitch
11 believes timely recovery of fuel costs is essential to an electric utility's
12 creditworthiness and that its response to high and volatile cost pressures
13 will be a key determinant to a utility's credit quality and rating in 2006
14 and beyond.⁹

15 Q. HAVE THE RATING AGENCIES BEEN FOLLOWING THE PROGRESS OF
16 FACS IN MISSOURI AS THEY RELATE TO AQUILA?

17 A. Yes they have. A year ago, Fitch noted that their then-Positive rating outlook on
18 Aquila reflected their "expectation that the MPSC will adopt, in the near-term, a
19 fuel-adjustment clause that supports timely and sufficient cost recovery."¹⁰ More
20 recently, S&P echoed Fitch's anticipation and Moody's reiterated the importance
21 of fuel and power cost recovery:

22 S&P: [Aquila's] business risks are partially mitigated by an
23 improving regulatory environment (which for the first time
24 may allow a fuel-adjustment clause as early as next year)."¹¹

25 Moody's: "A key credit challenge for the company will be the
26 extent to which it is successful in recovering fuel and power

⁸ Fitch Special Report: "U.S. Electric Utilities: Credit Implications of Commodity Cost Recovery," February 13, 2006 at 1-2.

⁹ Fitch Special Report: "Cost Recovery and Public Power: Who Is at Risk?," June 1, 2006 at 1.

¹⁰ Fitch Ratings Credit Analysis: "Aquila Inc.," February 3, 2006 at p. 1.

¹¹ S&P Research Update: "Aquila Upgraded to 'B', Still on Watch Pos," September 1, 2006 at p. 1.

1 costs in Missouri, its largest service area.”¹²

2 Q. IN AN ENVIRONMENT OF RAPIDLY-ESCALATING FUEL AND
3 PURCHASED POWER COSTS, WHAT ARE THE IMPLICATIONS FOR
4 AQUILA IF THE COMMISSION FOLLOWS THE RECOMMENDATIONS OF
5 THE WITNESSES FOR THE PUBLIC COUNSEL AND THE INTERVENORS
6 IN THIS CASE?

7 A. News accounts over the past year show that attempts by regulators to artificially
8 hold the line on seemingly prudently-incurred fuel and purchased power cost
9 recovery solely because those costs are growing at a rapid rate can have very dire
10 consequences. Properly-structured FACs, with appropriate monitoring and
11 decision-making tied to prudence, are the best means to avoid negative financial
12 consequences for regulated utilities.

13 Uncertainty with regard to fuel cost volatility is the very reason that a
14 majority of states utilize a properly-structured power supply adjustment
15 mechanism in the first place – so that a utility can carry out its responsibilities to
16 provide reliable service to customers at the best cost available under then-existing
17 circumstances, without having to be concerned that its prudent expenditures in
18 this regard might be found to be unrecoverable at a later time. Because regulated
19 utilities in most cases do not earn any profit or return on their fuel and purchased
20 power expenditures, barring unusual behavior on the part of the utility such
21 expenses are presumed to be prudent, and rating agencies expect that utilities will
22 recover them without undue delay.

¹² Moody's Analysis: "Aquila, Inc.," December 2006 at p. 2.

1 Q. TURNING TO MR. KIND, DO YOU FIND ANY COMMON GROUND WITH
2 HIM?

3 A. No I do not. Mr. Kind views that an FAC is not in the public interest, and seems
4 to have formulated his own standards for approval of an FAC that I cannot find
5 anywhere in the law or in rule: "Does Aquila have a need for a FAC because it
6 would face a substantial threat to its financial viability if it did not have a FAC in
7 effect that would recover some or all of the increased costs of fuel and purchased
8 power in between rate cases?" (Kind at p. 4) Thankfully for good regulatory
9 policy, that is not the standard the MPSC is operating under within this
10 proceeding.

11 Moreover, Mr. Kind cites former Union Electric Co. Chairman Charles
12 Mueller for a proposition that I do not believe is consistent with Mr. Mueller's
13 intent. The quote was from Mr. Mueller's Chairman's Letter in the company's
14 1998 Annual Report to Shareholders:

15
16 We are also focused on lowering our fuel costs. In 1998
17 In Illinois, we chose to eliminate the fuel adjustment clauses,
18 which called for offering credits if certain fuel costs dropped
19 or increasing customer bills if they rose. That decision,
20 coupled with the fact that we have operated for several years
21 without a fuel adjustment clause in Missouri, has given
22 us additional incentive to continue to manage our fuel costs
23 effectively.
24

25 Mr. Kind points to this quote as showing the adverse incentive that arises when a
26 company operates under an FAC. I would argue the converse of that notion.
27 What I read is that Mr. Mueller was talking about a situation where a fuel factor
28 was included in base rates, and thus any savings that beat that level would not be
29 reconciled as they would under an FAC, but rather would go to the audience that

1 Mr. Mueller was addressing: Union Electric Co.'s shareholders! It is further
2 interesting to note that AmerenUE, the successor company to Union Electric, now
3 has pending in its current rate case before the MPSC (Case No. ER-2007-0002) a
4 request for approval of an FAC.

5 Q. THAT LEAVES MR. FEATHERSTONE OF STAFF. ANY AGREEMENT
6 THERE?

7 A. Actually I believe Mr. Featherstone accurately portrays the benefits that an
8 interim energy charge, or IEC, can provide, and I can appreciate why the MPSC
9 has in the past utilized such mechanisms. But those policy judgments came at a
10 time when the Commission **was legally barred from using FACs**. I strongly
11 believe that now the MPSC would be better served by approving an FAC targeted
12 at actual fuel costs rather than continuing the use of forecasted fuel costs within
13 the next-best alternative, the IEC. For instance, if an IEC's ceiling fuel price is set
14 incorrectly, either the Company will be doomed to inappropriate under-recovery
15 of prudent fuel expenditures, or customers will overpay and then be required to
16 wait an extended period of time before receiving a refund. Given the choice
17 between actual cost recovery versus the stakeholders' (and Commission's) best
18 estimates, I think an FAC clearly represents the better option.

19 Moreover, Mr. Featherstone makes one statement that should put to bed
20 the arguments by Messrs. Johnstone, Binz and Kind that fuel and purchased
21 power costs are predictable enough that some form of predominantly base rate
22 treatment is sufficient for Aquila going forward. At p. 20, Mr. Featherstone
23 states:

1 Along with purchased power costs, the volatility in natural gas
2 costs is probably the most difficult to predict with any certainty.
3 Natural gas markets have historically been quite volatile, but in
4 The recent past they have been even more volatile. No one
5 can predict with a reasonable degree of certainty, the natural
6 gas prices that utilities will pay in the future to fuel their power
7 generating facilities.”
8

9 In view of Mr. Featherstone’s sincerely-stated concerns, I believe the
10 proper course for this Commission is clear. An IEC has been and would
11 be a device that would come close to matching up prudent expenditures
12 with recovery. However, it is not as precise nor as timely as a properly-
13 functioning FAC, which focuses on actual costs, prudently-made, and
14 recovered close in time to their being expended. Having served as a
15 regulator in a jurisdiction where an FAC was operational and effective, and
16 seeing the vast majority of states that currently utilize FACs, I encourage
17 the MPSC to embrace the opportunity provided by the Missouri
18 Legislature and put into effect as part of this rate case an FAC for Aquila
19 going forward.

20 IV. CONCLUSION

21 Q. DO YOU HAVE CONCLUDING THOUGHTS?

22 A. Yes. The concept of utility regulation is to provide a surrogate for the
23 competitive market that is not present when a company possesses monopoly or
24 near-monopoly status with regard to an essential good, such as utility service.
25 FACs attempt to align the costs that a utility expends for fuel and purchased
26 power with its recovery of those costs on a timely basis. Base rate cases with
27 their high expense – for all participants -- and lengthy duration are ill-suited to

1 deal with costs that 1) can vary widely from year-to-year; 2) are substantially
2 outside the control of the utility; and 3) represent a considerable financial outlay
3 by a utility, with no ability to receive a return on those expended funds. By being
4 able to recover prudently-incurred costs expeditiously, a utility lowers the risk of
5 its operations and achieves consistency with the level of risk faced by a wide
6 majority of other utilities within the United States, all of which are chasing the
7 same investor funds. Finally, it is wholly consistent with rational utility
8 economics for customers to pay the actual costs of fuel and purchased power that
9 are procured for customers' benefit, whether those costs are in an escalating mode
10 or actually going down.

11 Q. IS THERE A DOWNSIDE TO USE OF A FAC?

12 A. I alluded to it earlier. The expedited (and even sometimes near-automatic)
13 operation of an FAC should not allow imprudent actions by a regulated utility to
14 avoid regulatory scrutiny. If costs for fuel and power supply are not prudently-
15 incurred, there should be a process to allow challenge of such improper actions,
16 followed by the ability of the regulatory body to order disallowances and prevent
17 inappropriate recovery. Only in this way can a fair balance be struck between
18 customer and shareholder interests.

19 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

20 A. Yes it does.

STEVEN M. FETTER

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Education University of Michigan Law School, J.D. 1979
Bar Memberships: U.S. Supreme Court, New York, Michigan
University of Michigan, A.B. (Communications) 1974

April 2002 – Present

President – REGULATION UnFETTERED – Henderson, NV/Rumson, NJ

Founder of advisory firm providing regulatory, legislative, financial, legal and strategic planning advisory services for the energy, water and telecommunications sectors; federal and state testimony; credit rating advisory services; negotiation, arbitration and mediation services; and skills training in ethics, negotiation, and management efficiency.

- Service on Boards of Directors of: CH Energy Group (Chairman, Governance and Nominating Committee; Member, Audit; Previous Chairman, Audit and Compensation Committees), National Regulatory Research Institute (at Ohio State University), Keystone Energy Board, and Regulatory Information Technology Consortium; Member, Wall Street Utility Group and American Public Power Association; Participant, Keystone Center Dialogue on Financial Trading and Energy Markets.

October 1993 – April 2002

Group Head and Managing Director; Senior Director -- Global Power Group, Fitch IBCA Duff & Phelps -- New York/Chicago

Manager of 18-employee (\$15 million revenue) group responsible for credit research and rating of fixed income securities of U.S. and foreign electric and natural gas companies and project finance.

- Led an effort to restructure the global power group that in three years time resulted in 75% new personnel and over 100% increase in revenues, transforming a group operating at a substantial deficit into a team-oriented profit center through a combination of revenue growth and expense reduction.

- Achieved national recognition as a speaker and commentator evaluating the effects of regulatory developments on the financial condition of the utility sector and individual companies; Cited by Institutional Investor (9/97) as one of top utility analysts at rating agencies; Frequently quoted in national newspapers and trade publications including The New York Times, The Wall Street Journal, International Herald Tribune, Los Angeles Times, Atlanta Journal-Constitution, Forbes and Energy Daily; Featured speaker at conferences sponsored by Edison Electric Institute, Nuclear Energy Institute, American Gas Assn., Natural Gas Supply Assn., National Assn. of Regulatory Utility Commissioners (NARUC), Canadian Electricity Assn.; Frequent invitations to testify before U.S. Senate (on C-Span) and House of Representatives, and state legislatures and utility commissions.
- Participant, Keystone Center Dialogue on Regional Transmission Organizations; Member, International Advisory Council, Eisenhower Fellowships; Author, "A Rating Agency's Perspective on Regulatory Reform," book chapter published by Public Utilities Reports, Summer 1995; Advisory Committee, Public Utilities Fortnightly.

March 1994 – April 2002

Consultant -- NYNEX -- New York, Ameritech -- Chicago, Weatherwise USA -- Pittsburgh

Provided testimony before the Federal Communications Commission and state public utility commissions; Formulated and taught specialized ethics and negotiation skills training program for employees in positions of a sensitive nature due to responsibilities involving interface with government officials, marketing, sales or purchasing; Developed amendments to NYNEX Code of Business Conduct.

October 1987 - October 1993

Chairman; Commissioner -- Michigan Public Service Commission -- Lansing

Administrator of \$15-million agency responsible for regulating Michigan's public utilities, telecommunications services, and intrastate trucking, and establishing an effective state energy policy; Appointed by Democratic Governor James Blanchard; Promoted to Chairman by Republican Governor John Engler (1991) and reappointed (1993).

- Initiated case-handling guideline that eliminated agency backlog for first time in 23 years while reorganizing to downsize agency from 240 employees to 205 and eliminate top tier of management; MPSC received national recognition for fashioning incentive plans in all regulated industries based on performance, service quality, and infrastructure improvement.

- Closely involved in formulation and passage of regulatory reform law (Michigan Telecommunications Act of 1991) that has served as a model for other states; Rejuvenated dormant twelve-year effort and successfully lobbied the Michigan Legislature to exempt the Commission from the Open Meetings Act, a controversial step that shifted power from the career staff to the three commissioners.
- Elected Chairman of the Board of the National Regulatory Research Institute (at Ohio State University); Adjunct Professor of Legislation, American University's Washington College of Law and Thomas M. Cooley Law School; Member of NARUC Executive, Gas, and International Relations Committees, Steering Committee of U.S. Environmental Protection Agency/State of Michigan Relative Risk Analysis Project, and Federal Energy Regulatory Commission Task Force on Natural Gas Deliverability; Eisenhower Exchange Fellow to Japan and NARUC Fellow to the Kennedy School of Government; Ethics Lecturer for NARUC.

August 1985 - October 1987

Acting Associate Deputy Under Secretary of Labor; Executive Assistant to the Deputy Under Secretary -- U.S. Department of Labor -- Washington DC

Member of three-person management team directing the activities of 60-employee agency responsible for promoting use of labor-management cooperation programs. Supervised a legal team in a study of the effects of U.S. labor laws on labor-management cooperation that has received national recognition and been frequently cited in law reviews (U.S. Labor Law and the Future of Labor-Management Cooperation, w/S. Schlossberg, 1986).

January 1983 - August 1985

Senate Majority General Counsel; Chief Republican Counsel -- Michigan Senate -- Lansing

Legal Advisor to the Majority Republican Caucus and Secretary of the Senate; Created and directed 7-employee Office of Majority General Counsel; Counsel, Senate Rules and Ethics Committees; Appointed to the Michigan Criminal Justice Commission, Ann Arbor Human Rights Commission and Washtenaw County Consumer Mediation Committee.

March 1982 - January 1983

Assistant Legal Counsel -- Michigan Governor William Milliken -- Lansing

Legal and Labor Advisor (member of collective bargaining team); Director, Extradition and Clemency; Appointed to Michigan Supreme Court Sentencing

Guidelines Committee, Prison Overcrowding Project, Coordination of Law Enforcement Services Task Force.

October 1979 - March 1982

Appellate Litigation Attorney -- National Labor Relations Board -- Washington DC

Other Significant Speeches and Publications

- Perspective: Don't Fence Me Out (Public Utilities Fortnightly, October 2004)
- Climate Change and the Electric Power Sector: What Role for the Global Financial Community (during Fourth Session of UN Framework Convention on Climate Change Conference of Parties, Buenos Aires, Argentina, November 3, 1998)(unpublished)
- Regulation UnFettered: The Fray By the Bay, Revisited (National Regulatory Research Institute Quarterly Bulletin, December 1997)
- The Feds Can Lead...By Getting Out of the Way (Public Utilities Fortnightly, June 1, 1996)
- Ethical Considerations Within Utility Regulation, w/M. Cummins (National Regulatory Research Institute Quarterly Bulletin, December 1993)
- Legal Challenges to Employee Participation Programs (American Bar Association, Atlanta, Georgia, August 1991) (unpublished)
- Proprietary Information, Confidentiality, and Regulation's Continuing Information Needs: A State Commissioner's Perspective (Washington Legal Foundation, July 1990)

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila
Networks-MPS and Aquila Networks-L&P
for authority to file tariffs increasing electric
rates for service provided to customers in
the Aquila Networks-MPS and Aquila
Networks-L&P areas

Case No. ER-2007-0004


County of Jefferson)

State of Washington)

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AFFIDAVIT OF STEVEN M. FETTER

Steven M. Fetter, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony and schedule entitled "Rebuttal Testimony of Steven M. Fetter"; that said testimony was prepared by him or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedule he would respond as therein set forth; and that the aforesaid testimony and schedule are true and correct to the best of his knowledge, information, and belief.



Steven M. Fetter

Subscribed and sworn before me this 20th day of February, 2007


Notary Public

My commission expires:

05.11.09

