BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Tariffs of Aquila, Inc., d/b/a Aquila Networks - MPS and Aquila Networks - L&P Increasing Electric Rates for the Services Provided to Customers in the Aquila Networks - MPS and Aquila Networks - L&P Service Areas	))))))	Case No. ER-2007-0004

POST-HEARING BRIEF OF AQUILA, INC.

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I. INTRODUCTION

This brief supplements the Pre-Hearing Brief of Aquila, Inc. ("Aquila" or the "Company") filed on March 29, 2007.[1] It addresses the three (3) remaining contested issues, that is, Cost of Capital/Return on Common Equity, Sibley Accounting Authority Orders, and Fuel Cost Recovery.[2] As will be demonstrated herein, the evidence presented during the evidentiary hearing only further supports the Company's positions with regard to each issue.

II. COST OF CAPITAL - Return on Common Equity

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

A. Summary of Aquila's Position

A Return on Common Equity ("ROE") of 10.75%, as the starting point, adjusted upward by 50 basis points to 11.25% to account for Aquila's construction budget and corresponding risk, should be used for determining the Company's rate of return in this case.

Dr. Samuel C. Hadaway[3] provided rate of return evidence on behalf of Aquila. His testimony, based on alternative versions of the DCF model and adjusted upward for construction risk, supports an 11.25% return on common equity award for the Company. This recommendation is within the so-called "zone of reasonableness." The "zone of reasonableness" concept or test is a regulatory tool used by this Commission for determining authorized returns and is based on the premise that the national average ROE is an indicator of the capital market in which Missouri utilities compete. The

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[1] EFIS Doc. No. 201.

[2] The issue of Depreciation was abandoned at the time of the hearing. Tr. pp. 449-450.

[3] Dr. Hadaway has been described by the Commission as having "impeccable" credentials. 2006 Mo. PSC LEXIS 1734, Commission Case No. ER-2006-0314, *Report and Order* (issued December 21, 2006).

evidence in this case, based upon 25 regulatory decisions, shows the 2006 average ROE was 10.36 percent. Utilizing 10.36% as the national average indicates a "zone of reasonableness" in this case of 9.36% to 11.36%. Ample reasons exist to support an award for Aquila at the high end of this range.

First, many of the electric companies which make the 10.36% ROE average for 2006 are not more risky "fully integrated" electric utilities such as Aquila. Instead, they are, in fact, less risky "transmission and/or distribution" ("T&D") companies. These less risky T&D companies, with lower ROE awards, in turn lowered the 2006 average ROE. Eliminating these companies from the calculation would result in a 2006 national ROE average of 10.65 percent and a zone of reasonableness upper "cap" of 11.65 percent. Without the T&D observations, the lower end of the range would be 9.65 percent.

Second, in December 2006, this Commission authorized an ROE of 11.25% for Kansas City Power & Light Company ("KCPL"), on a capital structure of 53.69% equity, and a 10.9% ROE for The Empire District Electric Company ("Empire"), on a capital structure of 49.74% equity. These two companies both have more "equity thick" capital structures than does Aquila, which has only 48.17% equity in its capital structure. Given the capital structure differences, and stated another way, an 11.25% ROE for Aquila is not the same as an 11.25% ROE for KCPL.

Third, as a partner in the Iatan II Power Plant and with other pressing capital expenditure demands, Aquila has a higher "construction risk" than the average company in Dr. Hadaway's reference group. As explained by Dr. Hadaway, this construction and financing risk differential justifies a 50 basis point upward adjustment from his DCF starting point of 10.75%, to his 11.25% recommendation.

B. Legal Principles and Background

Competent and substantial evidence regarding the components of a proper rate of return for Aquila in this proceeding was provided through the testimony of Dr. Hadaway and Mr. Richard J. Winterman on behalf of Aquila. Testimony on this topic was also provided by Mr. David C. Parcell on behalf of the Staff of the Commission, by Mr. Michael Gorman on behalf of several intervenors[4] (the "Industrials"), and by Mr. Russell Trippensee on behalf of the Office of the Public Counsel.[5]

"Every utility does have an undoubted constitutional right to such a fair and reasonable return, and this is a continuing right which does not cease after beginning rates are initially determined." *State ex rel. Laclede Gas Company v. Public Service Commission*, 535 S.W.2d 561, 569. (Mo.App. K.C. 1976), *citing Bluefield Waterworks v. Public Service Commission,* 262 U.S. 679 (1923). This Commission is well aware of the standards established by the United States Supreme Court in *Bluefield* and *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944). A utility such as Aquila must be afforded the opportunity to earn a fair and reasonable return and, to be fair and reasonable, that return should be "commensurate with returns on investments in other enterprises having corresponding risks." *Hope*, 320 U.S. at 603.

The *Bluefield* and *Hope* decisions make it clear that in the context of utility regulation, fairness and reasonableness are synonymous with competitiveness. Aquila's revenues must be sufficient to ensure that it can compete with like-risked

[4] Federal Executive Agencies, Sedalia Industrial Energy Users Association and St. Joe Industrial Group.

[5] For purposes of settlement of a number of issues in this case and for rate-making purposes for this proceeding, Staff and the Company have agreed that Aquila's 2006 year end corporate capital structure, which consists of 51.83 percent debt and 48.17 percent equity, should be utilized for computing a proper rate of return for the two divisions. Further, the issue of cost of debt is no longer contested between the parties to this proceeding. The cost of debt to the MPS division is 6.668 percent, and the cost of debt for the L&P division is 7.8698 percent. The issue of a fair and reasonable return on common equity for Aquila in this proceeding remains contested.

enterprises in its efforts to attract investors and the necessary capital such investors provide. To achieve this result, the Commission must balance its concern for utility ratepayers with Aquila's need for rate levels that sustain sound infrastructure and discretionary capital investment.

Recognizing this principle of competitiveness, in its constitutional *Hope* and *Bluefield* analysis, as indicated previously, the Commission has stated that there are some numbers that it can use as guideposts in establishing an appropriate return on equity, although not limiting itself to a strict "zone of reasonableness."[6] A reasonableness check is especially important in this proceeding, given the low return on equity recommendations of Staff and the intervenors and the extensive capital requirements Aquila's Missouri Public Service ("MPS") and St. Joseph Light & Power ("L&P") operating divisions are facing. The divisions will have to compete against other enterprises to raise the capital needed to meet the Company's capital requirements and continue to provide safe and adequate service in Missouri.

This Commission has said that "(s)ince it is difficult, and nearly impossible, to establish a single scientifically correct rate, judgment must be exercised within the zone of reasonableness."[7] In a recent rate case involving Missouri Gas Energy ("MGE"), the Commission defined that "zone of reasonableness" as being 100 basis points above and below the national average.[8] This same "zone of reasonableness" concept or tool was utilized by the Commission in its recent cases involving KCPL (Case No. ER-2006-0314) and Empire (Case No. ER-2006-0315).

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[6] *See* Commission Case No. ER-2006-0314, *Order Regarding Motions for Rehearing* (January 18, 2007).
[7] *In the Matter of Missouri Power & Light Company of Jefferson City*, Case Nos. HR-82-179, ER-82-180 and GR-82-181, 25 Mo. P.S.C. (N.S.) 388 (Report and Order issued October 29, 1982).
[8] *In the Matter of Missouri Gas Energy*, Case No. GR-2004-0209, 235 P.U.R.4th 507 (Report and Order issued Sept. 21, 2004).

C. A Fair and Reasonable Return on Common Equity

A return on common equity of 11.25% should be used for determining Aquila's rate of return ("ROR") in this proceeding. As indicated, the 11.25% return is supported and explained by the testimony of Dr. Hadaway.

Guided by the fair rate of return principles of *Hope* and *Bluefield*, Dr. Hadaway used several approaches, including alternate DCF methods, to determine the appropriate ROE and overall rates of return for Aquila's two Missouri operating divisions.[9] Dr. Hadaway applied these methods and the underlying economic models to an investment grade company reference group of other similarly situated electric utilities. The methodology utilized by Dr. Hadaway is set out and explained in Aquila's Pre-Hearing Brief and the pre-filed testimony of Dr. Hadaway and is consistent with the approach he used in the recent KCPL rate case.

Although Dr. Hadaway's reference group provided the appropriate starting point for estimating ROE, the reference group ROE is actually lower than the fair cost of equity for MPS and L&P.[10] This is because Aquila's two Missouri operating divisions face a higher construction budget as a percentage of existing plant and higher operating risks, as compared to the average company in the reference group.[11] The updated construction requirements analysis shows the Company's six-year construction expenditures as a percentage of net plant is 118.2 percent, compared to an average of 60.9 percent for the comparable group.[12] In other words, while the DCF results for the comparable companies reflect everything known about each of those companies,

[9] Hadaway Exh. 013, p. 3.
[10] Hadaway Exh. 013, p. 4.
[11] Hadaway Exh. 013, p. 4.
[12] Hadaway Exh. 014, p. 19.

including their risks, those companies are not exposed to the same level of construction risk as is Aquila. To account for this construction and financing risk differential, Dr. Hadaway added 50 basis points to his DCF results to arrive at his 11.25% recommendation.

As indicated, this Commission has looked to the national average ROE as an indicator of the capital market in which Missouri utilities will have to compete for capital, and the Commission has considered the reasonableness of ROE recommendations in light of findings and decisions of other regulatory agencies. The evidence presented in this proceeding demonstrates that the average ROE for regulated utilities in 2006 was approximately 10.36 percent.[13] Application of the zone of reasonableness concept that has been authorized by the United States Supreme Court and utilized by other courts and regulatory commissions and this Commission, and use of recently reported ROEs for other utilities as a starting point, indicates that 9.36 to 11.36 percent may be viewed as the basic "zone of reasonableness" for Aquila in this rate case proceeding.

The competent and substantial evidence presented in this proceeding demonstrates that Aquila's authorized ROE should be 11.25%, which is at the high end of this range. Dr. Hadaway estimates the "market required" rate of return on equity for Aquila's MPS and L&P Missouri operating divisions at 11.25 percent. Dr. Hadaway's testimony and recommendations properly reflect industry-specific and company-specific factors, and his ROE recommendations for the divisions – 10.75% without and 11.25% with a necessary construction risk adjustment – fall within the zone of reasonableness.

[13] Hadaway Exh. 014, p. 3; Tr. p. 380, l. 15. There was also evidence that the number came down a bit during the first quarter of 2007, to 10.3 percent. Tr. p. 381.

There is ample evidence in the record upon which the Commission may rely in authorizing Aquila the 11.25% ROE which is at the high end of the zone of reasonableness.

First, as noted above, this Commission recently authorized an ROE of 11.25 for KCPL, with a capital structure consisting of 53.69 percent equity (ER-2006-0314), and an ROE of 10.9 for Empire with a capital structure consisting of 49.74 percent equity (ER-2006-0315). By way of contrast, Aquila's capital structure consists of only 48.17 percent equity. Specific company factors such as operating risks and debt and equity percentages determine a company's total risk, but the relationship between bond ratings (risk) and the cost of capital is a fundamental capital market principle. "More debt and less equity, for any level of operating risk, will result in a lower bond rating and higher interest costs for debt."[14] Stated another way, an authorized ROE of 11.25% for KCPL is, in effect, a higher award than an 11.25% ROE would be for Aquila. With regard to the 10.9% ROE awarded to Empire, Aquila's six-year construction expenditures as a percentage of net plant is 118.2 percent, compared with only 74.3 percent for Empire, supporting a higher authorized ROE for Aquila.[15]

Furthermore, like KCPL, Aquila is a partner in the Iatan II power plant, and, as such, has significant capital needs in connection with that and other construction projects. Denny Williams testified regarding Aquila's construction plans, and Dr. Hadaway explained the "construction risk" associated with these plans.[16] An adder or adjustment for this construction risk is necessary in order for Aquila's authorized ROE to comply with the standards set forth in *Hope* and *Bluefield*. Without this upward

[14] Hadaway Exh. 013, p. 12.
[15] Hadaway Exh. 014, SCH-17.
[16] Hadaway Exh. 013, pp. 4-5; Hadaway Exh. 014, p. 19; Hadaway Exh. 015, p. 13.

adjustment from the DCF-indicated reference group ROE, Aquila, with construction expenditures as a percentage of net plant at 118.2 percent, would be unable to complete with other enterprises – such as Dr. Hadaway's group of comparables, which have construction expenditures as a percentage of net plant at an average of only 60.9 percent.

During the evidentiary hearing, a misguided, and perhaps less than forthcoming attempt was made to demonstrate that Aquila's construction plans and capital needs are not viewed by the Company as serious risk factors. Exhibit 512, a *portion* of Aquila's 2006 Form 10-K was admitted into evidence at the request of the Industrials. Contrary, however, to the suggestion of the Industrials, this document, on its face, actually confirms the significance of Aquila's construction expenditures. Moreover, on redirect by Aquila, Exhibit 038, another part of the 10-K, was admitted into evidence, thereby completing the picture and demonstrating that the Company's construction requirements through 2009 are well over one billion dollars.[17] In fact, the Industrial's own ROE witness, Mr. Gorman, recognized Aquila's construction risk, and, for this reason, testified that he would support an ROE for Aquila "a little higher" than what he would support for other utility companies.[18]

A less-than-successful attempt was also made to discredit Dr. Hadaway's testimony with regard to risk factors and rate of return. Many questions were put to Dr. Hadaway on cross examination regarding how nuclear power and other specific elements of risk impact his proxy companies.[19] Each of these elements, however, had been fully considered and taken into account by Dr. Hadaway. He explained in his

[17] Tr. pp. 429-431.
[18] Tr. pp. 527-528.
[19] *See* Tr. beginning on page 333.

direct testimony[20] and later at the hearing the "screens" he employed in selecting his reference group of comparable companies. Regulated operations were at least 70 percent of operating revenues and were, on the average, 87% of the total revenue for each sample company, thus making these other elements (i.e. nuclear activities) "non-events" in terms of risk.[21]

Furthermore, each of these elements are fully considered and quantified by Standard & Poor's ("S&P") in arriving at the business profile risk number to assign to each company. To determine a utility's business profile, S&P analyzes various business or operating characteristics including markets and service area economy, competitive position, fuel and power supply, operations, asset concentration, regulation, and management.[22] Clearly, matters such as nuclear operations are taken into account by S&P. "Construction risk", however, is not mentioned by S&P in its business profile assessment, thus justifying an independent review of these circumstances as undertaken by Dr. Hadaway.

Next, as noted by Dr. Hadaway during the evidentiary hearing, many of the companies included in the 2006 rate decisions (reflecting the 10.36 average ROE) are distribution only or transmission and distribution only companies.[23] They are not "fully integrated" companies like Aquila. Fully integrated utilities are considered to be riskier, because such companies, with generation, transmission, and distribution functions, are

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[20] Hadaway Exh. 013, p. 4.
[21] Tr. p. 354, l. 11-23.
[22] *See* Exh. 039. Standard and Poor's U.S. Utility and Power Ranking List for May 2006 (Exhibit No. 039) was made a part of the record of this proceeding, subject to objection. As is demonstrated herein, there is ample additional evidence in the record supporting the concept of relative risk illustrated by Exhibit 039.
[23] Tr. pp. 381-382.

considered operationally more risky than "wires only" transmission and distribution companies.[24]

There can be no real argument on this point. In addition to the testimony of Dr. Hadaway regarding the higher risk associated with integrated companies like Aquila when compared to T&Ds, Staff witness Parcell referenced S&P's scale of one (low risk/excellent) to ten (high risk/vulnerable), stating that so-called "wires" companies are in the lower to mid range. Staff witness Parcell conceded that integrated companies like Aquila, on the other hand, are viewed as more risky, with numbers in the range of five to seven.[25] Mr. Gorman, the witness for the Industrials, also testified regarding the S&P business profile, stating that integrated electric utilities have business profile scores in the range of four to six.[26]

Consequently, it is readily apparent that the ROE average of 10.36 was lowered by the inclusion of the rate decisions involving the T&D companies, as ROEs for T&Ds are traditionally not as high as authorized ROEs for fully integrated utilities such as Aquila.[27]

Looking specifically to the 25 reported electric utility rate cases for 2006, there are ten distribution only or T&D companies and 15 vertically integrated companies. As indicated in the following table, the lower risk distribution only and T&D companies had authorized ROEs ranging from 9.55 to 10.20 percent, with an average of 9.91 percent for 2006. The corresponding S&P business profile score is also reflected on the table.[28]

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[24] Hadaway Exh. 013, pp. 11-12.
[25] Tr. pp. 496-497.
[26] Tr. p. 531.
[27] Tr. pp. 381-382, 423-424, 446.
[28] Exh. 039.

T&D Utilities

No.	Date	Company (Type)	State	ROE	S&P Bus. Profile
1	1/27/2006	United Illuminating (Distribution)	CT	9.75%	n/a
2	6/6/2006	Delmarva Power & Light (Distribution)	DE	10.00%	3
3	7/6/2006	Maine Public Service (Distribution)	ME	10.20%	n/a
4	7/24/2006	Central Hudson Gas & Electric (T&D)	NY	9.60%	3
5	7/28/2006	Commonwealth Edison (T&D)	IL	10.05%	4
6	8/23/2006	New York State Electric & Gas (T&D)	NY	9.55%	3
7	10/6/2006	Unitil Energy Systems (Distribution)	NH	9.67%	n/a
8	11/21/2006	Central Illinois Light (T&D)	IL	10.12%	6
9	11/21/2006	Central Illinois Public Service (T&D)	IL	10.08%	4
10	11/21/2006	Illinois Power (T&D)	IL	10.08%	4
Average T&D				9.91%	3.9

On the other hand, the more risky vertically integrated utilities like Aquila had authorized ROEs ranging from 10.0 to 11.25 percent, with an average of 10.65 percent for 2006, thereby indicating a zone of reasonableness cap of 11.65 percent.[29]

Vertically-Integrated Utilities

No.	Date	Company	State	ROE	S&P Bus. Profile
1	1/5/2006	Northern States Power	WI	11.00%	5
2	3/3/2006	Interstate Power and Light	MN	10.39%	5
3	7/6/2006	PacifiCorp	WA	10.20%	5
4	4/18/2006	MidAmerican Energy	IA	11.90%	5
5	4/26/2006	Sierra Pacific Power	NV	10.60%	6
6	6/27/2006	Upper Peninsula Power	MI	10.75%	n/a
7	7/26/2006	Appalachian Power	WV	10.50%	5
8	9/1/2006	Northern States Power	MN	10.54%	5
9	9/14/2006	PacifiCorp	OR	10.00%	5
10	12/1/2006	PacifiCorp	UT	10.25%	5
11	12/1/2006	Public Service of Colorado	CO	10.50%	4
12	12/7/2006	Central Vermont Public Service	VT	10.75%	6
13	12/21/2006	Empire District Electric	MO	10.90%	6
14	12/21/2006	Kansas City Power & Light	MO	11.25%	6

29 Even if one removes from this list the results from Wisconsin and Missouri, as suggested by Staff's designated expert witness, Stephen Hill, in Commission Case No. ER-2007-0002, 12 vertically integrated companies remain with authorized ROEs ranging from 10.0 to 11.9 percent, with an ROE average for 2006 of 10.55 percent.

15	12/22/2006	Green Mountain Power	VT	10.25%	5
Average Vertically-Integrated				10.65%	5.2

In summary, the evidence demonstrates a clear disparity between the risk associated with vertically integrated utilities (like Aquila) and T&D only companies. The national average ROE for integrated utilities is notably higher than the national average ROE for T&D only companies. Integrated utilities are riskier and require higher authorized ROEs.

In addition, the Commission should consider the fact that MPS and L&P, relatively speaking, are small utilities. Their size, as compared with Dr. Hadaway's proxy group, indicates greater risk and the necessity for a higher authorized return on equity.[30]

Furthermore, given its load profile and concentration of residential load, Aquila is more dependent on natural gas in the generation of electricity and is, therefore, subject to the risks associated with fluctuations in the cost of that and other fuels. Dr. Hadaway, however, did not make an upward adjustment to his ROE to account for this risk. This is because most of the companies that make up his proxy group have fuel recovery mechanisms. As a consequence, Dr. Hadaway's 10.75% starting point is based on the assumption that a fuel adjustment mechanism will be authorized for Aquila in this proceeding. If no such mechanism is authorized, an upward ROE adjustment will be necessary to account for this additional risk.

Lastly, the record reflects that Aquila has taken a series of positive steps to improve its financial condition. In this regard, the Company's asset sale strategy has

[30] Hadaway Exh. 013, pp. 4-5; Hadaway Exh. 014, p. 19.

improved Aquila's balance sheet position and will continue to provide much improved access to required capital for utility infrastructure investments.[31] It is fair to say that Aquila is on the way to restoring its financial integrity which should ultimately lead to an investment grade bond rating.

In summary, based on his DCF and risk premium results, and given the current market, industry, and company-specific factors appropriate for the case, including a 50 basis point adjustment for construction risk, Dr. Hadaway estimates the fair cost of equity for MPS and L&P at 11.25 percent.[32] Dr. Hadaway's chosen methodology, as set forth in his direct, rebuttal, and surrebuttal testimony and as further explained at the evidentiary hearing, provides an appropriate approach for estimating each operating division's cost of equity capital.

D. Intervenor Positions

Little or no weight should be given to the ROE testimony offered by Staff witness Parcell, Industrial witness Gorman, or Public Counsel witness Trippensee. The recommendations of these witnesses do not satisfy the principles of *Hope* and *Bluefield*. As is explained by Dr. Hadaway, Mr. Gorman's financial integrity analysis is essentially an academic exercise. Mr. Gorman fails to provide consideration for the divisions' construction risks and the size of their required construction budgets.[33] It is no surprise that Mr. Gorman simply went through this "academic exercise," as he readily admitted on cross examination that he believes the Commission has recently authorized ROEs

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[31] Hadaway Exh. 013, pp. 13-14.
[32] This recommendation is 25 basis points lower than the ROE requested in the Company's original filing on July 3, 2006. The net 25 basis point reduction consists of two parts: (1) the base cost of equity for Dr. Hadaway's comparable group was lowered to 10.75 percent; and (2) the Company updated its construction requirements, resulting in a recommended construction risk adder of 50 basis points (instead of 25 basis points). Hadaway Exh. 014, pp. 18-19.
[33] Hadaway Exh. 014, p. 5.

which are higher than necessary to fairly compensate the utilities.[34] Similarly, Staff witness Parcell offers an "obsolete coverage ratio analysis" to support his recommendations, and he makes no attempt to consider Aquila's prospective condition on a going-forward basis.[35]

The recommendations of Mr. Parcell and Mr. Gorman are inadequate, and Public Counsel witness Trippensee does not even provide an indication of the effect of his recommendation. Many of the problems with the chosen methodologies and resulting recommendations of these witnesses are detailed in Dr. Hadaway's pre-filed rebuttal and surrebuttal testimony and in the Company's prehearing brief. It should be noted, however, that at the evidentiary hearing in this matter, Staff witness Parcell acknowledged that witnesses before FERC generally need to utilize FERC's chosen methodology in order to have their testimony given weight.[36] Mr. Parcell also testified that he had reviewed recent decisions of this Commission.[37] Armed with this knowledge, Mr. Parcell utilized a reference group of only five companies and recommends an ROE of only 9.625 percent (midpoint of his range of 9.0 to 10.25 percent). This small reference group approach is wrong because the resulting calculation can easily be dominated by unusual data for one or two of the companies, as is the case with Mr. Parcell's analysis.[38]

Additionally, the results of Mr. Parcell's own DCF analyses are well below the zone of reasonableness for this proceeding (approximately 9.36 to 11.36 percent). Using his selected five companies, Mr. Parcell arrived at a mean of 8.1 percent; and

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[34] Tr. p. 521.
[35] Hadaway Exh. 014, p. 5.
[36] Tr. p. 473.
[37] Tr. p. 478.
[38] Hadaway Exh. 014, p. 8.

using Dr. Hadaway's comparables, Mr. Parcell arrived at a mean of 8.2 percent.[39] Mr. Parcell simply disregarded these numbers,[40] as they clearly would not pass a basic check of reasonableness. Mr. Parcell then turned to his highest DCF results, as shown on page 24 of his direct testimony. Even these numbers are skewed. If you remove one company (Cleco) with an out-lying First Call EPS growth rate from Mr. Parcell's sample set, the result is 8.3 percent. Try as he might, Mr. Parcell simply could not arrive at a fair and reasonable estimate of the proper rate of return on equity for Aquila's MPS and L&P Missouri operating divisions, and Mr. Parcell's ROE recommendation should be disregarded by this Commission.

The purported ROE testimony of Public Counsel witness Trippensee should also be disregarded by this Commission. The information relied upon by Mr. Trippensee is so slight as to render his opinion fundamentally unsupported. Mr. Trippensee states that the authorized ROE for Aquila should be reduced if a fuel adjustment clause is adopted in this case, but most of the companies in Dr. Hadaway's group of comparables already have fuel and purchased power cost recovery adjustment clauses,[41] and Mr. Trippensee himself acknowledged that the DCF model takes into account this factor.[42] If Aquila's two Missouri operating divisions are granted a fuel adjustment clause, they will simply be like Dr. Hadaway's comparable group companies. On the other hand, if the Company's FAC request is denied, as is urged by Public Counsel, then the Company's Missouri operating divisions will be even more risky, and the cost of common equity, as computed by Dr. Hadaway, will be understated.

[39] Tr. pp. 481-485.
[40] Tr. pp. 481-482.
[41] Hadaway Exh. 014, p. 18.
[42] *See* Tr. p. 456, l. 11-18.

III. <u>SIBLEY ACCOUNTYING AUTHORITY ORDERS</u>

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?

The testimony at the hearing showed that the Commission granted two separate accounting authority orders ("AAO") addressing Aquila's extraordinary expenditures in connection with the Sibley life extension project (the "Rebuild") and the western coal conversation project. The Sibley Rebuild occurred between 1986 and 1993[43] and the associated Accounting Authority Order (AAO) covered a period spanning from 1989 through September of 1990 and a second period of October 1990.[44] The AAO associated with the western coal conversation project covered the period from January 1992 to June of 1993.[45] In each case, the Company was allowed the amortization expense over a 20 year period, plus the inclusion of the unamortized amount in rate base.[46]

The Sibley Rebuild extended the life of the three generating units at the Sibley Power Station by twenty (20) years. If this project not have been undertaken, then MPS would have had to have found alternative sources of energy to meet its customer's demand before Units 1 and 2 were retired from use in 1990 and Unit 3 by the mid-1990s.[47] The western coal conversation project at the Sibley Power Station allowed MPS to achieve significant reductions in sulfur dioxide emissions and allowed the Company to stay in compliance with the federal Clean Air Act amendments.[48]

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[43] Klote Tr. p. 94, l. 21
[44] *Id.*, l. 21-23.
[45] Klote Tr. p. 94, l. 24-25; p. 95, l. 1.
[46] Klote Tr. p. 95, l. 21-24.
[47] Klote Exh. 018, p. 49, l. 16-19.
[48] *Id.*, l. 19-22.

The Commission's conclusion that these expenses were extraordinary in nature justified the special accounting treatment. Allowing the deferral of the costs allowed the Company to avoid a series of rate cases that otherwise would have been timed to capture the staged elements of the Sibley Rebuild and the western coal conversation projects. In issuing its deferral orders, the Commission recognized the public benefits of this approach.[49]

Aquila and Staff agree that the unamortized balances of the AAOs should be included in rate base. Public Counsel, however, disagrees but without reasonable basis. As noted in its initial brief, Aquila is seeking the same ratemaking treatment for the Sibley AAO deferral as it received in two prior rate cases, that is, Case Nos. ER-90-101[50] and ER-93-37.[51] Public Counsel, relying on a Commission decision in a subsequent MGE rate case (Case No. GR-98-140), claims that the treatment of these costs should be handled differently than in the past.[52] The arguments in support of this contention are misleading and, ultimately, unpersuasive.

First, Public Counsel's reliance on the MGE decision as precedent for change is entirely unjustified. Public Counsel has failed to point out that a reconsideration order of the Commission in the MGE case expressly concluded that it was not granting retroactive application of its exclusion of unamortized balances of certain deferrals that already had been included in rate base. In this regard, the Commission stated as follows:

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[49] December 27, 1989 *Order Concerning Application for Approval of Accounting Procedure and Consolidating Dockets*, Case No. EO-90-114 and *Report and Order* in Case Nos. EO-91-358 and EO-91-360, 1 Mo. P.S.C. 3d 200 (1991). The latter case included an extensive and thoughtful analysis of the purpose of and requirements for an AAO.

[50] *Re Missouri Public Service*, 30 Mo.P.S.C.(N.S.) 320, 336-341 (1990).

[51] *Re Missouri Public Service,* 2 Mo.P.S.C.3d 230, 233-237 (1994).

[52] The MGE case addressed recovery of service line replacement program ("SLRP") costs.

> If MGE can separate the funds affected under prior decisions which permitted the unamortized balance to be included in the rate base from the SLRP deferral amounts deferred under the authority of the most recent accounting authority order in Case No. GO-97-301, **the Commission has no objection to its doing so and continuing to include unamortized balance amounts existing and treated during prior rate cases in the rate base.**[53] (emphasis added)

In other words, the Commission was <u>not</u> changing its prior policy of permitting rate base treatment of previous SLRP deferrals.

With respect to the Sibley deferrals, the amounts in question all relate back to the AAOs that were issued in late 1989 and early 1990s, and concerning which rate base treatment already has been granted. In contrast to the case that addressed the MGE SLRP deferrals, no additional deferred amounts are under consideration in this case. Consequently, the MGE decision provides <u>no justification</u> for different ratemaking treatment of the same deferred amounts as were allowed in rate base in the past. To the contrary, the Commission's orders in the MGE case upon which Public Counsel's argument is premised actually support Aquila's and Staff's proposed ratemaking treatment in this case.

Second, the SLRP deferrals in the MGE case were allowed to be recovered over a period of ten years instead of twenty as is the case with the Sibley AAOs. This is a significant factual distinction that justified a different ratemaking treatment. Aquila witness Ronald Klote made this point during the evidentiary hearing.

> Now, there were unique circumstances, I think, in that case that -- that really supports the argument that these costs are looked at on a case-by-case basis. In that MGE case, instead of using a twenty (20) year amortization period, that amortization period was moved to a ten (10) year amortization period, and, basically, return of those -- those

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[53] *Order Granting Reconsideration And Rehearing In Part, Order Denying Reconsideration And Rehearing In Part, And Order Denying Motion To Stay And Alternative Request To Collect Subject To Refund*, 8 Mo. P.S.C.3d 2, 3 (1998).

> amounts were sped up. So there were unique circumstances that -- that may have led to -- to that.[54]

Ultimately, there is no compelling factual parallel between the MGE case and the Sibley deferrals in this case.

Third, Public Counsel's advocacy for a different ratemaking treatment of the Sibley AAO deferral also ends up with an unjust result. Public Counsel's argument that Aquila should be entitled to a return <u>of</u> but not a return <u>on</u> the Sibley deferrals ignores the fact that the 20 year deferral denies Aquila the time value of money associated with the expenses incurred many years ago in the Sibley Rebuild and western coal conversation projects. No rational financial institution would ever agree to such terms and Aquila should not be expected to extend an interest-free loan either.

Finally, Public Counsel's position in this case is inherently contradictory. During cross-examination, Public Counsel witness Ted Robertson stated that he was articulating the official position of the Office of the Public Counsel and not just his personal opinion.[55] Significantly, Mr. Robertson stated that in no circumstances would he support a return on as well as a return of costs placed in a regulatory asset account.[56] The problem with this contention is that it is contradicted by the record in this case.

For example, with respect to the issue of demand-side management ("DSM") costs, Public Counsel witness Ryan Kind was asked the following:

> Q. Does Public Counsel support Ms. Mantle's DSM cost recovery proposal?

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[54] Tr. p. 99, l. 20-25; p. 100, l. 1-4.
[55] Tr. p. 190, l. 4-7.
[56] Tr. p. 189, l. 7-11.

> A. Yes.[57]

Staff witness Lena Mantle's recommendation concerning the handling of those costs is illuminating.

> Q. What methodology are you proposing for recovery of Aquila's demand-side costs?
>
> A. I am proposing the demand-side costs that were incurred in the test year other than the costs of the energy efficiency programs agreed to in Aquila's last rate case, be placed in a regulatory asset account and amortized over a ten (10) year period. Further, **under this proposal Aquila would be allowed to place its future demand-side costs in the regulatory account where they would be allowed to earn a return not greater than Aquila's Allowable Funds Used During Construction (AFUDC) rate.[58]** (emphasis added)

No explanation for these differing approaches has been provided by Public Counsel. Clearly, Public Counsel's ratemaking philosophy on the topic of a return on deferred costs is extremely malleable and, for ratemaking policy purposes, unreliable.[59]

Ultimately, Public Counsel has given no legitimate legal, policy or factual basis for changing the manner in which the Sibley AAO costs historically have been handled for ratemaking purposes. In fact, its proposal concerning the Sibley AAOs contradicts its proposal for recovery of Aquila's DSM costs. Absent a compelling showing to the contrary, a showing that has not been made, there is no legitimate basis for the Commission to deviate from its past practice on this issue.

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[57] Exh. 402, p. 4, l. 22, 23 and p. 5, l. 1.

[58] Exh. 217, p. 3, l. 5-12.

[59] It should be noted that the Stipulation and Agreement as to Certain Issues filed in this case, signed by Public Counsel and approved by the Commission on April 12, 2007, resolved this issue in the following manner:

> The Signatories agree that for ratemaking purposes Aquila will defer the costs of DSM programs in Account 186 and calculate allowance for funds used during construction (AFUDC) annually.

IV. FUEL COST RECOVERY

Should the Commission authorize Aquila to use a fuel and purchased power recovery mechanism allowed by 4 CSR 240-20.090?

Although automatic cost recovery mechanisms date back to the early years of the twentieth century, the fuel and energy cost increases that electric utilities experienced during the 1970s because of the Arab oil embargo saw the use of such mechanisms greatly expand. Regulators embraced automatic cost recovery mechanisms for two primary reasons: 1) they recognized that utilities are legally entitled to recover prudently-incurred fuel and purchased power costs, and 2) they realized that traditional modes of regulation were inadequate to achieve full recovery of such costs in an environment of volatile and/or increasing fuel and energy costs.[60]

The Virginia State Corporation Commission explained the need for automatic adjustment mechanisms as follows:

> [T]he main purpose of the escalator clause is procedural: When prices are rising, the time that necessarily elapses between the date when earnings fall fellow the permissible minimum rate of return and the date when the commission enters its order allowing increased rates, is a time during which the utility earns less than a fair and reasonable return. . . .
>
> The inevitable delay between the happening of an event that entitles a party to legal relief and the date when he gets relief, makes it impossible in some kinds of cases for law and equity to do complete justice. Ever since Hamlet mentioned "the law's delay" as on of the things that made him wonder whether it would be better "to be or not to be, " lawyers and legislators have sought ways of overcoming so far as possible the time lag in the machinery of justice. One purpose of the fuel clause in electric rate schedules and the escalator clause in natural gas rate schedules is to keep the mere lapse of time from operating in favor of or against either the stockholders or the consumers.

Lynchburg Gas Co., 6 P.U.R. 3d 33, 35-36 (1954).

[60] *See* Sydney Jerald Martin, Comment, *The Fuel Adjustment Clause and Its Role in the Regulatory Process*, 47 Miss. L. J. 302 (1976).

Currently, regulatory commissions in 27 of the 29 non-restructured states[61] and 42 states altogether[62] allow electric utilities under their jurisdictions to employ some form of automatic fuel and purchased power cost recovery mechanism. However, for almost thirty years – since the Missouri Supreme Court's 1979 decision in *State ex rel. Util. Consumers Council of Missouri v. Pub. Serv. Comm'n.*[63] – Missouri's electric utilities have been denied the ability to use automatic rate adjustment mechanisms to assure timely recovery of their prudently-incurred fuel and purchased power costs. But with the passage of Senate Bill ("SB") 179,[64] the Missouri General Assembly removed the obstacles that had prevented the Commission from authorizing fuel and energy cost recovery mechanisms for electric utilities operating in this state. Now the Commission is free to "approve rate schedules authorizing an interim energy charge, or periodic rate adjustments outside of general rate proceedings to reflect increases and decreases in [a utility's] prudently incurred fuel and purchased power costs."[65] And in so doing, the Commission can re-join the regulatory mainstream where federal and state regulators have found automatic cost recovery mechanisms to be a tool that is not only useful but is also necessary to allow them to fulfill their legal obligation to set rates that allow electric utilities to have a reasonable opportunity both to recover their prudently-incurred operating costs and to earn a fair rate of return.

Aquila was the first Missouri electric utility to request an automatic fuel and energy cost recovery mechanism (hereinafter referred to as a "fuel adjustment clause" or "FAC") in a general rate case whose operation of law date fell after the effective date

[61] Tr. p. 818.
[62] Exh. 009, p. 11.
[63] 585 S.W. 2d 41.
[64] Codified as Section 386.266, RSMo 2005.
[65] Section 386.266(1), RSMo.

of the Commission's fuel adjustment rules.[66] The evidence presented during hearings on this issue clearly established: 1) that Aquila's request complies with all requirements of both Section 386.266, RSMo, and the Commission's FAC rules; 2) the proposed FAC protects the legitimate interests of both Aquila and its customers; and 3) the Company requires an FAC because traditional modes of ratemaking, including the Interim Energy Charge ("IEC"), have not allowed Aquila a reasonable opportunity either to fully and timely recover its prudently-incurred fuel and purchased power costs or to earn a fair rate of return.

A. Why Aquila Needs an FAC

Much of the evidence establishing Aquila's need for an FAC is uncontroverted. For example, no party challenged the fact that fuel and purchased power costs constitute approximately 46 percent of the Company's total annual operating expenses[67] or that those costs have increased between 13-20 percent annually for each of the past three years.[68] Similarly, no party contested the Company's assertion that, because traditional modes of ratemaking have prohibited Aquila from adjusting its rates to pass-through cost increases as they are incurred, the return on equity the Company has been able to earn on its Missouri operations has suffered greatly. For 2006, Aquila's L&P Division earned a ***negative return on equity***, and the return earned by the MPS Division for the same period was ***less than four percent***.[69] In Case No. ER-2004-0034 Aquila sought to remedy, or at least mitigate, the effect under-recovered fuel and energy

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[66] The Company's proposed FAC is described at pages 3-5 of the direct testimony of Dennis Williams (Exh. 032), at pages 6-7 of his surrebuttal testimony (Exh. 034), and at pages 44-46 of Aquila's Pre-Hearing Brief.
[67] Exh. 034, p. 5
[68] *Id.*, p. 6.
[69] Tr. pp. 668-69.

costs were having on earnings by implementing an IEC. But the anticipated relief never materialized because, over the twenty months rates set in that case were in effect, under-recovery of fuel and purchased power costs continued totaling approximately $34 million for that period.[70]

Other evidence, although contested, further supports Aquila's need for an FAC. The following statements from the Company's 2005 Form 10-K Report,[71] which is filed annually with the Securities and Exchange Commission, explain the financial impacts that increasing fuel and energy costs, coupled with the lack of an automatic adjustment mechanism, have had and will continue to have on Aquila:

- "Our [Aquila's] fuel and purchased power costs for our Missouri electric utilities are expected to significantly exceed the costs we are able to pass through to customers during 2006 . . . ***Our inability to pass through fuel and purchased power costs to our Missouri electric customers may also adversely affect our ability to satisfy the financial covenants in our credit agreements***, which if breached could cross default our other debt instruments.[72] (emphasis added)

- "In Missouri, which is our largest service area, we currently do not have the ability to adjust the rates we charge for electric service to offset all or part of any increase or decrease in prices we pay for fuel we use in generating electricity or for purchased power (i.e., a fuel adjustment mechanism). ***These costs could substantially reduce our operating results***.[73] (emphasis added)

- "If rules implementing the adopted fuel adjustment legislation are delayed, ***we may incur significant losses if we are not otherwise permitted to pass through to ratepayers costs associated with fuel purchases for our Missouri electric operations***.[74] (emphasis added)

[70] Tr. p. 596.
[71] At the Company's request, and pursuant to Section 536.070(6), RSMo, the Commission took administrative notice of Aquila's 2005 Form 10-K Report. Tr. p. 941.
[72] Tr. p. 920.
[73] Tr. p. 921.
[74] Tr. p. 922.

It is well established that, as a matter of constitutional law, public utilities are entitled to rates that allow them a reasonable opportunity both to recover their prudently-incurred operating costs and to earn a fair return on equity.[75] And it goes without saying that rates that do not allow full recovery of the largest single item of a utility's annual cost of service are unlikely to satisfy that legal requirement. Indeed, in explaining the applicable legal standard, the Court in *Hope* specifically noted that "[f]rom the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the company."[76] But, as noted previously in this brief, due largely to increasing fuel and energy costs the 2006 return on equity for Aquila's L&P Division was negative – which means that rates for that division were not sufficient to cover either its operating expenses or its capital costs.

The shortcomings that are inherent in traditional ratemaking are responsible for this result.[77] Because base rates are set using estimates of test period costs, including fuel and energy costs, if those estimates are too low – as they often are in periods of rising prices for fuel and purchased power – then the utility will not recover its operating costs and will not have a reasonable opportunity to earn a fair rate of return. But the problems that afflict the one-year test period used to set rates are compounded by the fact that rates are usually set for more than one year, and the reliability of estimates of future fuel and purchased power costs do not improve the farther removed they are from the present. Finally, regulatory lag prevents utilities, like Aquila, from promptly

[75] *See FPC v. Hope Nat. Gas. Co*, 320 U.S. 591, 603 (1944); *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n.*, 262 U.S. 679, 692 (1923).
[76] *Hope*, *supra*, at 603.
[77] See discussion at pp. 39-40 of Aquila's Pre-Hearing Brief.

addressing the reduced earnings that result from inaccurate cost estimates used to set rates. In Missouri, the normal lag between a request for a rate increase and an order authorizing one is 11 months. Throughout this period the under recovery of a utility's fuel and energy costs continues to mount and its earnings continue to deteriorate. And there is no lawful way for the utility to recoup those earnings after-the-fact.

The only way that Aquila can escape the recurring cycle of under-recovered fuel and energy costs and the under-earnings that inevitably follow is for the Commission to authorize a properly designed FAC that assures the Company will timely recover all of its prudently-incurred fuel and purchased power costs. That is the conclusion that the overwhelming majority of other state regulatory commissions have reached; and that is the conclusion this Commission should reach – and act on – as well.

B. The Legal Standards Governing FACs in Missouri

Under applicable law, the Commission may approve any FAC that satisfies only five requirements, four of which are specifically prescribed by Section 386.266, RSMo. The statutory requirements are:

1. the proposed FAC must be reasonably designed to provide the utility a sufficient opportunity to earn a fair return on equity;[78]

2. the proposed FAC must include provisions for an annual true-up to address under- or over-collections, including interest at the utility's short-term borrowing rate;[79]

3. the proposed FAC must include provisions requiring the utility to file a general rate case with the effective date of new rates no later than four years after the effective date of the FAC;[80] and

4. the proposed FAC must provide for prudence reviews of costs subject to the clause no less frequently than every 18 months.[81]

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[78] Section 386.266(4)(1), RSMo.
[79] Section 386.266(4)(2), RSMo.
[80] Section 386.266(4)(3), RSMo.

The fifth, and final, requirement is that the proposed FAC must satisfy the requirements of 4 CSR 240-20.090, the Commission's rule that governs applications to establish, continue, or modify automatic rate adjustment mechanisms.

Aquila's proposed FAC satisfies each of these requirements. By allowing the Company to timely recover all of its prudently-incurred fuel and purchased power costs, the FAC is designed to finally provide a reasonable and sufficient opportunity to earn a fair rate of return. That opportunity will be negated, however, if any of the "sharing" proposals advanced by other parties to this case are adopted.[82] Aquila's proposal also provides for an annual true-up to address under- and over-collections and for review of the FAC in a general rate case to be filed within 37 months of its effective date. In addition, although the statute requires that a prudence review be conducted at least every 18 months, the Company's proposal exceeds that standard by requiring annual prudence reviews.[83]

The Company's proposal also satisfies the requirements of 4 CSR 240-20.090, the rule governing requests for automatic rate adjustment mechanisms. Information related to each of the items prescribed in 4 CSR 240-3.161(2)(A) through (S) is provided either in Exhibit 032, the direct testimony of Dennis Williams, or in Exhibit 024, the direct testimony of Davis Rooney. An index showing where in the testimonies of these witnesses evidence can be found that relates to each of the filing requirements specified in the Commission's rules is attached to this brief as Appendix A.

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[81] Section 386.266(4)(4), RSMo.
[82] See discussion *infra* at pp. 31-37.
[83] Aquila's proposed FAC is described in detail in Exh. 032, pp. 3-5; Exh. 34, pp. 6-7; and at pp.44-46 of the Company's Pre-Hearing Brief.

In the written testimonies that were pre-filed in this case, no party challenged the overall sufficiency of Aquila's request for an FAC. Staff witness Michael Taylor came closest when he stated in his rebuttal testimony that he did not believe that the heat rate and/or efficiency testing procedures that were proposed in Mr. Rooney's direct testimony satisfied the requirements of 4 CSR 240-3.16(2)(P).[84] However, during cross examination regarding this testimony, Mr. Taylor acknowledged that there is a difference between a proposal that Staff deems to be inadequate and a proposal that fails to comply with the rules altogether.[85] From his testimony it appears that Mr. Taylor simply believes the Company's proposal for compliance with 4 CSR 240-3.161(2)(P) is inadequate – not that it fails to comply with the rule.[86]

The only other questions regarding the Company's filing were raised by Public Counsel witness Ryan Kind, who stated that he had "not been able to locate" certain information required by 4 CSR 240-3.161(2) and criticized the Company for failing to include "some kind of roadmap" to guide readers to the information that was responsive to each of pertinent filing requirements.[87] But nowhere did Mr. Kind allege that Aquila's request was deficient because it failed to comply with the Commission's rules. Indeed, after the Company, in response to a data request, provided Mr. Kind the "roadmap" he sought, neither he nor any other witness for the Public Counsel raised – or even mentioned – any concerns about the sufficiency of Aquila's filing in their rebuttal or surrebuttal testimonies.[88]

[84] Exh. 227, pp. 3-4.
[85] Tr. pp. 953-54.
[86] Tr. pp. 954-55.
[87] Exh. 401, pp. 15-16.
[88] See, Exh. 402-408.

During hearings on this issue, however, it appeared that Public Counsel and one or more other parties attempted to raise for the first time – and to support with live testimony – questions regarding whether Aquila's request for an FAC complies with certain of the requirements of 4 CSR 240-3.161(2). This was done over the objections of the Company's counsel[89] and during the redirect examination of Mr. Kind – a time when, under the Commission's hearing procedures, Aquila had neither the opportunity to challenge that testimony through cross examination or to put on controverting evidence.[90] This tactic is reprehensible and should not be allowed to succeed for several reasons: 1) it violates the requirement that parties pre-file their testimony and evidence; 2) it constitutes unfair surprise in that it raises new issues for consideration at the eleventh-hour; and 3) it denies Aquila its due process right to meaningfully confront the witnesses against it and to present an adequate defense. Most importantly, however, is the obvious conclusion that Mr. Kind's redirect testimony on this topic was a mere afterthought and not one to be taken seriously by the Commission.[91]

The appropriate penalty for this attempt to circumvent the procedural schedule in this case, the Commission's rules, and applicable principles of law is for the Commission to disregard the offending portions of Mr. Kind's live testimony. But regardless of whether it elects to impose this penalty, the evidence presented in the pre-filed direct testimonies of Messrs. Williams and Rooney clearly establishes that Aquila has complied with the requirements of the Commission's rules governing applications for an FAC. Certainly, the Commission is free to reject the manner of compliance with

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[89] Tr. pp. 925-26.
[90] *See*, Tr. pp. 925-29.
[91] Had Public Counsel or any other party genuinely believed Aquila's filing was deficient, certainly one would have expected that claim to have been raised in pre-filed testimony as required by the Commission's Rule 4 CSR 240-2.130(7).

those rules that has been proposed by the Company and to substitute alternate means or methods for compliance that the Commission deems to be more appropriate. But, as Mr. Taylor noted, disagreement with Aquila's proposal does not imply or establish non-compliance with the Commission's rules.

In addition, several parties to this case have suggested numerous other standards – beyond those included in Section 386.266, RSMo and the Commission's FAC rules – that they argue Aquila should be required to meet before it is authorized to implement an FAC. But these standards: 1) are not required by law, 2) have already been rejected by the Commission or otherwise addressed, or 3) constitute bad regulatory policy. For example, the Industrials argue that the Company should be required to demonstrate "acute need"[92] and Public Counsel suggests a showing of a "substantial threat to its financial viability"[93] before Aquila is allowed an FAC. Although the evidence of Aquila's acute need for an FAC is abundant, the Commission has already addressed – and dismissed – these contentions. At page 14 its final order of rulemaking for 4 CSR 240-20.090, the Commission stated that "an earnings threshold for eligibility to use a RAM is contrary to the intent of the legislature, as articulated in SB 179."[94]

Public Counsel also argues that the Commission should make a determination as to whether an FAC is in the public interest.[95] But no such determination is necessary because the General Assembly already answered that question when it enacted SB 179 and authorized the Commission to approve FACs for electric utilities.

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[92] Exh. 505, p. 9.
[93] Exh. 401, p. 4.
[94] *Final Order of Rulemaking*, Case No. EX-2006-0427 (September 21, 2006).
[95] Exh. 401, p. 3.

The list of suggested additional standards goes on and on, although no party proposing any of them offered any legal support for requiring Aquila to meet any or all of those standards before it is authorized to implement an FAC. The reason for this is simple: there is no legal support and most, if not all, of the suggested standards have already been considered by the legislature, the Commission, or both, and have been rejected. Both the legislature and the Commission have spoken as to what standards the Company's proposed FAC is required to meet before it can be approved. Any additional standards are proposed for one reason and one reason only: to thwart the will of the legislature and the Commission, as expressed in SB 179 and the FAC rules, and to deny access to the FAC that Aquila is entitled to and has clearly documented its needs.

C. Full Recovery of Fuel and Purchased Power Costs vs. "Sharing"

Aquila's proposed FAC provides for a complete pass-through of all prudently-incurred fuel and purchased power costs above or below the amount included in base rates. This assures that customers will only bear the actual cost of fuel and energy that the Company prudently-incurs in order to provide service – no more and no less. Under the Company's proposal, if Aquila's fuel and purchased power costs increase, the Company will be able to recover from customers all prudently-incurred increases. But if those costs decrease, Aquila will pass-on to the customers 100 percent of those decreases.

Two parties to this case – the Industrials and AARP – have proposed alternate FACs that, if adopted by the Commission, would: 1) prohibit Aquila from collecting from customers a portion of its fuel and purchased power costs, even if those costs were determined to have been prudently-incurred, and 2) prohibit customers from receiving the full benefit of any decreases in fuel and energy costs. These parties denominate their proposals, which will compel under-recovery of a significant portion of Aquila's legitimate cost of providing electric service to its customers, as "sharing" because they claim the Company has an opportunity to gain under their proposals that is symmetrical to its opportunity to lose. But the Commission must not be fooled by euphemisms, because what these proposals really represent is subsidization, not sharing. If adopted, these alternative FACs will most likely require Aquila's shareholders to provide tens of millions of dollars annually to subsidize customers' rates or will require customers to subsidize Aquila's shareholder returns. And as for the argument that these proposals balance the Company's opportunity for gains and losses, the evidence in this case shows any element of symmetry in these proposals is illusory and any opportunity for gain is purely theoretical.[96]

There are numerous compelling reasons – rooted in both law and sound regulatory policy – why the Commission should reject these "sharing" proposals:

- if adopted by the Commission, these alternative FACs virtually guarantee that Aquila will under-recover its prudently-incurred fuel and purchased power costs for the foreseeable future;

- not only will under-recovery of the Company's prudently-incurred costs be a fact, adoption of either of these alternative proposals will establish compulsory under-recovery of fuel and energy costs as a tenet of regulatory policy in Missouri;

[96] Aquila witness Trent Cozad performed a statistical analysis that proved the "sharing" mechanism proposed by Mr. Johnstone is not symmetrical. Mr. Cozad's study showed that while there may be an equal chance that prices will go up or down, the absolute value of a price increase is greater than a price decrease. (Exh. 006, p. 6) That means that the probability that Aquila will lose money if fuel and energy costs increase is a greater than the probability the Company will gain if costs decrease. The Industrials' "sharing" proposal will thus have a disparate and asymmetrical financial impact on Aquila even if prices go up and down.

- the magnitude of the likely under-recovery is significant, as was illustrated by a hypothetical posed during hearings on this issue which, based on estimates of Aquila's current, actual fuel and energy costs and actual cost increases the Company has experienced during the past three years, showed that under-recoveries within a two-year period could approach $50 million;[97]

- if Aquila is prohibited from recovering a significant portion if its prudently-incurred cost of service, the Company will be denied its legal right to a reasonable opportunity to earn a fair rate of return because a utility cannot earn any return unless and until it first covers all of its operating expenses;[98] and

- the "sharing" element of these proposals is contrary to the legislative intent embodied in SB 179, which was enacted to allow electric utilities to recover their actual, prudently-incurred costs – no more and no less – and was never intended to provide a windfall to either the utility or its customers.

The main argument offered in support of these alternative FACs is that some sort of "sharing" mechanism is necessary to ensure that Aquila will act prudently in procuring the fuel and purchased power necessary to provide service to its customers. Aquila's management, we are told, cannot be trusted to act responsibly and prudently if the Commission authorizes an FAC that allows full recovery of fuel and purchased power costs. And prudence reviews are ineffectual, it is alleged, because "utilities understand that prudence reviews are an imperfect tool for catching inefficiency and eliminating its effects from rates."[99]

Similar arguments were made to the Federal Power Commission (now the Federal Energy Regulatory Commission) in the mid-1970s when that agency was considering changes to its FAC regulations. The commission responded to those arguments as follows:

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97 Tr. pp. 781-88.

98 *See Final Order of Rulemaking* , Case No. EX-2006-0472 (4 CSR 240-20.090) (September 21, 2006), p. 4 (addressing proposals by lay commenters that electric utilities should be required to bear a portion of their prudently-incurred fuel and energy costs, the Commission stated that such a requirement "would not allow for the setting of just and reasonable rates that allow a utility a reasonable return.)

99 Exh. 601, p. 14.

> Other comments suggest that utilities be permitted to recover only a portion of increased fuel costs in order to provide an incentive to bargain for lower cost fuel. It should be noted that to the extent that only a portion of charges in fuel costs are permitted to be reflected in rates, the purpose of the fuel clause (namely to pass on to customers the increases or decreases in the fuel costs actually incurred by the utility) is to that extent defeated. When fuel costs are rising the utility is disadvantaged by not being able to collect the full amount of the increase; when fuel costs are falling the customers are disadvantaged because the full amount of the reductions are not passed along, but are partly retained by the utility. In addition, the lag in collections for fuel expenses inherent in a typical fuel cost adjustment clause provides some incentive for companies to bargain for favorable prices during periods of rising fuel costs.

18 C.F.R § 35.14 (1975).

But the dire predictions of what will occur if the Commission does not adopt some sort of "sharing" mechanism are both overwrought and unfounded.[100] Aquila is not aware of any state where regulators have compelled an electric utility to accept recovery of only a portion of the prudently-incurred fuel and energy costs that have been authorized for collection through an FAC.[101] Yet, despite years of experience, there is no evidence – other than the vague and unspecific comments offered by AARP witness Nancy Brockway – that regulators have observed or complained of rampant and recurring incidents of imprudence by utilities that utilize FACs, or that regulators have given up on prudence reviews as an effective means of discovering imprudence when

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[100] *Compare, e.g.,* Mr. Kind's prediction about "the reduced attention that Aquila will likely give to hedging at its Missouri electric operations" if the Company is allowed to implement its proposed FAC (Exh. 401, p. 9), *with* statements by Aquila that, despite its ability to pass-through increases in fuel costs to its gas customers, the Company still hedges approximately 57% of its expected on-peak gas requirements. (Form 10-K Report for 2005, p. 71)

[101] Testimony filed by AARP describes a fuel and energy cost recovery mechanism for Rocky Mountain Power in Wyoming that provides for collection of less than 100% of the utility's fuel and purchased power costs. (Exh. 600, pp. 21-22) But this mechanism was implemented as part of a stipulated settlement of a general rate case filed by the utility in 2005 (Docket No. 20000-230-ER-05). (Tr. pp. 832-33)

and if it occurs.[102] Where this topic is concerned, Ms. Brockway's criticisms must be treated with a healthy degree of skepticism because, during her five-year tenure as a member of the New Hampshire Public Utilities Commission, she never once: 1) voted against an FAC or an adjustment to rates based on prudently-incurred costs, or 2) issued a concurring opinion expressing her concerns about FACs, in general, or the inadequacy of after-the fact prudence reviews.[103] The credibility of her testimony regarding the efficacy and thoroughness of prudence review is further called into question by the facts surrounding one such review in which she participated when she served on the New Hampshire Commission. As described during cross examination, that proceeding, which reviewed prudence issues related to three outages in generating facilities operated by Public Service Company of New Hampshire, involved six parties, featured the pre-filed testimony by six witnesses, included a full evidentiary hearing, was briefed by all parties, and was resolved in a 44-page final order.[104] After that thorough review, the New Hampshire Commission unanimously found that there was no credible evidence of imprudence regarding any of the outages.

But the Commission need not look elsewhere for evidence that compulsory "sharing" is not required to incentivize a utility's management to act prudently or that prudence reviews of energy costs can and do work. For many years Missouri has allowed gas utilities to recover their fuel costs through a Purchased Gas Adjustment

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[102] *See Final Order of Rulemaking*, Case No. EX-2006-0472 (4 CSR 240-20.020)(September 21, 2006), p. 13 (the Commission stated that "the PSC Staff is satisfied that prudence reviews and surveillance procedures are adequate).

[103] Tr. pp. 836-37. In sharp contrast to Ms. Brockway's criticisms, Aquila witness Steven Fetter, who served for 6 years as Chairman of the Michigan Public Service Commission, testified that his experience with both FACs and prudence reviews had been completely satisfactory. Exh. 009, pp. 12-13.

[104] Tr. pp. 839-40. To allow the Commission to see for itself how thorough a prudence hearing can be, a complete copy of the New Hampshire Commission's Order No. 24,108 in *Public Service Company of New Hampshire* (Case No. DE 01-150), is attached to this brief as Appendix B.

mechanism, and there is no evidence that the aspects of that mechanism that are relevant to the FAC issue in this case – prudence reviews and the full pass-through of prudently-incurred costs without compulsory “sharing”– have proved to be unfair to the utilities or their customers or otherwise unsatisfactory.

And there is one additional fact the Commission should keep in mind as it evaluates the proposed alternative FACs: each of those proposals includes a requirement for after-the fact prudence reviews – the very same types of reviews that would be required under Aquila’s proposal. That gives rise to an obvious question: If those reviews are satisfactory for the alternative FACs, why are they unsatisfactory for the FAC that has been proposed by the Company?[105]

As it considers the various “sharing” proposals, the Commission must weigh the speculative benefits of those proposals – increased prudence and efficiency – against their actual consequences – the probability that Aquila will be prohibited from recovering all of its prudently-incurred fuel and purchased power costs. The New Hampshire Commission faced a similar task when it considered – and rejected – a fuel cost recovery mechanism proposed by Public Service Company of New Hampshire. In overturning the commission’s order, the Supreme Court of New Hampshire stated as follows:

> While the decision of the commission recognized that “fuel costs will continue to increase,” it speculated that the proposed fuel adjustment clause “could” give undue weight to a single cost item, “could” minimize changes in other costs, and would pass the fuel cost on to the customers without allowing for compensating economies the “might” accrue with

[105] A similar question was posed to Staff witness Cary Featherstone during hearings on the FAC issue. As might be suspected, he was unable to give a satisfactory answer. Tr. p. 751.

> respect to other costs. It nowhere found that such undesirable results were probable, or that offsetting economies were likely.
>
> . . .
>
> While the commission is not bound as a matter of law to approve such a clause, allowance in some form must be made for increase [sic] in fuel costs shown to be inevitable.

Pub. Serv. Co. of New Hampshire v. State, 113 N.H. 497, 502; 311 A. 2d 513, 517 (1973).

If the General Assembly believed that an electric utility should be limited to only partial recovery of its prudently-incurred fuel and purchased power costs, there was no need to enact SB 179. For almost three decades, traditional modes of ratemaking accomplished that objective by making it a virtual certainty that companies, like Aquila, would, in an environment of rising costs, annually under-recover their fuel and purchased power costs by millions of dollars. But partial cost recovery was not the legislature's objective. Instead, SB 179 was designed to assure timely recovery of ***all prudently-incurred fuel and energy costs*** – no more and no less. ***Aquila's proposed FAC is the only proposal that guarantees both that customers will pay no more than the Company's prudently-incurred fuel and purchased power costs and that customers will receive 100 percent of the benefits of decreases in those costs.*** Because they do not include these guarantees, the "sharing" proposals made by the Industrials and AARP are inconsistent with – if not antithetical to – the objective of SB 179, and should be rejected for that reason.

D. Performance Standards

As part of its "Alternative FAC," the Industrials are asking the Commission to adopt specific performance standards that would apply to the coal-fired generating plants that Aquila uses to satisfy its base load power requirements. As explained in the testimony of the Industrials' witness on this issue, Donald Johnstone, the purpose of these standards is to protect consumers from the expense of higher-cost replacement power that Aquila might have to acquire if there is an outage in one of its lower-cost base load units. Mr. Johnstone characterizes the cost of replacement power as "outage insurance," and argues "[t]here is no good reason for consumers to provide such insurance."[106] The specific performance standard that has been recommended is ninety-six percent of the coal-fired MWh output that was included in the fuel run that was included as part of Staff's direct testimony.

Aquila opposes the imposition of performance standards, in general, and the standards proposed by the Industrials in this case, in particular, for several reasons. Primary among those is the Company's belief that the rationale underlying the proposed standards – that customers should not be required to pay the costs of replacement power even if those costs are prudently-incurred – is erroneous and, if adopted by the Commission, would constitute bad regulatory policy. The mantra that "customers ought not be required to provide Aquila with outage insurance" is catchy but hollow. Mr. Johnstone's statement that "[i]f such insurance is a good idea, it should be purchased by Aquila and addressed in the context of base rate proceedings"[107] is meaningless by itself, because it ignores two critical questions: 1) Is such insurance available? and, 2) If so, at what cost? There is no evidence in the record of this case that provides any meaningful insights as to the answer to either of those questions.

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[106] Exh. 505, p. 17.
[107] *Id.*

But notwithstanding the evidentiary deficiencies in the Industrials' case, adopting fixed and inflexible performance standards is not the appropriate way for the Commission to deal with either question.[108] In the prudence reviews that are required under both Section 386.266, RSMo and the Commission's rules, the main question will always be: Were Aquila's fuel and purchased power costs prudently-incurred? This will include all such costs – including the cost of replacement power that is purchased to fill in when base load generating resources are out of service. So questions regarding specific outages and specific purchases of replacement power can and will be addressed as part of the prudence review to which those outages and purchases relate. There is no need to attempt to deal with those issues now by adopting arbitrary performance standards.

Power plant outages are a normal and expected part of a utility's business. Many outages are scheduled, to allow the utility to properly maintain and service these key resources. But even if outages are unscheduled, that fact, alone, does not warrant any presumption of imprudence. Yet such a presumption is implied in the performance standards that have been proposed, because if Aquila's total outages during a review period exceed an arbitrary threshold, then the cost of replacement power is presumptively deemed to be imprudent.

The decision of the New Hampshire Commission in the Public Service Company of New Hampshire case that is appended to this brief is an example of the folly of trying to prejudge outages as imprudent. In that case, the commission considered three separate outages and the circumstances surrounding each one. And, after considering

[108] *See Final Order of Rulemaking,* Case No. EX-2006- 0472 (4 CSR 240-20.090) (September 21, 2006), pp. 13-14 (the Commission stated that requiring generating unit efficiency testing and monitoring were sufficient to achieve the objective of ensuring that operations meet minimum standards).

the evidence and arguments of several parties, the commission concluded that none of those outages was the result of the utility's imprudence. Although compelled by the evidence, such a result would likely not have been possible had performance standards similar to those proposed by the Industrials been in effect.

There are several other factors that the Commission should also consider as it weighs whether it would be appropriate to include performance standards as part of any FAC adopted in this case. Those considerations include the following:

- Mr. Johnstone's proposal applies to Aquila's entire fleet of coal-fired generating plants – Sibley, Lake Road, Jeffrey, and Iatan – even though the Company owns and operates only the Sibley and Lake Road plants;[109]

- the proposed performance standards also would apply to the Gentleman and Cooper generating facilities that are owned and operated by the Nebraska Public Power District, which supplies Aquila with purchased power from those facilities;[110]

- Aquila believes that the fuel run that is contained in Staff's direct testimony – and which provides the basis for Mr. Johnstone's performance standards – does not accurately represent the operating levels that the Company's generating facilities will be able to achieve, even in the near term, because of normal declines in operating efficiency that occur as plants age;[111] and

- imposing performance standards as part of the Industrials' "sharing" mechanism would likely result in even greater under-recovery of Aquila's fuel and purchased power costs than the nominal amount suggested by "50/50 sharing."

The Industrials' proposed performance standards also create incentives for Aquila to make decisions that are not in the best interests of either the Company or its customers. For example, circumstances sometimes arise that make it economical for Aquila to use purchased power instead of running one or more of its base-load units.

[109] Exh. 034, p. 18. Although Aquila is a part owner of both the Jeffery Energy Center and Iatan generating plants, the Company operates neither of those facilities and is, therefore, powerless to control outages at either location.
[110] *Id*., p. 19. Aquila has no ownership interest in either the Gentleman or Cooper generating facilities and, therefore, has no ability to control outages at either location.
[111] *Id*., p. 18.

But if the Company stands to be penalized for not running a generating plant – regardless of the reasons – it is unlikely to decide not to run that plant. Another example is the discovery of an unanticipated mechanical problem during a regularly-scheduled maintenance outage. If repairing that problem will extend the outage, the proposed performance standards incent Aquila to defer the repair so that the generating facility is not out of service longer than expected – even if it would be more costly to perform the needed repairs at a future date and the risk of failure due to the mechanical problem is increased. The proposed performance standards also are unbalanced because while there are penalties if Aquila fails to meet a minimum standard there are no corresponding rewards if Aquila exceeds that standard.

There is a final problem with the Industrials' proposed performance standards that the Commission should also consider: the proposal does not comply with the Commission's rules. 4 CSR 240-20.090(11)(B) requires any party who proposes "[a]ny incentive mechanism or performance-based program" to demonstrate that "[t]he anticipated benefits to the electric utility's customers from the incentive or performance-based program shall equal or exceed the anticipated costs of the mechanism or program …" The Industrials have made no such showing in this case. When questioned about this deficiency in his proposal, Mr. Johnstone glibly asserted that no such showing was necessary because Aquila will not incur any costs in attempting to comply with the proposed performance standards.[112] That assertion is patently ridiculous. There can be no doubt that Aquila likely will incur substantial costs if it is required to maintain and operate its generating facilities to satisfy some arbitrary performance standard. The Company may also be forced to incur costs to assure that generating facilities it neither

[112] Tr. p. 791.

owns nor operates – but which are still subject to the proposed standards – are operated in a manner that will not result in a disallowance of replacement power costs. Yet none of these costs has been estimated and/or compared to the perceived benefits that customers will derive if the Commission adopts the proposed performance standards. Not only would such information be very useful to the Commission in evaluating the proposed performance standards, it is required by the Commission's rules. The Industrials' failure to provide that information is a fatal error.

E. Staff's Proposed Interim Energy Charge

Staff proposes that the Commission approve an Interim Energy Charge ("IEC") instead of the FAC that Aquila has proposed. The Company opposes this proposal.

As Aquila stated in its Pre-Hearing Brief, although an IEC is a minor improvement over more traditional modes of ratemaking, adoption of an IEC during periods when fuel and energy costs are expected to increase still likely will result in a utility under-recovering its costs. The Commission's recent experience with IECs supports this proposition. For example, in the final Report and Order in the recently-completed rate case of Empire, the Commission noted that an IEC authorized for that company in late 2005 had resulted in an annual under-recovery of prudently-incurred fuel and purchased power costs totaling $26.8 million.[113] And Aquila's experience with an IEC was similar to Empire's. As a result of a Stipulation and Agreement approved by the Commission in Case No. ER-2004-0034, Aquila implemented an IEC. But the Company abandoned its IEC in its next rate case because, within a period of approximately 20 months, Aquila under-recovered its fuel and purchased power costs by approximately $34 million.[114]

[113] *Report and Order*, Case No. ER-2006-0315 (December 21, 2006), pp. 44-45.
[114] Tr. p. 596.

Although Section 386.266, RSMo allows the Commission to authorize an IEC for Aquila, the Commission should refuse to do so for one simple reason: IECs routinely fail to accomplish the objective for which they were designed – allowing electric utilities to collect all of their prudently-incurred fuel and purchased power costs.

F. The Appropriate Structure for an FAC

1. Recovery Period

Although Aquila originally proposed four, quarterly recovery periods, several parties – including Staff, Public Counsel, and the Industrials – testified that customers would prefer an annual recovery period. After considering these arguments, the Company has concluded that it will not oppose an annual recovery period. But, as it considers this issue, the Commission should note that an annual recovery period may add costs to the amount that Aquila will collect from customers through the FAC. These added costs are attributable to carrying charges that will accumulate on the uncollected balance of the Company's prudently-incurred fuel and purchased power costs until that balance is fully collected from customers. So although a 12-month recovery period could mitigate the effect of seasonal variations in fuel and purchased power costs, it may also add a cost burden that would be avoided if a shorter period were used.

2. Costs Recoverable through an FAC

Aquila originally proposed to recover through the FAC all costs recorded in FERC Accounts 501, 509, 547, and 555. In addition to the actual costs of fuel and purchased power, these accounts also included related costs, such as unit train lease, depreciation, and maintenance costs; freeze/dust suppression costs; fuel handling costs; costs associated with fly-ash removal; gas reservation charges; and demand charges for purchased power contracts with terms in excess of one year. After considering the objections of various parties that some or all of these related costs should not be recovered through an FAC, the Company is willing to exclude the related costs listed above from its proposal.

In making this concession, Aquila wants to make sure that the Commission understands and recognizes that none of the parties disputes the fact that the related costs are properly included in the Company's base rates. The only issue was whether increases or decreases in those costs should be passed through the FAC.

Aquila continues to believe, however, that hedging costs and demand charges related to purchased power with terms of one year or less should be recovered through the FAC.

3. Line Losses

When Aquila filed its rate case in July 2006, the Commission had not yet adopted final rules governing FAC filings. The draft rules under consideration at the time of the Company's filing made recognition of line losses in the FAC optional; however, the rules that finally were adopted made recognition of line losses mandatory.[115]

The Industrials' witness Maurice Brubaker proposed line loss factors for the FAC[116] and, after considering Mr. Brubaker's testimony, Aquila believes his proposal should be adopted by the Commission as part of any FAC that it approves.

4. Frequency of FAC Adjustments

Aquila believes that FAC adjustments should be made quarterly, but will not oppose semi-annual adjustments. Annual adjustments, as proposed by some parties,

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[115] *Final Order of Rulemaking* in Case No. EX-2006-0472 (4 CSR 240-20.090), pp. 6-7.
[116] Exh. 501, pp. 3-6.

are not desirable for at least three reasons: 1) they could result in rate shock to customers because recent annual increases in fuel and purchased power costs have ranged between 13-20 percent, and 2) there would be carrying charges associated with delayed recovery; and 3) annual adjustments are inconsistent with the objective of the FAC statute – to allow full and timely recovery of prudently-incurred fuel and purchased power costs.

5. Rate Mitigation "Cap"

To mitigate the impact on customers of sharp increases in Aquila's fuel and purchased power costs, Mr. Johnstone has proposed that a "soft cap" be included as part of any FAC approved by the Commission. Mr. Johnstone's proposed cap is 1.5 percent for each six-month accumulation period, or 3 percent annually. Any recoverable cost increases above the amount of the cap would be deferred, with interest, for collection in the future.

Although Aquila's FAC proposal does not include a cap, the Company is not fundamentally opposed to Mr. Johnstone's recommendation; provided, however, that the cap is set at an appropriate level. Based on the Company's recent experience with the rate of increase of fuel and energy costs, Aquila believes a quarterly cap of 1.5 percent, or 6 percent annually, would be more appropriate.[117]

As it considers whether Mr. Johnstone's proposal is in customers' best interests, the Commission should, again, understand and recognize that the proposed cap is not cost free. Not only will fuel and purchased power costs above the cap be deferred for later collection, those deferrals will accrue interest until they are collected and those interest charges will be passed on to customers. In his surrebuttal testimony, Mr.

[117] Exh. 034, pp. 24-25.

Williams illustrated the potential cost impact of a soft cap mitigation feature based on an assumed increase in fuel and energy costs of 15 percent – which is well within the range of actual increases that Aquila has experienced in recent years. In Mr. Williams' illustration, an increase in fuel and purchased power costs of $30 million would result in a deferral of more than $12 million if a 3 percent soft cap, as recommended by Mr. Johnstone, is adopted.[118] Rather than eliminating a cost spike to customers, the proposed soft cap may just defer the spike. And, if fuel and energy costs continue to increase, adding a deferred amount to a customer's normal FAC charges could easily exacerbate the customer cost problem, not mitigate it. Under a cap, therefore, it is possible that the total amount customers would pay through the FAC would be greater than without a cap, because under a cap not only would fuel and energy costs flow through the FAC, accumulated interest charges would too.

6. Heat Rate Testing

As part of its FAC filing, Aquila included a schedule for heat rate and/or efficiency testing that includes written testing procedures. Under the Company's proposal, testing will be conducted in accordance with Southwest Power Pool ("SPP") criteria – specifically, Section 12.1 – Electrical Facility Ratings.[119] A 100 percent capability test will be performed on each of Aquila's generating once every three years, and a 90 percent operational test will be performed every two years. Heat rates will then be

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[118] *Id.*

[119] Although Aquila is not a member of the SPP, the Company chose the pool's criteria after evaluating them and determining that they met the requirements of 4 CSR 240-3.161(2)(Q). During hearings on this issue, at least one party questioned use of the pool criteria by a non-pool member. But it goes without saying that Aquila is free to impose on itself any heat rate or efficiency criteria that it believes are appropriate – which is exactly what it has done.

determined using data collected during those tests and in accordance with SPP procedures.[120]

As noted earlier in this brief, Staff has expressed doubts about whether data derived using the SPP procedures will yield meaningful conclusions regarding the heat rates and/or efficiency of Aquila's generating plants.[121] Representatives of Staff and the Company have already engaged in preliminary discussions aimed at resolving their differences regarding appropriate heat rate/efficiency testing standards and procedures, and have memorialized terms under which further discussions will occur and a timetable for completing those discussions.[122] Also, Staff's witness on this issue expressed the opinion that, if the Commission authorizes an FAC for Aquila in this case, those discussions could be concluded and appropriate standards and procedures agreed upon before any testing would need to be conducted.[123]

If the Commission believes that the SPP criteria and procedures are not satisfactory, Aquila is willing to continue its discussions with Staff (and any other interested party) until consensus is reached on appropriate alternative standards and procedures. That consensus position can then be submitted to the Commission for final review and approval. And the Company agrees with Staff that this process can be completed well in advance of the time any heat rate or efficiency testing is required under the proposed FAC or applicable rules.

[120] Exh. 024, p. 27.
[121] Exh. 227, pp. 3-7.
[122] Exh. 242.
[123] Tr. p. 955.

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I hereby certify that a true and correct copy of the above and foregoing document was delivered by first class mail, electronic mail or hand delivery, on the 27th day of April, 2007, to the following:

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