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

PRE-HEARING BRIEF OF AQUILA, INC.

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I. INTRODUCTION

On July 3, 2006, Aquila, Inc. ("Aquila" or the "Company") filed for a $94.5 million or 22% increase in base rates for its Aquila's Networks-MPS division and a $24.4 million or 22.1% increase in base rates for its Aquila Networks L&P division. That initial filing included a "placeholder" for the costs associated with a 600 MW capacity solution. The "placeholder" subsequently was superseded with two contracts totaling 300 MW of firm capacity as of year-end 2006. The practical effect of this development was to reduce the requested increase for Aquila Networks-MPS to $55.7 million and to reduce the requested increase for Aquila Networks-L&P to $24.1 million.

The primary drivers for the Aquila Networks MPS service area increase was the need for additional long-term generation capacity and the increased fuel and purchased power prices in volume. (Empson Direct, p. 2, l. 21-23; p. 3, l. 1) It is important to note that 82% of the increase in an average residential customer's bill on the MPS system from 1983 to 2006 has been driven by the increase in usage per customer while only 18% has been driven by the increase in the price of the service. (Empson Direct, p. 3, l. 18-23)

There are three primary purposes for the Aquila Networks L&P filing. About 59% is attributable to fuel, purchased power and lower level of off-system sales credited to that division. About 28% is to recover costs for the investments in plant and equipment necessary to serve customers. Finally, about 13% is

attributable to the general increase in cost, including the demand side (?) management program proposal.

Equally important to what is included in the case for rate recovery is what is not included. Aquila has not included in this filing costs related to executive bonuses and incentives; restructuring costs; bonus or incentive components for calculating SERP; specific costs related to the South Harper Peaking facility; and costs that resulted from Aquila being non-investment grade. (Empson Direct, p. 5, l. 1-10) In the case of Aquila Networks L&P, 113% of the increase of an average residential customer's bill from 1983 through 2006 has been driven by the increase in the usage per customer, meaning that if electric usage had been the same in 2006 as in 1983, the customer's bill actually would lower today than it was 23 years ago. (Empson Direct, p. 6, l. 1-4)

Aquila is committed to managing its on-going repositioning plan in a manner that protects the customers of its regulated utility operation. It does this by focusing on three key business principles that is protecting utility customers from potential adverse financial impact, maintaining quality customer service and enhancing regulatory transparents. (Empson Direct, p. 7, l. 3-20) Aquila has maintained a capital assignment process since 1988 that was specifically designed to insulate and separate each of its utility divisions from the Company's other activities. Regulated utility operating units are assigned capital based upon what comparable utilities would receive. This practice has been reviewed by the Commission in every rate case filed by the Company since 1988. The objective

is to financially and operationally "ring fence" the utility operations from Aquila's non-utility business. (Empson Direct, p. 8, l. 4-10)

Aquila remains committed to continue to delivering quality service to its customers. In this regard, Aquila has developed internal service quality matrix which are maintained on a monthly basis on its intranet dashboard. These matrixes include such functions as meter reading accuracy, emergency response time, safety, SAIDI, SAIFI, CAIDI, generation availability, heat rates and call center performance. The Company's state operating vice-president provides status reports on a monthly basis which are published on the intranet and reviewed by the Company's senior management. (Empson Direct, p. 12, l. 1-13)

Aquila has implemented a state-based utility organization that is focused on providing excellent service to its customers. Aquila maintains a detailed cost allocation manual which is revised annually. It has initiated detailed affiliate transaction procedures, monitoring and reporting in response to the Commission's regulations of this topic that commenced in 2000.

Finally, Aquila has developed a code of business conduct to provide employees essential guidelines to help understand their responsibilities. Aquila believes that its employees acting ethically and with integrity makes the Company a good place to work and a good provider of products and services to customers, a good citizen in the community and sound investment for shareholders. The Company has initiated on-line, computer-aided training and all new employees are required to complete the training in a series of updates that are provided periodically each year. (Empson Direct, pp. 12-15)

Aquila has made significant progress in repositioning the Company over the past few years. It is committed to rebuilding the financial position of the Company while remaining focused on the importance of ensuring that its customers are insulated and well served.

II. REVENUE REQUIREMENT

A. Rate of Return

1. Cost of Capital

a. Return on Common Equity

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

A return on common equity ("ROE") of 11.25% should be used for determining Aquila's rate of return ("ROR") in this proceeding. This position is supported and explained by the testimony of Dr. Hadaway. Staff witness Parcell recommends an ROE of 9.625 percent (midpoint of his range of 9.0 to 10.25 percent), and Industrial witness Mr. Gorman recommends an ROE of 10.0 percent. Mr. Parcell's and Mr. Gorman's recommendations do not reflect certain industry-specific and company-specific factors and should be disregarded by the Commission. The testimony of Public Counsel witness Trippensee should also be given little or no weight.

This Commission should look to the national average ROE as an indicator of the capital market in which Missouri utilities will have to compete for capital. Further, the Commission should consider the reasonableness of ROE recommendations in light of findings and decisions of other regulatory agencies.

The average ROE for 2005 was 10.54 percent, and the average ROE for 2006 was 10.36 percent. (Hadaway, Rebuttal, p. 3) 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." *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). In a recent rate case, *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), the Commission defined that "zone of reasonableness" as being 100 basis points above and below the national average. More recently, this same "zone of reasonableness" concept was utilized by the Commission in Commission Case Numbers ER-2006-0314 (Kansas City Power & Light Company) and ER-2006-0315 (The Empire District Electric Company).

In its constitutional *Hope* and *Bluefield* analysis, the Commission stated that there are some numbers that the Commission can use as guideposts in establishing an appropriate return on equity, although not limiting itself to a set "zone of reasonableness." *See* Commission Case No. ER-2006-0314, *Order Regarding Motions for Rehearing* (January 18, 2007). A reasonableness check, however, is especially important in this proceeding given the low ROE recommendations of Staff and the intervenors and the extensive capital requirements being faced by Missouri Public Service ("MPS") and St. Joseph Light & Power ("L&P"). The divisions will have to compete against other electric

utilities to raise the capital needed to meet their capital requirements and continue to provide safe and adequate service in Missouri.

The cost of equity is the rate of return that common stockholders expect, and equity investors expect a return on their capital commensurate with the risk they take and the returns that might be available from other similar investments. The return on equity is not directly observable and must be estimated or inferred from capital market data and trading activity. To properly estimate the cost of equity for a utility, one must apply informed judgment about the relative risks of the company in question and utilize knowledge of the risk and expected rate of return characteristics of other available investments. A cost of equity recommendation should reflect certain industry-specific and company-specific factors. (Hadaway, Direct, p. 35)

Dr. Hadaway estimates the "market required" rate of return on equity for Aquila's MPS and L&P Missouri operating divisions. Dr. Hadaway's testimony and recommendations properly reflect industry-specific and company-specific factors, and his recommendations are premised upon the fair rate of return principles established by the United States Supreme Court in *Federal Power Commission v. Hope Natural Gas Company*, 320 US 591 (1944), and *Bluefield Waterworks v. Public Service Commission,* 262 US 679 (1923). As the Commission is well aware, the U.S. Supreme Court has held that the return authorized a utility by a regulatory body should be "commensurate with returns on investments in other enterprises having corresponding risks." *Hope*, 320 US at 603. In addition, the return should be "sufficient to assure confidence in the

financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Id.*

> The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

Bluefield, 262 US at 693. Dr. Hadaway explained that "[i]f a utility earns its market cost of equity, neither its stockholders nor its customers should be disadvantaged."

Given the principles of *Hope* and *Bluefield*, Dr. Hadaway used several methods to determine the appropriate ROE and overall rates of return for Aquila's two Missouri operating divisions. Dr. Hadaway applied these methods and the underlying economic models to an investment grade company reference group of other similarly situated electric utilities. To summarize, Dr. Hadaway's ROE estimate is based on alternative versions of the Discounted Cash Flow ("DCF") model and was confirmed by a risk premium analysis and a review of projected interest rates and economic conditions. (Hadaway, Direct, p. 3)

Dr. Hadaway indicates that models employing market-based data for comparable utilities are most widely used in the industry. (Hadaway, Direct, p. 27) Accordingly, an authorized rate of return for a regulated utility should be commensurate with returns on investments in other enterprises having corresponding risks. Three general categories of modeling techniques are used today: comparable earnings methods, risk premium methods, and DCF methods.

The DCF model is the most widely used in regulatory proceedings. In essence, the DCF model results in an ROE estimate that is the sum of the expected dividend yield and the expected long-term dividend (or price) growth rate. According to Dr. Hadaway, the DCF model, like the risk premium method, has a sound basis in theory, and the DCF model has the advantage of simplicity. (Hadaway, Direct, p. 29)

As explained by Dr. Hadaway, the DCF model cannot be applied directly to Aquila, as the Company does not presently pay dividends to its shareholders. In this case, diverse "parent" Company financial data is not the appropriate basis for setting the required rates of return for the two operating divisions. Accordingly, to perform his DCF analysis, Dr. Hadaway applied the DCF model to a large sample reference group of investment grade electric utilities selected from the Value Line Investment Survey. (Hadaway, Direct, pp. 3-4) To be included in the reference group, a company must have at least a BBB/Baa2 bond rating, must derive at least 70 percent of revenues from regulated utility sales, must have consistent financial records not affected by recent mergers or restructuring, and must have a consistent dividend record with no recent dividend cuts. (Hadaway, Direct, p. 4)

Dr. Hadaway's reference group analysis indicates a reasonable DCF ROE range of 11.0 to 11.4 percent (Hadaway, Direct, p. 6), although this was adjusted to 10.75 percent to reflect a decline in utility interest rates (Hadaway, Surrebuttal, p. 3). To test his DCF results, Dr. Hadaway conducted a risk-premium analysis based on ROEs allowed by state regulators relative to Moody's utility debt costs.

As explained by Dr. Hadaway, under current economic, market, and electric utility industry conditions, the combination of the DCF and risk premium models, tempered by consensus forecasts regarding future interest rates, provides an appropriate approach for estimating a fair cost of equity capital for Aquila's two Missouri operating divisions. (Hadaway, Direct, p. 4)

Based on his DCF and risk premium results, and given the current market, industry, and company-specific factors appropriate for the case, Dr. Hadaway now estimates the fair cost of equity for MPS and L&P at 11.25 percent. 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, Rebuttal, pp. 18-19)

Although Dr. Hadaway's reference group is the appropriate starting point for estimating ROE, the reference group ROE is lower than the fair cost of equity for MPS and L&P. (Hadaway, Direct, p. 4) The two 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. The updated construction requirements analysis shows that 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. (Hadaway, Rebuttal, p. 19) Further, the divisions are smaller than the reference group

companies, and there are uncertainties about fuel and purchased power cost recovery for the Company. To reflect the higher utility risk profile of the operating divisions, the Commission should add an ROE increment or adjustment to the reference group ROE. (Hadaway, Direct, pp. 4-5; Hadaway, Rebuttal, p. 19)

Given the current economic, market, and electric utility industry conditions, Dr. Hadaway's chosen methodology, as set forth in his direct, rebuttal, and surrebuttal testimony, provides an appropriate approach for estimating each operating division's cost of equity capital.

On the other hand, little or no weight should be given to the ROE testimony offered by Staff witness Parcell. His chosen methodology – and his resulting recommendation – simply do not meet the basic checks of reasonableness. The same is true for the testimony offered by Mr. Gorman. 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 constructions budgets. (Hadaway, Rebuttal, p. 5) Similarly, Staff witness Parcell offers an "obsolete coverage ratio analysis" to support his recommendations, and he makes no attempt to consider the Company's prospective condition on a going-forward basis. (Hadaway, Rebuttal, p. 5) The recommendations of Mr. Parcell and Mr. Gorman are inadequate, and Public Counsel witness Trippensee does not even indicate the effect of his recommendation.

Portions of Staff witness Parcell's ROE analysis are "extreme and do not appear to fit the Commission's standards." (Hadaway, Rebuttal, p. 6) His ROE recommendation is low and inappropriate due, in part, to Mr. Parcell's singular reliance on the constant growth version of the DCF model, his selection of only a five-company primary comparable group, and his use of historical growth rates and near-term analysts' growth rate forecasts. "Each of these factors detracts from the reliability of Mr. Parcell's DCF estimates." (Hadaway, Rebuttal, p. 7) Under present market conditions, Mr. Parcell's constant growth results are below the reasonable range. Mr. Parcell's CAPM and CE analyses also fail to produce meaningful results.

Mr. Gorman's ROE recommendation is low because of his improper assumptions. He consistently used assumptions that subtly skewed his results toward the lower end of each range. (Hadaway, Rebuttal, p. 11) Such an approach is unnecessary and inappropriate. In his DCF analysis, Mr. Gorman used only the constant growth version of the DCF model and, in that model, he used growth rates that are not consistent with that model's long-term requirements. Dr. Hadaway evaluated three versions of the DCF model, and he ultimately rejected the constant growth version because it failed to meet basic risk premium tests of reason. (Hadaway, Rebuttal, p. 13) In fact, the constant growth results were 100 basis points below the alternate risk premium tests of reasonableness. (Hadaway, Surrebuttal, p. 5)

With his bond yield plus risk premium analysis, Mr. Gorman fails to include the well-documented tendency for risk premiums to widen when interest rates are

low. With his CAPM analysis, Mr. Gorman focuses only on long-term Treasury bonds as the risk-free asset, producing lower CAPM estimates than with the application of intermediate or short-term Treasuries. (Hadaway, Rebuttal, pp. 11-12) Mr. Gorman even rejected the results of his own CAPM analysis as applied to Dr. Hadaway's group of comparable companies. Upon finding that his analysis produced an ROE of 10.6 percent, Mr. Gorman excluded the result from his recommended range. Mr. Gorman's ROE results would have been much higher, had he replaced his improper assumptions with a more balanced approach. (Hadaway, Rebuttal, p. 12)

Public Counsel witness Trippensee offers testimony purportedly to address revenue implications of a FAC, although he offers no specific ROE or ROR recommendations. Mr. Trippensee states that the authorized ROE for Aquila should be reduced if a FAC is adopted in this case, but Mr. Trippensee's recommendation should be rejected. The facts and data relied upon by Mr. Trippensee in reaching his opinion are not of the type reasonably relied upon by experts in the field, and the information relied upon by Mr. Trippensee is so slight as to render his opinion fundamentally unsupported.

Most of the companies in Dr. Hadaway's group of comparables already have fuel and purchased power cost recovery adjustment clauses. (Hadaway, Rebuttal, p. 18) In his analysis and costs of capital estimate, Dr. Hadaway explicitly assumes adoption of a FAC for Aquila in this case. If Aquila's two Missouri operating divisions are granted a FAC, they will simply be like Dr. Hadaway's comparable group companies. On the other hand, if the request for a

FAC is denied, as is urged by Public Counsel, then the Company's Missouri operating divisions will be even more risky and the cost of capital will be understated.

b. Capital Structure

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

Although the issues of return on common equity and cost of debt are contested, there does not appear to be any dispute regarding capital structure. The following tables reflect Staff's proposed capital structure, Aquila's proposed return on equity and cost of debt components, and the resulting overall rates of returns for the two Missouri operating divisions:

Missouri Public Service (MPS)

Capital Components	Ratio	Cost	Weighted Cost
Debt	51.83%	6.668%	3.456%
Common Equity	48.17%	11.25%	5.42%
TOTAL	100.0%		8.876%

St. Joseph Light & Power (L&P)

Capital Components	Ratio	Cost	Weighted Cost
Debt	51.83%	7.698%	3.99%
Common Equity	48.17%	11.25%	5.42%
TOTAL	100.0%		9.41%

c. Cost of Debt

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

The cost of debt for the MPS division is 6.668 percent, and the cost of debt for the L&P division is 7.698 percent. During 2006, specific maturities of long-term debt assigned to the Company's two Missouri operating divisions were tendered early and retired at maturity. This debt was then refinanced with other Aquila long-term debt, and both MPS and L&P required additional assignments of long-term debt to maintain their target capital structures. This resulted to each division's cost of debt declining from the Company's original filings in this proceeding. (Winterman, Rebuttal, p. 2; Sch. RJW-1)

On behalf of the Industrials, Mr. Gorman suggests that the cost of debt for MPS should be adjustment to reflect the retirement of debt due in 2007. As explained by Mr. Winterman, this is inappropriate, as it is outside the test year and true-up period for this case. (Winterman, Rebuttal, p. 2) Mr. Winterman also disagrees with Mr. Gorman's suggested repricing of the 2006 maturity. Refinancing of a relatively small issue could not likely be done in the capital markets as a public offering, but only as a more expensive private placement, and Aquila's experience with small issues suggests that 28 to 42 basis points would need to be added to appropriately reflect issuance expenses. (Winterman, Rebuttal, p. 2)

Although Mr. Gorman does not recommend a specific adjustment to L&P's cost of debt, he does argue against the use of L&P's actual embedded cost of

debt and states that Aquila should be ordered to pursue every opportunity to reduce L&P's cost of debt. (Gorman, Surrebuttal, p. 17) Mr. Gorman's testimony in this regard should be disregarded by the Commission. Contrary to the contentions of Mr. Gorman: (1) L&P's debt was fixed without any step-up or step-down provisions, and there have been no increases to those rates because of Aquila's credit rating downgrades; (2) very little of L&P's debt can be refinanced at attractive or economical rates; and (3) L&P's cost of debt is not out of line, as compared to the cost of debt for other Missouri utilities. (Winterman, Rebuttal, pp. 3-4)

B. Rate Base Issues

1. Generation Resources

What are the prudent types and amounts of generation re-courses to include in Aquila Networks-MPS's rate base and for determining the fuel and purchased power expense of Aquila Networks-MPS and Aquila Networks-L&P?

In this case Staff witnesses, Mantle, Featherstone, and Hyneman have offered testimony to the effect that Staff does not agree with the Company's mix of capacity in purchase power. Staff witness Mantle states: "Staff's view that Aquila should own its generation assets [to the exclusion of purchased power agreements] is based on the proposition that owned assets will produce the lowest long-term revenue requirement and thus the lowest overall customer rates." (Mantle Direct, p. 7, l. 16-18). Consequently, Staff hypothecates into the Company's capacity portfolio two (2) imaginary 105 (MW) combustion turbines

(CTs) in addition to other Aquila-owned power plants. (*Id.).* This mythical view of resource planning is legally and factually flawed.

Staff's Phantom Turbines Adjustment is Legally Flawed

At the outset, Staff's case is squarely contrary to the prohibition set forth in § 393.135, RSMo 2000 which precludes a party from including in the rates of an electrical corporation any charge for property before it is "fully operational and used in service." Staff makes no secret of the fact that the two hypothecated CTs are entirely imaginary and, therefore, are not, and cannot be, used in providing service to Aquila's customers.[1] The Staff adjustment is unlawful on its face and should be rejected. Beyond that, Staff's recommendation, if adopted, would exceed the Commission's statutory authority in that it is a transparent attempt to manage the Company's operations.

It is axiomatic that the Commission is an administrative body of limited powers, created by state law. Accordingly, it has only such powers as are expressly conferred upon it by the statutes and reasonably incidental thereto. *State ex rel. and to the Use of Kansas City Power and Light Co. v. Buzard*, 315 Mo. 763, 168 S.W.2d 1044, 1046 (1943); *State ex rel. City of West Plains v. Public Service Commission*, 310 S.W.2d 925, 928 (Mo. banc 1958). Although the Act is remedial in nature, and should be construed liberally, neither convenience, expediency nor necessity are proper matters for consideration in the determination of whether or not an act of the Commission is authorized by

[1] This is in contrast to the three (3) 105 MW CTs installed at the South Harper power station that were placed in commercial operation in the Summer of 2005 and have been dispatched to supply peaking power to meet the demands of Aquila Networks' customers and, as such, are fully operational and used for service.

statute. *State ex rel. Kansas City v. Public Service Commission*, 301 Mo. 179, 257 S.W. 462 (Mo. banc 1923); *State ex rel. Utility Consumers Counsel of Missouri Inc. v. Public Service Commission*, 585 S.W.2d 41, 49 (Mo. banc 1979).

So long as Aquila conducts its power resource planning in a manner consistent with its obligations under the Commission's IRP rules, the consequent power procurement activities for Aquila's various operating divisions is not a matter that can be directed or determined by the Commission or by its Staff. The law on this topic is clear and unambiguous. The Commission's authority to regulate certain aspects of a public utility's operations and practices does not include the right to dictate the manner in which the company conducts its business. *State ex rel. City of St. Joseph v. Public Service Commission*, 30 S.W.2d 8 (Mo. banc 1930).

The *City of St. Joseph* case involved an appeal by St. Joseph, Missouri, of an order of the Commission affixing the value of property of St. Joseph Water Company for ratemaking purposes and approving a schedule of rates. In rejecting the Appellant's contention that the Commission should not have authorized an administrative charge imposed on the operating company by its parent company, the Missouri Supreme Court stated the following:

> The holding company's ownership of the property includes the right to control and manage it, subject, of course, to state regulation through the Public Service Commission, but it must be kept in mind that the Commission's authority to regulate does not include the right to dictate the manner in which the company shall conduct its business. The company has the lawful right to manage its own affairs and conduct its business in any way it may choose, provided that in doing so, it does not injuriously affect the public. The customers of a public utility have a right to demand efficient service at a reasonable rate, but they have no right to dictate the methods which the company must employ in that rendition of that service.

> It is of no concern of either the customers of the water company or the Commission, if the water company obtains necessary material, labor, supplies, etc. from the holding company, so long as the quality and price of the service rendered by the water company are what the law says it should be.

Id. at 14. Similarly, in *State ex rel. Harline v. Public Service Commission*, 343 S.W.2d 177 (Mo. App. 1960), the Court observed that the Commission's powers are "purely regulatory." *Id.* at 181. Further, the Public Service Commission Act provides "regulation which seeks to correct the abuse of any property right of a public utility, not to direct its use." *Id.* The Court of Appeals elaborated on this important principle:

> The utility's ownership of its business and property includes the right to control and management, subject, necessarily to state regulation through the Public Service Commission. The powers of regulation delegated to the Commission are comprehensive and extend to every conceivable source of corporate malfeasance. Those powers do not, however, clothe the Commission with the general power of management incident to ownership. The utility retains the lawful right to manage its affairs and conduct its business as it may choose, as long as it performs its legal duty, complies with lawful regulation and does no harm to the public welfare.

Thus, the Commission may regulate Aquila's Missouri operations, but it has no authority to manage the Company's business or to substitute its business judgment for that of Aquila, so long as Aquila is meeting its public service obligation to provide safe and adequate service to its patrons. In this regard, Staff fails to allege that the Company has not determined its resource needs through valid resource planning practices or that its implementation of those plans has resulted in inadequate service to its customers.[2] Absent any such

[2] To the contrary, Aquila has supplied the testimony of Robert Davis of the engineering consulting firm of R.W. Beck who is sponsoring a study the results of which demonstrate that Aquila's existing resource portfolio is "reasonably consistent with a hypothetically optimum power supply

plausible showing, Staff's attempt to place two make-believe CTs in Aquila's portfolio of owned power generation must be rejected.

Staff's Phantom Turbines Adjustment is Factually Flawed

In addition to these glaring legal deficiencies, it is important to recognize that Aquila's power portfolio is a function of its integrated resource planning practices. For the relevant period of the topic in this case, Aquila's preferred plan had included some element of purchased power as part of the capacity planning objective. This is to be expected given the fact that the Stipulation and Agreement entered into by and between the Company, Staff and other parties in Case No. ER-2004-0034 requires that Aquila consider purchase power agreements as part of its capacity planning. Additionally, the Commission's IRP rule also requires consideration of purchase power agreements. *See,* 4 CSR 240-22.040(1). Staff's inclusion of two make-believe CTs (in addition to the three actual combustion turbines currently operating at the South Harper power station) is not a reality-based recommendation, disregards the expressed terms of a Stipulation and Agreement in Aquila's 2004 rate case and is inconsistent with the requirements of the Commission's IRP rule. On these grounds alone, Staff's recommendation should be rejected by the Commission.

Additionally, the details of the Staff's proposal are deeply and fundamentally flawed. First, the two make-believe turbines are drastically undervalued by the Staff. Despite its claims to the contrary, Staff does not use the actual cost of the three combustion turbines located at the South Harper

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mix in 2005." Moreover, he states that "the planned resource expansion identified as the Preferred Plan" in the Company's 2005 IRP "is reasonably consistent with a theoretically optimum expansion plan." (Rebuttal, p. 2-3)

location to establish a value for the two additional phantom turbines. In fact, only a fraction of the value proposed by Staff is based on actual cost data from Aquila's purchase of the first three combustion turbines. (Rooney Rebuttal, p. 15, l. 9-16). The fact of the matter is that Staff's evaluation is merely superficial in that it is based on an one-off, isolated price quote listed in a trade publication (*Gas Turbine World* or *"GTW")*, an offer that was not even close to comparable. The *GTW* offer dealt with an entirely different model of combustion turbine with different maintenance requirements. Furthermore, the *GTW* quote excluded the cost associated with breakers, transformers, training, transportation, technical assistance and low nitrous oxide (NOX) combustors. (Rooney Rebuttal, p. 16-19) In other words, Staff's evaluation is not anywhere close to an apples-to-apples comparison.

Moreover, Staff's proposal penalizes the Company because owned capacity has a front-loaded revenue stream as compared to a level payment purchased power agreement (PPAs). Staff's adjustment has not provided for Aquila to earn on the two make-believe turbines from the hypothetical in-service date of the summer of 2005. In other words, no capital or operating costs associated with the two phantom turbines are included in Aquila's current rates nor has Staff accounted for gas reservation costs associated with the two imaginary CTs. This drastically understates the revenue stream in the early years that otherwise would be available to offset the lower imputed revenue requirement in future years. The ultimate result is the Company will not cover its full and fair cost of providing service pursuant to the terms of its PPAs under

Staff's approach. (Rooney Rebuttal, pp. 12-14) This is simply unfair and unreasonable.

Notably absent from Staff's testimony is any allegation (much less proof) that the price terms of Aquila's purchase power agreements (PPAs) created to meet its capacity requirements during the updated test year are imprudent, unjust or unreasonable. Absence any such evidence, it would constitute a manifest abuse of discretion to deny the Company anything less than full recovery of its prudent and reasonable purchase power costs.

2. South Harper

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

Aquila does not believe it is an issue with respect to which any revenue requirement is associated. Rather, this is a subsidiary matter to the immediately preceding topic, "Generation Resources". Consequently, Aquila presents no separate argument on this topic.

3. Accounting Authority Orders

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?

Included in rate base in Aquila's filing are unamortized balances as of December 31, 2006 of the Accounting Authority Order (AAO) deferrals reflecting a return authorized by the Commission associated with Sibley Power Station

rebuild and western coal conversion projects.[3] Also included in cost of service is an annual amount of associated amortization expense. (Klote Rebuttal, p.2, l. 12-22; p. 3, l. 1-2) Staff adopted the test year amortization and included expense amortizations for each of the AAOs in its direct case. (P. Williams Direct, p. 19, l. 17-21)

In previous rate cases,[4] the Commission has authorized a return on the unamortized balance of the AAOs and recovery of associated amortization expense consistent with the treatment proposed by Aquila in this case. (Klote Rebuttal, p. 3, l. 6-9) Public Counsel, however, has recommended disallowance of the unamortized balances from the determination of Aquila Networks-MPS rate base. (Robertson Direct, p. 5, l. 20-22; p. 6, l. 1-2) Despite the Commission's contrary rulings in the Company's 1991 and 1993 rate cases, Public Counsel contends a subsequent Missouri Gas Energy (MGE) rate order in Case No. GR-98-140 in which the Company was denied rate base treatment for service line replacement program (SLRP) costs somehow supersedes the treatment proposed by Aquila and Staff. This theory is unfounded.

The Report and Order issued in Case No. EO-91-358 expressly notes that AAOs are fact-based and granted on a case-by-case basis so the MGE order has meaning only within the context of that company's accounting request concerning SLRP costs and is not relevant to the costs associated with the Sibley rebuild or western coal conversion projects. Additionally, no language in

[3] The deferrals were authorized in Case Nos. EO-90-114 and EO-91-358.
[4] Case Nos. ER-90-101 and ER-93-37.

the MGE decision suggests it has any broader applicability than the topic that is specifically addressed therein.

The Commission should grant the same rate treatment to the Sibley AAOs as it did in Aquila's 1991 and 1993 rate cases. The Company and Staff are in agreement on this topic. Accordingly, Public Counsel's recommended disallowances should be denied.

C. Expense Issues

1. Allocation of fuel and purchased power between Aquila networks-MPS and Aquila Networks-L&P

On what basis should Aquila's fuel and purchased power expense be allocated between Aquila Networks-MPS and Aquila Networks-L&P?

Based on the filed testimony there appears to be agreement to allocate these expenses at an 81:19 ratio.

2. Fuel and Purchased Power Expenses

What amount of fuel and purchased power costs should be included in expenses?

3. Coal Prices

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

With respect to fuel expense in base rates and, specifically, coal prices for generation, Aquila has included in its direct case actual annualized costs for high-Btu bituminous coal for the 2005 test year. Aquila specifically excluded a coal contract with C.W. Mining, which terminated the contract in early 2005 under

a claimed "*force majeure*" incident. C.W. Mining cited on-going labor issues. (Herl Rebuttal, p. 3, 1. 6-7) Aquila excluded the cost of coal under the C.W. Mining contract because Aquila is not receiving any coal pursuant to the terms of that contract[5] and will not be receiving any additional coal delivery under the terms of the contract. Instead, the Company has calculated fuel expense in base rates on its contract price with coal supplier Consolidated Coal Company (Consol) which operates the Emery Mine in Utah. (Herl Rebuttal, p. 2, l. 12-20)

Staff and intervener SIEUA have proposed adjustments that would include the price of coal from C.W. Mining as part of Aquila's price of coal for generation and disregarded the Consol contract. Essentially, Staff and interveners propose that the Commission ignore the plain fact that no coal is being delivered pursuant to the terms of the C.W. Mining. Apparently, Staff is recommending that the Commission set an expense level for coal fuel based on the fiction that coal from this former supplier continues to be supplied despite the undisputed facts to the contrary. This is another example of regulation by myth.

The bizarre nature of Staff's adjustment is illustrated by its suggestion that signing the contract with C.W. Mining was imprudent in that Aquila "did not investigate labor issues" as part of its due diligence while at the same time, paradoxically, insisting that the terms of the allegedly imprudent contract be utilized by the Commission in determining coal prices during the 2005 test year. (Featherstone Direct, p. 38, l. 10-11) This internally contradicted argument does not pass a laugh test.

[5] Aquila has not received any coal from C.W. Mining since April of 2005. (Herl Rebuttal, p. 3, 1. 3-4)

The other arguments offered in support of a pretend coal supply are equally groundless. Staff claims that Aquila would not pursue legal action against C.W. Mining absent some punitive compulsion from the Commission and that if Aquila did not pursue legal action in an attempt to recover its costs, Staff would deny any rate recovery under the current contract with Consol. (Vesley Direct, p. 4, l. 3; Featherstone Direct, p. 36, l. 4-6) These arguments are an attempt to micromanage the Company[6] and, also, ignore the fact that Aquila filed a breach of contract action in a Utah federal court in February 2005 to collect nearly $54 million in damages from the coal supplier, a circumstance acknowledged by Staff in its direct testimony. (Featherstone Direct, p. 36, l. 3-6)[7] In fact, a three-day bench trial was held from February 12-14, 2007. (Herl Rebuttal, p. 3, l. 10-17) Indeed, this proposed condition to cost recovery, to the extent it has any validity, has already been met.

As noted above, Staff suggests that Aquila may have imprudently entered into the C.W. Mining contract (Featherstone Direct, p. 36, l. 21-22) and, further, that Aquila may have imprudently adhered to the agreement during an initial delivery delay. (Featherstone Direct, p. 38, l. 3-5) Neither of these arguments is fact-based or meritorious. To the contrary, the evidence shows that C.W. Mining was the best acceptable respondent to Aquila's coal RFP and, further, it was the only RFP respondent that offered to meet the Company's tonnage requirements

[6] The Commission may regulate certain aspects of Aquila's utility operations but it has no authority to usurp its management discretion. *State ex rel. City of St. Joseph v. Public Service Commission*, 30 S.W.2d 8 (Mo. banc 1930).

[7] Why Staff filed testimony in this case the stated purpose of which is to compel the Company to pursue a legal action that was filed long before this rate case commenced in July of 2006 is anyone's guess.

with an acceptable quality coal. (Rooney Rebuttal, p. 7, l. 2-5) Accordingly, Aquila prudently entered into the C.W. Mining contract.

Further, it was not imprudent for Aquila to continue its operations consistent with the terms of the C.W. Mining contract when it was notified of reduced deliveries by the supplier. The supply slow-down was anticipated to be fairly brief and Aquila had adequate reserves of coal on hand for the period of delay included in the notification from C.W. Mining. (Rooney Rebuttal, p. 5, l. 12-16; Vesley Direct, p. 11, l. 13-15)[8] Staff witness Featherstone concedes that: "C.W. Mining indicated to Aquila that it thought it would be able to fulfill the terms of the contract." (Direct, p. 37, l. 8-9) By the end of the first period of delay, coal prices already had increased. Staff witness Vesley states that Aquila's first purchase of high-Btu coal to make up for the C.W. Mining contract shortfalls in May of 2004 already reflected an upward movement in pricing. (Vesley Direct, p. 12, l. 18-22) In addition, under the terms of the contract Aquila did not have a valid legal basis for rescinding the contract.[9]

Finally, the ultimate impact of Staff's proposed adjustment is plainly unreasonable. It substantially understates the current, known cost of coal in setting base rates,[10] and Staff is aware of this. As noted previously, Staff intends this. It is not just or reasonable to factor into Aquila's fuel cost a price that knowingly understates the cost of coal that Aquila is actually paying absent a

[8] Aquila had reason to believe that full-contract deliveries would resume. (Rooney Rebuttal, p. 5, l. 5-p. 6, 1. 1-2)
[9] While the contract was signed in September of 2003, the terms of the agreement did not begin until January 1, 2004. Had Aquila terminated the contract in December of 2003, after initially being notified by C.W. Mining of delivery problems, as suggested by Staff, Aquila could have been in material breach of the contract and subject to damages. (Herl Rebuttal, p. 7, 1. 3-6)
[10] The price of coal under Aquila's contract with Consol is significantly higher than the 2006 price under the C.W. Mining contract. (Herl Rebuttal, p. 2-3)

compelling showing that Aquila imprudently entered into the C.W. Mining contract - a showing that has not been made. Staff's pointlessly punitive adjustment should be rejected.[11]

Not only has no showing been made of imprudence on the part of Aquila in entering with the C.W. Mining contract, no such showing can be made. C.W. Mining was not some sort of fly-by-night operation. It was a significant supplier of coal for electric utilities. Records of the Federal Energy Regulatory Commission show that C.W. Mining supplied coal to the Tennessee Valley Authority (TVA), PacifiCorp., Northern Indiana Public Service Company (NIPSCo), Nevada Power and Portland Gas and Electric in 2001. In 2002, TVA, PacifiCorp. and NIPSCo received C.W. Mining coal. TVA and PacifiCorp. continue to receive coal from C.W. Mining in 2003. Records concerning C.W. Mining's production level gave no indication that it would have difficulty meeting Aquila's contracted quantity. The information available at the time the contract was executed in September 2003 indicated production levels at 1,100,000 tons in 2001 and 850,000 tons in 2002. These are production levels that far exceeded the required deliveries under Aquila's contract with the Company. (Herl Rebuttal, p. 6, l. 8-21) Staff's suggestion that Aquila's due diligence of C.W. Mining did not include a review of labor relations and practices also is a non-starter. It is not a general business practice to review the labor relations and practices of a supplier. No policy,

[11] It also should be rejected on the grounds that imposing a financial penalty on Aquila in the context of a rate case is an effort to circumvent to the statutory complaint procedures set forth in the Public Service Commission Act. Such an action reverses the burden of proof and denies the Company its procedural due process rights.

requirement or expectation exists that would prompt such a review. (Herl Rebuttal, p. 5, l. 14-20)

As to any recovery that Aquila receives in the form of damages from the C.W. Mining lawsuit, Aquila proposes that customers be refunded a proportionate share of the replacement coal tonnage included in the Company's proposed fuel adjustment clause, less attorneys' fees and litigation costs amortized over the next five years. Absent authorization to implement a fuel adjustment clause, Aquila proposes an appropriate refund mechanism be developed along the lines as what was implemented in Case No. ER-82-39 involving the Peabody Coal lawsuit. (Rooney Rebuttal, p. 6, l. 17-22).

4. Natural Gas Prices

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

Aquila has included for costs of total fuel and purchased energy expense, actual expenses that were dependent upon actual operating conditions during the test year. Those fuel costs have been adjusted to properly represent normal expenses for a rate case test period. The adjustments have included resource mix adjustments and adjustments in fuel and purchased power prices to reflect current market conditions. Also, the Company has adjusted high and low expenses to develop an appropriate annualized fuel and purchased energy expense for the test period. (Rooney Direct, p. 7, l. 1-9) The annualized test fuel and purchased power expense has been dispatched by RealTime computer software which is a reliable and accurate production cost computer model

designed to develop the appropriate generation and purchased energy levels and the resulting amount of fuel burned. (Rooney Direct, p. 7, l. 12-19) Both the Aquila Networks-MPS and Aquila Networks-L&P systems were dispatched using this same model. (Rooney Direct, p. 8, l. 5-8)

This process has included the determination of a final average gas price which refers to the weighted average cost of gas at the burner tip as reflected in the Company's dispatch model. The cost of the natural gas commodity is the largest component of the burner tip cost. The commodity cost used by the Company is based on the New York Mercantile Exchange ("NYMEX") commodity prices at the Henry Hub, the most widely used index in the gas industry. (Rooney Direct p. 10, l. 6-18)

As in its previous rate case, Aquila proposes burner tip prices that are derived from a natural gas price curved based upon an average NYMEX natural gas futures prices. In this regard, the Company has calculated a 90 day average of the NYMEX futures market price for each individual month of the 2007 calendar year. (Rooney Direct, p. 10, l. 19-23) Aquila has proposed the price for natural gas as set forth in Schedule HDR-4HC to Company witness Davis Rooney's direct testimony. That schedule shows both the commodity component of burner tip gas, and the monthly and annual weighted average burner tip cost of gas from the dispatch model. (Rooney Direct, p. 14, l. 11-14) The weighted average burner tip cost of gas from the dispatch model presented by Aquila is **_____** per MCF. (Rooney Surrebuttal , p. 12, l. 1-3)

Staff and Aquila have submitted gas price proposals that are similar in result if not in methodology. Aquila's gas prices in this case are slightly higher but the Company believes that the method employed by the Company is more reasonable than that employed by Staff.

The method used by Staff to normalize gas prices should be rejected by the Commission. Staff proposed gas price of **_____** is based on flawed methodology. It is based on the incorrect assumption that normalized gas prices can accurately predict actual gas prices. This assumption is flawed in that normalized prices are expected to be different from actual prices just as normalized temperatures for rate making do not necessarily reflect actual temperatures a year later. Additionally, Staff's analysis does not recognize that gas generation occurs predominately in the summer and that gas prices are more volatile in the winter. Failure to account for these points leads Staff to incorrect conclusions. (Rooney Surrebuttal p. 13, l. 1-8)

Witness Brubaker on behalf of Sedalia Industrial Users Association and St. Joe Industrial Group has proposed gas prices that are much lower than those proposed by Aquila or Staff. The **_____** proposed by Mr. Brubaker significantly less than the prices presented by Aquila and Staff and is not adequately normalized and cannot, therefore, be reasonably expected to reflect conditions that will occur during the time that the rates are in effect. Additionally, he has included prices that pertain to periods outside of the test year and the update of this case. (Rooney Surrebuttal, p. 7, l. 9-14)

As to the latter point, Mr. Brubaker has included in his calculations gas prices from March 2006 through February 2007. This data is not appropriate because the update period for this case extends only through December 2006.[12] As such, Mr. Brubaker has attempted to include market conditions that are outside the update period. (Rooney Surrebuttal, p. 8, l. 1-17)

Also, Mr. Brubaker is using price points from very limited time periods as the basis for his expected prices. This is inappropriate because of the volatility of gas prices which can react strongly to changing information about temperatures, weather and storage. Moreover, the conditions applicable to the narrow time period used by Mr. Brubaker do not reflect normal market conditions. January 2006 was significantly warmer than normal and the high storage levels held down the price of gas for the remainder of the year. Weather conditions throughout the year resulted in October gas storage levels nearing maximum limits. That taken together with a short-term outlook for a warm January and the January 2007 futures contract closed at $5.84, the lowest January price in four years. Even if such conditions were to repeat, they would not represent normal conditions any more than a hot summer in one year represents normal temperatures. (Rooney Surrebuttal, pp 10-11)

Mr. Brubaker has proposed the lowest gas prices in this case. As the Company has shown hereinabove, they should be rejected by the Commission as inappropriate, inaccurate and unreliable.

[12] *See*, August 22, 2006, Order Adopting Procedural Schedule and Modifying Previously Ordered Test Year, ¶ Ordered: 4.

5. Off-System Sales Margins

How should off-system sales margins be determined? What amount of off-system sales margins should be included in expenses?

This issue has been settled or otherwise resolved. Aquila does not believe this is any longer a contested matter.

6. Depreciation

What depreciation rates should be used for determining Aquila's depreciation expenses?

In this case, Aquila proposes that currently authorized depreciation service lives and depreciation rates should be retained. (D. Williams Rebuttal, p. 16, l. 12-14) The Company further proposes that a depreciation study of all functional plant assets be performed and the results of that study be submitted in Aquila's next rate case. (*Id.* at l. 14-15) Aquila plans to submit its next depreciation study in late 2007 or early 2008. (*Id* at l. 9-11) The Company's proposal is aligned with Staff's recommendation. (Schad Direct, p. 6, l. 20-21)

Witness Gorman on behalf of a number of interveners,[13] has proposed an adjustment to "Other Production" plant (OPP) suggesting an average service life of 35 years for Account Nos. 341 through 346. (Direct, p. 38-40) This recommendation has been based on an AmerenUE proposal (*Id*. at p. 40, l. 10-18)

This adjustment, however, should be rejected by the Commission. There is no good reason to adjust service lives of OPP simply because AmerenUE has

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

proposed to do so. In this regard, one size does not necessarily fit all. Rather, the average service life of OPP, as well as all functional plant, should be based on an analysis of assets and not an arbitrary protocol. (D. Williams Rebuttal, p. 15, l. 16-17) By doing so, relevant factors such as the age of the assets, current use of the assets, planned use of the assets, obsolesce of technological changes can all be considered. (*Id.* at l. 17-22) Staff and the Company share this analytical philosophy. (Schad Direct, p. 6, l. 5-6)

Also, it is not appropriate to review an isolated plant function in setting depreciation expense levels. Instead, established depreciation study procedures should be followed. This typically includes a review of all plant functions (intangible, production, transmission, distribution and general). Failure to do the analysis in this fashion results in a mismatch of the benefits and costs with the appropriate rate payer. (D. Williams Rebuttal, p. 15, l. 1-6)

Use of current depreciation rates in this case makes good sense. Aquila's depreciation rates have been studied in each of its last three rate cases so the current depreciation rates[14] are up to date, adequate and reliable for rate making purposes in this case.

[14] Schad Direct, p. 3, l. 8-11.

III. DEMAND SIDE MANAGEMENT

Should the Demand Side Management programs Aquila proposes be approved? If so, who should bear the costs of the programs?

Aquila's believes this issue has been settled or otherwise resolved.

IV. HEDGING

Should the Commission allow rate recovery of the results of Aquila's hedging program?

Aquila uses swaps, calls and puts to hedge the price of natural gas. (Rooney Direct, p. 13, l. 17-18) The hedging program is described in detail by Company witness Gary Gottsch. The purpose of the program is to reduce the impact of gas and purchased power price of volatility. When gas prices are rising, the hedge program will reduce costs by producing off-setting gains. Conversely, when prices are falling, the hedge program will produce off-setting costs. It is important to remember, however, that reducing volatility does not necessarily mean reducing costs. (Rooney Direct, p. 16, l. 7-11)

Aquila's hedging program was in effect during the test period in the Company's last rate case. That program generated gains during the relevant test period which were booked below-the-line by the Company and, consequently, were not included in the Company's filed case as a component of natural gas cost.[15] Aquila's decision to record both hedge benefits and costs below-the-line prior to the resolution of Case No. ER-2005-0436 was criticized by Staff. Staff claimed that significant gains in the Company's hedging program would have

[15] This was driven by the Company's view that hedging is a program with high regulatory risk in that hedge benefits would be flowed back to customers whereas hedge costs would be disallowed through some pretext or other. (Rooney Rebuttal, p. 24, l. 11-18)

reduced gas costs had it been reflected in an interim energy charge ("IEC") mechanism. Staff contrasted Aquila's approach with that of The Empire District Electric Company which flowed net settlement amounts through that company's IEC mechanism. (Rooney Rebuttal, p. 25, l. 7-13) As a result of Stipulation and Agreement in Case No. ER-2005-0436, Aquila agreed to book net settlements from its hedging program above-the-line for ratemaking purposes. (Rooney Rebuttal, p. 24, l. 11-21)

During the 2006 test period in this case, the Company's hedging program has generated significant settlements losses. (Rooney Rebuttal, p. 29, l. 7-9) Consistent with its commitment in the last rate case, Aquila included these costs to price for fuel used for generation in its dispatch model and to price the fuel underlying purchased power generation. (Rooney Direct, p. 16, l. 19-23; p. 17, l. 1-4)

All too predictably, Staff excluded these losses in its direct case in the determination of energy costs. The Company believes that this issue is controlled by the terms of the Stipulation and Agreement which provided as follows:

> The Signatory Parties agree, for accounting and ratemaking purposes, that hedge settlements, <u>both positive and negative</u>, and related costs (e.g., option premiums, interest on margin accounts, and carrying costs on option premiums) directly related to natural gas generation and on-peak purchased power transactions under a formal Aquila Networks-MPS hedging plan will be considered part of the fuel costs and purchased power costs recorded in FERC Account 547 or Account 555 when the hedge arrangement is settled. (emphasis added)

From the Company's perspective, Staff's position in this case is at odds with the expressed terms of the settlement of Case No. ER-2005-0436.

Aquila is concerned that its initial reservations about recording hedge benefits and cost above-the-line are being realized in this case.[16] Staff's position is that the standard for prudence for hedging is whether or not there is a gain during any particular period and, based on Staff 's omission of the hedging losses during the test period, leaves the impression that only positive settlement are acceptable. (Rooney Rebuttal, p. 27, l. 1-4) This asymmetrical method of regulation is nothing more than results-oriented auditing.

If this is in fact Staff's position, it is unrealistic in addition to being inconsistent with the Commission's Order in the last Aquila rate case. Over time, gains and losses of the fixed positions will substantially offset each other. The only scenarios in which gains are likely to be consistently produced are highly improbable. (Rooney Rebuttal p. 27, l. 11-17) Staff's position in this case is nothing less than using 20/20 hindsight in the determination of the prudence of Aquila's execution of its hedging program.[17] Prudence should be determined based on the information that was available at the time decisions were made, not on the actual settlements results.

The Commission should include historical 2006 hedge costs in determining energy costs in this case. This is how the issues should be handled

[16] The pretext for excluding hedge costs in this case is the alleged imprudence of Aquila's hedge program. (Hyneman Surrebuttal, p. 23-45)

[17] It might be more accurate to describe it as a manifestation of buyer's remorse on the part of Staff. Having insisted on above-the-line accounting treatment for settlements gains or losses, the reality of significant losses on the regulated books of account has caused Staff to pull out the ever popular imprudence argument as the only remaining justification for effectively disregarding the terms of the settlement. (Hyneman Surrebuttal, p. 40, l. 24-29)

even if the Commission accepts Staff's energy costs for gas of purchased power. Those costs are historical in nature and the Staff should have included historical hedge results in costs in accordance with the specific terms in the Stipulation and Agreement the Commission approved in Case No. ER-2005-0436, absent a compelling showing of imprudence.[18] It is unreasonable and unfair to exclude the 2006 hedge costs as categorically imprudent without further explanation.

V. FUEL COST RECOVERY

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

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.*[19] – Missouri's electric utilities have been denied the ability to use automatic rate adjustment mechanisms to assure timely recovery all of their prudently-incurred fuel and purchased power costs from customers. That changed when the Missouri General Assembly passed SB 179,[20] which, *inter alia*, allowed the Commission 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 . . .." [21] To implement the statute, the legislature required

[18] Staff did not make a decision to recommend disallowance of the results of Aquila's hedging plan until after it had filed in its direct case. (Hyneman Surrebuttal, p. 44, l. 12-15) This apparently is so despite the claim that its alleged concerns about Aquila's hedge program have carried over from the Company's 2005 rate case. (Hyneman Rebuttal p. 14, l. 5-15) This is indicative of unhappiness with the results of the program, not the methods employed and, consequently, is no more than a *post hoc* rationalization.

[19] 585 S.W. 2d 41.

[20] Codified as Section 386.266, RSMo 2005.

[21] Section 386.266(1).

the Commission to adopt rules to govern the filing and administration of fuel and purchased power cost recovery mechanisms. Those rules were adopted in late 2006 and became effective in January 2007.

Aquila was the first electric utility in Missouri to request approval of an FAC in a general rate case whose operation of law date fell after the effective date of the Commission's FAC rules. AmerenUE also has a pending request for an FAC, and although Aquila supports AmerenUE's request, Aquila believes that each company's proposal should be judged independently of the other's and that each request should stand or fall on its own merits. Aquila and AmerenUE are different companies whose histories and operating characteristics differ considerably from one another. And, to the extent the Commission believes that some or all of a utility's history and/or operating characteristics should affect the decision to authorize an FAC, those differences must be recognized and carefully weighed.

Several witnesses will present testimony on the FAC issue in this case: witnesses for Aquila favor an FAC while witnesses for Staff, Public Counsel, the Industrials, and AARP either oppose an FAC altogether or oppose the specific FAC that the Company has proposed. As it considers this evidence that will be presented by each of these parties, the Commission must keep foremost in its mind that the legislature enacted SB 179 because it recognized that: 1) electric utilities are entitled to timely recover all of their prudently-incurred fuel and purchased power costs; 2) traditional modes of regulation available under Missouri law have proven inadequate to achieve that objective, especially in an

era of ever-increasing fuel and energy costs; and 3) the FAC, through countless applications in numerous other states, has proven itself as a ratemaking tool that fairly balances and accommodates the legitimate interests of both a utility and its customers.

A. Why Aquila Needs an FAC

Since 1979, both the Commission and Aquila have tried to deal with the problems created by volatile and ever-increasing costs for fuel and purchased power within the confines of a regulatory regime that did not allow periodic rate adjustments to reflect actual costs. Instead, costs were recovered through rates that were based on estimates of what those costs would be in the future. When those estimates proved to be too low – as was often the case when costs increased – Aquila and its shareholders were forced absorb the difference between actual and estimated fuel and energy costs until the Company could file a rate case and new rates could be put into effect. In the interim, the earnings Aquila could reasonably expect to achieve would be well below the level that the Commission had previously determined was “fair and reasonable.”

This occurred because: 1) reliance on estimates of future costs is an inherent weakness of traditional ratemaking; and 2) the Commission was powerless to react to that weakness because Missouri law did not permit approval of cost recovery mechanisms that would allow periodic rate adjustments, outside general rate proceedings, to reflect increases or decreases in the cost of fuel and purchased power.

Because no one can predict the future with certainty, the test period cost of service that has been used to set rates in Missouri is nothing more than a best guess of what costs will actually be during the period those rates are in effect. If the cost estimates are too low, then a utility has no meaningful chance to earn its fair rate of return. And, although there some cost estimates do balance out over time – with the detrimental effects of estimates that are too low being cancelled out by the beneficial effect of estimates that are too high – that balance is imperfect and far from adequate, as can be seen from the relatively few instances where a utility's actual earnings equal or exceed its authorized rate of return.

But the Commission was unable to meaningfully address the problems posed by volatile and ever-increasing fuel and energy costs because of the restrictions that were imposed by the Public Service Commission Law[22] as it existed prior to 2006. Forced to operate within those strictures, there was little the Commission – or the utilities it regulates – could do to develop and implement innovative approaches to ratemaking that did not employ estimates of future costs and that did not require recovery of those estimated costs through base rates. One attempt at innovation -- the Interim Energy Charge ("IEC") – proved to be ineffective in addressing the problem for which it was designed, as was clearly demonstrated in a recent case involving The Empire District Electric Company.[23]

With the enactment of SB 179, however, the legal restrictions that prevented the Commission from effectively addressing the problems posed by

[22] Title XXV, RSMo.

[23] *See*, Report and Order in Case No. ER-2006-0315 (Dec. 21, 2006), p. 39 (IEC failed to provide for recovery of almost $27 million in prudently-incurred fuel and purchased power costs.)

volatile and ever-increasing fuel and purchased power costs were removed. By making FACs lawful in Missouri, the legislature both allowed and encouraged the Commission to rejoin the regulatory mainstream. Aquila's witness Steven Fetter notes in his rebuttal testimony that Regulatory Research Associates, a respected analyst of the public utility industry, has identified 42 states that use some form of FAC for their electric utilities. (Fetter Rebuttal, p. 11) And, by authorizing an FAC for Aquila, Missouri can join the substantial majority of state utility regulators that have successfully employed automatic mechanisms to allow the electric utilities they regulate to timely recover all of the costs they incur for fuel and purchased power.

Like most electric utilities, fuel and purchased power costs represent the largest, single element of Aquila's cost of service. These costs, which amounted to almost $204 million for the test period, constitute approximately 46 percent of the Company's total operations and maintenance expenses. (D. Williams Surrebuttal, p. 5) Due to changes in national and international markets for fuel, Aquila's costs for fuel and energy have both fluctuated widely and increased significantly over the past several years. In fact, Aquila's fuel and energy costs have increased between 13–20 percent per year in each of the past three years.[24] And this trend is expected to continue into the foreseeable future.

Neither traditional modes of regulation – where fuel and energy costs are estimated and recovered entirely through base rates – nor innovations like the IEC have proven to be successful in assuring Aquila that it will be able to recover the actual costs it incurs for fuel and purchased power. Only an FAC can do that,

[24] D. Williams Surrebuttal, p. 6.

which is why legislature authorized the mechanism and why the Company has proposed one in this case. Only an FAC will assure that Aquila realizes the objective to which it is entitled by law and which SB 179 was enacted to make possible: timely recovery of all prudently-incurred fuel and purchased power costs. The consequences of failing to authorize a meaningful FAC for Aquila are obvious: as noted by Regulatory Research Associates, utilities operating in jurisdictions without FACs "have always been, and continue to be, at risk for fluctuations in fuel and purchased power between rate cases." (Fetter Rebuttal, p. 11)

B. Legal Standards for FACs in Missouri

Several witnesses will present testimony that purports to identify the legal and/or regulatory standards that should govern the Commission's decision regarding Aquila's proposed FAC. Not surprisingly, the witnesses who oppose the Company's proposal, in whole or in part, argue that it fails to meet some or all of those standards. But Aquila's witnesses will testify that the standards the opposing witnesses argue for are fallacious because they are either unsupported by applicable law are contrary to law and sound regulatory policy.[25] As it considers the conflicting testimonies of these witnesses, the Company urges the Commission to keep foremost in mind that the law governing FACs in Missouri is contained in SB 179. And, although rules adopted by the Commission to govern the filing and administration of FACs supplement the statute, neither those rules nor the Commission's exercise of whatever discretion it has should thwart the intent, objectives, and judgments of the legislature that are embodied in SB 179.

[25] See, e.g., Fetter Rebuttal, p. 10-11.

An analysis of SB 179 shows the following to be among the intentions and judgments of the legislature that are reflected therein, either explicitly or by implication:

- Through its enactment of SB 179, the legislature expressed its judgment that it is in the public interest for the Commission to authorize FACs;

- To be lawful, an FAC need only: 1) comply with the terms of SB 179, and 2) comply with the rules adopted by the Commission;

- Neither SB 179 nor the Commission's rules require an electric utility to demonstrate or prove financial need before it can implement an FAC;

- Although an FAC can only be approved in a general rate proceeding where "all relevant factors which may affect the costs or overall rates and charges" of the requesting electric utility are to be considered, SB 179 strongly suggests the legislature intended the Commission should approve any FAC that: 1) is reasonably designed to provide the utility a sufficient opportunity to earn a fair return on equity; 2) provides for an annual true-up to remedy any under- or over-collections; 3) obligates the utility to file a general rate case with an operation of law date is no greater than four years after the effective date of the Commission order implementing the FAC; and 4) provides for prudence reviews no less frequently than every eighteen months.

- The requirement in SB 179 for periodic prudence reviews reflects the judgment of the legislature that such reviews are adequate to protect the interests of electric utilities and their customers.

Moreover, there can be little doubt as to why the legislature passed the statute: SB 179 was designed so that electric utilities, like Aquila, could use an FAC to assure timely recovery of all prudently-incurred fuel and purchased power costs. The legislature recognized that FACs, although commonplace in most other states, had been denied to Missouri's electric utilities by the Supreme Court's decision in *UCCM*, and that this was a significant detriment. If the legislature had believed that the recovery of fuel and purchased power costs through base rates adequately met the needs of Missouri's electric utilities,

passage of SB 179 would not have been necessary. But the legislature concluded that it was necessary to pass the statute, which implies that not only did the legislature believe that FACs could be used to deal with the problems that volatile and ever-increasing fuel and energy costs pose for utilities and their shareholders but that they should be used for that purpose.

C. Aquila's Proposed FAC

Aquila's proposed FAC -- which is described at pages 3-5 of the direct testimony of Dennis Williams, at pages 6-7 of his surrebuttal testimony, and in specimen FAC tariffs that accompany both his direct and surrebuttal testimonies-fully satisfies all of the requirements of both SB 179 and the Commission's FAC rules, 4 CSR 240-3.161 and 4 CSR 240-20.090.[26] The major elements of the Company's proposal are as follows:

- A base cost of fuel and purchased power – consisting of expenses recorded in FERC Accounts 501, 509, 547, and 555 – will be determined in this case and included in Aquila's base rates;

- The difference between the fuel and purchased power costs included in base rates and Aquila's actual costs will be collected or refunded through the FAC. An FAC factor based on this difference would be calculated quarterly and will be applied to customer usage on a per mWh basis to effectuate collections or refunds;

- In addition to fuel and purchased power, costs recoverable through the FAC will include emission allowance costs, hedge costs, and settlement costs and revenues. Capacity costs associated with purchased power contracts of less than one year would flow through the FAC, but the capacity costs of contracts whose duration is greater than one year will be excluded;

[26] As originally proposed, Aquila's FAC contained a formulaic error, which was identified by Public Counsel's witness Russell Trippensee (Trippensee Rebuttal, p. 15-17). The specimen tariff that is attached to Mr. Williams' surrebuttal testimony contains the correction that Mr. Trippensee identified.

- All off-system sales margins above or below the amount the Commission includes in base rates[27] and all insurance proceeds that the Company receives from generation outages would flow through the FAC;

- FAC costs would be accumulated quarterly in a tracking account, which would accrue interest at a rate equal to the weighted average cost of Aquila's short-term debt. After review and verification by the Staff that the costs in the tracking account were prudently-incurred, under- or over-collected amounts would be collected or credited either quarterly or over a period of twelve months.[28]

- FAC charges will be billed as a separate line item on customers' bills and all revenues collected through the FAC will be recorded in FERC accounts 440000, 442000, 442100, 444000, and 445000 to facilitate audit and review; and

- A formal prudence review and audit, to verify that costs were prudently incurred and revenues were properly collected and credits were properly made, would be held annually.

In addition, Aquila has considered, and is willing to adopt, certain suggestions made by Public Counsel and the Industrials for changes to the Company's proposal, provided the Commission concludes that any or all of those changes should be adopted. Specifically, Aquila is willing to: 1) assign different loss factors based on rate class and voltage level of service, as proposed by the Industrials;[29] and 2) extend the collection period to one year, as suggested by both Public Counsel and the Industrials.[30] The specimen tariff that is attached to Mr. Williams' surrebuttal testimony shows how these proposals would be incorporated into the Company's FAC tariff if they are adopted by the

[27] In its original FAC proposal, Aquila proposed a 50/50 sharing of off-system sales margins above the level of those sales that was included in base rates. The Company now proposes to flow 100% of off-system sales margins through the FAC for the benefit of customers.

[28] See discussion *infra*. Aquila originally proposed that costs be collected/credited entirely within the quarter that begins six months after the beginning of the accumulation period. The Company, however, is willing to adopt a one-year collection period, as proposed by Public Counsel and the Industrial Intervenors if the Commission believes the longer collection period is desirable.

[29] Johnstone Rebuttal, p. 26.

[30] Johnstone Rebuttal, p. 22; Trippensee Rebuttal, p. 4.

Commission. As it considers the second proposal, however, the Commission should keep in mind that extending the collection period to one year may benefit or harm customers, depending on the circumstances. Although, spreading the effect of any under-collected amounts over an entire year may lessen the impact on customers' monthly bills, the longer collection period also means more interest will accrue on the uncollected balance, which ultimately must also be paid by customers.

D. Proposed Changes to Aquila's FAC

Other changes to or concerns about the Company's proposed FAC that will be suggested or expressed by certain of the other parties are not acceptable, however. For example, Public Counsel argues for annual rather than quarterly accumulation periods. (Trippensee Rebuttal, p. 4) Aquila believes a twelve-month accumulation period accomplishes little, if anything, other that to postpone recovery of fuel and purchased power costs for more than a year. The Company believes that consequence of Public Counsel's argument is inconsistent with one of the legislative objectives underlying SB 179 – that utilities be assured timely recovery of prudently-incurred fuel and energy costs. In addition, accumulated fuel and energy costs would accrue interest charges throughout the one-year accumulation period, thereby increasing the total amount that customers ultimately will have to pay. (D. Williams Surrebuttal, p. 10)

Public Counsel and Staff each oppose including certain fuel-related costs – such as railcar repair costs; repair costs for Company-owned coal handling and other facilities; short-term capacity and purchased power agreements; the net of

ash disposal costs and sales revenues; fuel handling expenses fuel disposal costs; labor costs related to fuel; and insurance, maintenance, and hedging costs and revenues – in the FAC.[31] Neither party appears to argue that these costs are inappropriate; the only issue is whether the costs should be recovered through base rates or the FAC. The basis for their positions on this issue appears to be Public Counsel's and Staff's belief that these costs, both individually and collectively, are not sufficiently volatile to warrant inclusion in the FAC. (See Trippensee Rebuttal, p. 10-13; Featherstone Rebuttal, p. 8)

But this rationale is not supported by law. Nowhere in SB 179 is there any requirement that costs included in an FAC must be shown to be volatile. Indeed, the word "volatile" does not even appear in the statute. As stated in Section 1 of SB 179, the only requirement for costs to be recoverable through an FAC is that they be "prudently incurred fuel and purchased-power costs, including transportation." As defined in the FERC Uniform System of Accounts, all of these costs are closely related to fuel and purchased power (D. Williams Surrebuttal, p.13), and Aquila believes that because these costs are so closely related to fuel and purchased power that they, too, should be recovered through the FAC. Moreover, trying to separate these costs for base rate treatment unnecessarily complicates the ratemaking process, and does so without any cognizable, corresponding benefit.

The Industrials will suggest two additional changes to Aquila's proposed FAC. The first is a "soft cap" that would limit increases in a customer's bill

[31] Mr. Williams will testify that the total of the costs that Public Counsel seeks to exclude amounted to almost $17 million in 2006, so the costs at issue here are not insignificant. (D. Williams Surrebuttal, p. 13)

attributable to the FAC to no more than 1.5 percent every six months. (Johnstone Rebuttal, p. 24) Actual fuel and purchased power costs above the cap would be deferred and would accrue interest until some unspecified date in the future when they, too, would be recoverable through the FAC or otherwise. The second proposed change is an elaborate set of performance standards that Aquila would be required to meet in order to earn the right to flow through the FAC the Company's prudently-incurred fuel and purchased power costs. (Johnstone Rebuttal, p. 16-21)

Aquila opposes both of these proposed changes. Regarding the Industrials' demand for performance standards, the Company's witnesses will testify that not only are performance standards unnecessary, they are based on faulty assumptions and would be administered in a way that is fundamentally unfair. (D. Williams Surrebuttal, pp. 16-19) The standards that will be outlined by the Industrials would punish Aquila if it failed to meet the standards in a given period, but there would be no corresponding reward if the Company exceeded the standards in another period. Maintenance schedules vary greatly by season and by year, so it is likely that, within a narrow time period, Aquila's performance would seem deficient when, in reality it is not. Yet the performance standard concept advanced by the industrials makes no provision for this type of situation.

But, more importantly, Aquila believes the Commission should recognize the Industrials' argument for performance standards for what it really is: yet another attempt to thwart the intent of SB 179 by erecting standards and attaching conditions to the use of an FAC that are not provided for in the statute

and were never contemplated or intended by the legislature. But even if it believes that the Industrials' proposal is more than that, the Commission cannot act on that proposal because no detailed performance standards, or evidence establishing the validity of those standards, will be in the evidence in this case. All the Industrials will offer is an argument that detailed standards are desirable and that such standards should be developed sometime by somebody. Under Missouri law, that is not enough; if the Industrials want the Commission to adopt performance standards is incumbent on them to create an evidentiary record that would allow such action. No such record will be created in this case.

And, as for the Industrials' proposal for a "soft cap," if the Commission believes the concept of a cap has merit, it should be set much higher than the Industrials' propose. Aquila's witness will testify that, based on the large fuel and energy cost increases that the Company has experienced in the recent past, unless a reasonable cap is applied – for example, 1.5 percent for each quarterly accumulation period – the balance of deferred costs, plus interest, could be so large that flowing-through that balance to customers will cause rate shock – the very result the cap was intended to mitigate. (D. Williams Surrebuttal, pp. 23-25)

E. The Subsidization Mechanisms Proposed by AARP and the Industrials

Perhaps the most troubling proposals that will be made by the parties who oppose an FAC for Aquila are those made by AARP and the Industrials in the guise of "alternative" FACs. Witnesses for these parties will present proposals that, though different in detail, share a fundamental feature: they will, by design, deny Aquila the opportunity to recover all of its prudently-incurred fuel and

purchased power costs. Under these proposals, fuel and purchased power costs above or below the amount included in base rates would be "shared" between the Company and its customers,[32] which AARP and the Industrials claim is necessary to establish incentives and motivate Aquila to act prudently and to make decisions regarding fuel and purchased power that are in the long-term best interests of its customers. But Aquila need not be concerned, the parties argue, because the "sharing" arrangements they propose are symmetrical, and both the Company and its customers will benefit if the Commission chooses to adopt one of the alternative proposals.

The Commission must not be fooled, because the alternatives proposed by AARP and the Industrials are neither benign nor balanced. Moreover, they are antithetical to both law and sound regulatory policy and also to the objectives of the legislature that are embodied in SB 179. In reality, these proposed alternatives have nothing to do with "sharing"; if adopted, they will require Aquila's shareholders to subsidize a significant portion of the fuel and purchased power costs that the Company will incur to provide electricity to its customers.[33] Subsidization is not "sharing." In addition, the proposals are not symmetrical but, instead, are grossly asymmetrical with all or virtually all of the subsidies going one way – from Aquila's shareholders to its customers.[34] Finally, it is not necessary to establish incentives or motivate Aquila to act prudently in acquiring the fuel and purchased power necessary to serve the Company's customers.[35]

[32] See, Binz Direct, p. 23-24; Johnstone Rebuttal, p.16.
[33] See, Fetter Surrebuttal, pp. 2, 5-6; D. Williams Surrebuttal, p. 22.
[34] D. Williams Surrebuttal, p. 22.
[35] Fetter Rebuttal, pp. 7-8; Fetter Surrebuttal, pp. 6-7; Williams Surrebuttal, pp. 26-27.

The legislature and the Commission have already done that by mandating periodic reviews to evaluate whether Aquila acted prudently and by limiting costs recoverable through the FAC to those that are prudently-incurred. In reality, therefore, the proposals advanced by AARP and the Industrials are "alternative" FACs at all. Instead, they are further attempts to thwart the intent of the legislature and deny Aquila the ability to timely collect all of the prudently-incurred fuel and purchased power costs as authorized by SB 179.

Though different in detail, the subsidization proposals of AARP and the Industrials would operate similarly. A base level of fuel and purchased power costs would be included in the Company's base rates. If actual costs exceed that level, customers will pay part of the shortfall and Aquila – or more specifically, Aquila's shareholders – would pay the rest. If actual costs are less than the level costs included in base rates, only a portion of that difference would be returned to customers; through to the magnanimity of AARP and the Industrials, Aquila would get to keep the rest.

Although employing euphemisms like "sharing" may mask their proposals, it does not change the true nature of the alternatives that AARP and the Industrials will suggest. But to see what actually would be in store for the Company if either of these proposal is adopted, the Commission must look past the facade. Aquila did, and this is what it found:

> [E]ven if Aquila operates as efficiently as it possibly can, it will not be able to recover 100% of its prudently-incurred costs. This on its face would appear to violate U.S. Supreme Court precedent (dating back more than 60 years in the Bluefield and Hope cases, which defined the concept of 'just and reasonable rates' as it relates to fair utility rates of return).

(Fetter Surrebuttal, pp. 4-5)

It is axiomatic that a utility cannot have a reasonable opportunity to earn a fair rate of return if it is not first able to cover all of its prudently-incurred operating expenses. Yet AARP and the Industrials will ask the Commission to establish an FAC that, by design, prohibits Aquila from recovering all of its fuel and purchased power costs, regardless of whether those costs were prudently-incurred.[36] In fact, as the Company understands it, the proposal made by the Industrials would cap recovery of fuel and purchased power costs at 75 percent. As noted previously in this brief, Aquila's actual fuel and energy costs for test period exceeded $200 million. Had the Industrials' alternative FAC been in effect the Company's shareholders would have been required to "share" approximately $50 million of that total. AARP's proposal is somewhat less extreme, but the end result is the same. Under neither of these scenarios would Aquila have a reasonable opportunity to earn a fair rate of return. Yet that is what is required by *Hope*[37] and *Bluefield*.[38] And under neither of these scenarios would Aquila have an opportunity to recover all of its prudently-incurred fuel and energy costs. Yet that is what the legislature intended when it enacted SB 179.

It is nonsense to argue – as AARP and the Industrials will – that the shareholder subsidies required under their proposals would be offset by the opportunity for Aquila and its shareholders to gain if actual fuel and purchased power costs fall below the level that is included in base rates. This is true

[36] See, D. Williams Surrebuttal, pp. 19-20.
[37] *FPC v. Hope Nat. Gas Co.*, 320 U.S. 591 (1944).
[38] *Bluefield Water Wrks. Co. v. Pub. Serv. Comm'n.*, 262 U.S. 679 (1923).

because there is no real likelihood that fuel and energy costs will ever fall to levels that would trigger the ratepayer "sharing" aspects of either of the proposed alternative FACs. Aquila's evidence will show that, based on a statistical analysis, the probability of upward and downward movement around a set price is asymmetrical. That means that even if fuel and purchased power costs fluctuate both above and below the level that would be included in base rates under either AARP's or the Industrials' proposals, Aquila would lose much more if costs increase than it would gain if costs decrease.[39] But any benefits to Aquila as a result of costs falling below the level included in base rates are, in reality, illusory any way, because: 1) fuel and energy costs are much more likely to increase in the future, not decrease;[40] and 2) an occasional dip in costs from their current levels will not result any benefits to Aquila – especially under the subsidy mechanism proposed by the Industrials.[41]

The legislature never intended that FACs be designed to provide subsidies, either from Aquila to its customers or vice versa, or that they prohibit a utility from recovering all of its prudently-incurred fuel and energy costs. Indeed, SB 179 was enacted to ensure that electric utilities would recover all prudently-incurred fuel and purchased power costs – no more or no less. Because the alternatives proposed by AARP and the Industrials are designed prevent that objective from being realized, they are contrary to SB 179. But even if SB 179 did

[39] Cozad Surrebuttal, pp. 4-6.
[40] See, D. Williams Surrebuttal, p. 22-23.
[41] Because, under Mr. Johnstone's proposed Alternative FAC, only 50% of the current level of fuel and purchased power would be included in base rates, actual costs would have to fall to less than half of current costs before any ratepayer subsidy would be payable to Aquila.

not exist, these proposals are both unconstitutional and represent bad regulatory policy. (Fetter Surrebuttal, pp. 5-6)

F. Staff's Proposed IEC

As an alternative to Aquila's proposed FAC, Staff proposes that the Commission adopt an IEC, which is described in the direct and rebuttal testimonies of Staff's witness Cary Featherstone. Staff's proposed IEC would follow the model that has been used in the past by Aquila and other Missouri electric utilities.

Aquila opposes Staff's proposal because IEC's, although an minor improvement over more traditional modes of ratemaking that limit recovery of fuel and purchased power costs to the level of those costs that are included in base rates, still suffer from the same shortcoming as the base rate approach: fuel and energy costs are based on forecasts and estimates. If those estimates are lower than a utility's actual costs – as often occurs when fuel and purchased power costs continually rise – the utility and its shareholders must bear the burden of the shortfall. As noted earlier in this brief, the inability of IECs to effectively deal with volatile and ever-increasing fuel costs was one of the factors that moved the legislature to enact SB 179. Had IECs – which were lawful under the Public Service Commission Law as it existed prior to 2006 – been able to adequately meet the need for which they were designed, SB 179 would have been unnecessary.

But now, Aquila and other Missouri electric utilities do not have to settle for a "second best" remedy, like the IEC. They no longer have to rely on cost

estimates and hope that those estimates mirror reality. By authorizing the Commission to approve FAC's, the legislature ensured that both utilities and their customers will be treated fairly. Utilities were assured that they can timely recover from customers all prudently-incurred fuel and purchased power costs. And customers were assured that they would pay no more – or no less – than the actual cost of fuel and energy used to provide them electricity.

The IEC mechanism, although well-intentioned, never was able to fully meet the demands of volatile fuel and purchased power costs, and its shortcomings were especially apparent when those costs were not just volatile but ever-increasing, as well. Aquila's proposed FAC can meet that challenge, and the Commission should not deny the Company that opportunity simply because Staff, due to its reluctance to embrace the FAC, seeks to resurrect the IEC regardless of its well-documented failures.

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CERTIFICATE OF SERVICE

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 29th day of March, 2007, to the following:

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