

Exhibit No.:

Issues: Accounting Authority Order
(AAO)-IEC

Witness: Dennis R. Williams

Type of Exhibit: Direct

Sponsoring Party: Aquila Networks-MPS
& L&P

Case No.: EU-2005-0041

Date Testimony Prepared: September 3, 2004

Before the Public Service Commission
of the State of Missouri

Direct Testimony

of

Dennis R. Williams

September 3, 2004


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

In the matter of the Application of Aquila, Inc.)
for an Accounting Authority Order Concerning) Case No. EU-2005-0041
Fuel Purchases.)

County of Jackson)
) ss
State of Missouri)

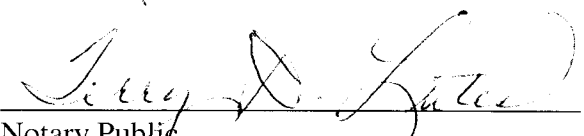
AFFIDAVIT OF DENNIS R. WILLIAMS

I, Dennis R. Williams, being first duly sworn, state that I am the witness who sponsors the accompanying testimony entitled "Direct Testimony of Dennis R. Williams;" that said testimony was prepared by me and under my direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, I would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of my knowledge, information, and belief.



Dennis R. Williams

Subscribed and sworn to before me this 1st day of September, 2004.



Notary Public
Terry D. Lutes

My Commission expires:

8-20-2008



TERRY D. LUTES
Jackson County
My Commission Expires
August 20, 2008

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
DIRECT TESTIMONY OF DENNIS R. WILLIAMS
ON BEHALF OF AQUILA, INC.
CASE NO. EU-2005-0041**

WITNESS INTRODUCTION

1
2 Q. Please state your name and business address.

3 A. My name is Dennis R. Williams. My business address is 10700 East 350
4 Highway, Kansas City, Missouri 64138.

5 Q. By whom are you employed and in what capacity?

6 A. I am employed by Aquila, Inc. ("Aquila" or "Company") as Vice President –
7 Electric Regulatory Services for our electric network operations.

8 Q. Briefly describe your education and work experience.

9 A. I graduated in 1974 from Central Missouri State University, receiving a Bachelor
10 of Science in Business Administration degree, with majors in accounting and
11 finance. After graduation, I was licensed in Missouri as a Certified Public
12 Accountant and employed as an auditor in the regulated industries division of
13 Arthur Andersen and Company. After leaving Arthur Andersen, I was employed
14 for five years with the regulatory consulting firm of Lubow McKay Stevens and
15 Lewis. Since 1986 I have been employed by Aquila in various capacities.

16 **PURPOSE**

17 Q. What is the purpose of your testimony in this proceeding?

18 A. My testimony is to support the application filed on August 4, 2004, regarding the
19 request for an order to authorize deferred accounting treatment for certain fuel
20 costs incurred by Aquila in providing electrical service to its customers in

1 Missouri. I will also explain the accounting treatment Aquila is seeking for costs
2 related to Aquila's hedging program.

3 **ACCOUNTING AUTHORITY ORDER**

4 Q. Please provide some background regarding the request for deferred accounting
5 treatment.

6 A. The deferral treatment request relates to the Interim Energy Charge ("IEC") that
7 the Commission approved for Aquila Networks – MPS and Aquila Networks –
8 L&P as a result of the Stipulation and Agreement in Case No. ER-2004-0034.

9 The IEC is a portion of the variable amount of fuel and purchased power that is
10 being recovered in rates on an interim basis. The IEC collected over the IEC
11 period is subject to true-up and refund upon its expiration on April 21, 2006.

12 Q. Why is Aquila seeking an AAO?

13 A. The Stipulation in the above referenced case contemplated that in any given
14 month, interim IEC collections would differ from actual fuel costs incurred. At
15 the end of a two-year period, a true-up review will take place in order to verify the
16 amount by which actual fuel costs exceed or fall short of IEC collections over the
17 entirety of the IEC period. While the ultimate IEC over-collection or under-
18 collection will therefore not be known for two years, Aquila, is currently required
19 to record any shortfall as an expense on a monthly basis.

20 Q. Why is this the case?

21 A. Generally accepted accounting principles require companies to expense costs
22 when they are incurred. That is, when the related goods or services have been
23 received. Therefore, the cost of fuel must be recognized as an expense at the time

1 it is used to generate electricity or when purchased power is received. In other
2 words, despite the fact that the IEC charge was based upon a two-year
3 mechanism, absent approval of the AAO requested in this docket, Aquila must
4 expense all fuel charges as they are incurred.

5 Q. Did the Stipulation address this issue?

6 A. No. Unfortunately, the Stipulation and rate order establishing the IEC mechanism
7 did not contemplate the need for alternative accounting treatment.

8 Q. What is the impact of the existing accounting treatment?

9 A. The current accounting treatment results in dramatic earnings fluctuations from
10 month to month. The IEC interim charge was based on an estimated average
11 energy cost over a 24-month period. The average cost utilized for ceiling prices
12 was \$19.71 per Mwh each and every month of the IEC period for MPS, and
13 \$13.98 per Mwh each and every month of IEC period for L&P. IEC collections
14 from customers were based on a consistent price every month of the IEC period.
15 On the other hand, actual fuel expenses recorded under traditional accounting
16 methods vary significantly from month to month and are especially high during
17 Aquila's summer peaking periods. Thus, recorded monthly expenses will not be
18 matched with monthly revenues received unless the accounting order is approved.
19 This defeats one of the primary benefits of the IEC mechanism, which was
20 intended to spread the price volatility of fuel prices over time.

21 Q. Can you provide an example of this effect?

22 A. Yes. For simplicity, I will limit my example to MPS actual experience during
23 May of 2004 versus October of 2003. In May, 436,036 Mwh of energy were

1 consumed by customers. As a result, MPS collected \$8,594,000 in IEC revenues
2 (436,036 x \$19.71). However, the average energy cost incurred during May was
3 \$30.83 per Mwh or \$13,442,000 – an earnings shortfall of almost \$5 million. In
4 the third quarter when usage declines, this example would be expected to reverse.
5 Using October 2003 sales of 380,000 Mwh as a proxy for a non-peak month,
6 would result in IEC revenue of approximately \$7,500,000 (380,000 x \$19.71).
7 The energy costs for the month of October 2003, however, were \$12.78 per Mwh,
8 resulting in total recorded energy costs of \$4,850,000, or a \$2.6 million IEC over-
9 collection. This example provides a demonstration of how large, unintended
10 earnings fluctuations can arise under current accounting procedures.

11 Q. Why do such large monthly variances occur?

12 A. Fluctuations occur for two reasons. As I noted previously, the Interim Energy
13 Charge is an estimate of the average monthly energy cost that will be incurred
14 over a two-year period. During non-peak periods, Aquila utilizes little peaking
15 generation, but instead relies on base-load capacity. Base-load units typically
16 have higher fixed costs, but their energy costs - those costs subject to the IEC –
17 are relatively low. During peak periods, particularly during the summer air
18 conditioning season, peaking units are dispatched. These units have lower fixed
19 costs but burn higher cost energy, typically fueled with natural gas. Therefore,
20 when the IEC interim charge was developed, energy costs would have been
21 expected to exceed the average IEC rate in the summer months and to fall below
22 the average in off peak periods.

1 Moreover, IEC over-collections and under-collections are impacted by fuel price
2 volatility. The IEC charge remains constant from month to month even though
3 energy prices rise and fall. Natural gas, in particular, has been subject to recent
4 extreme price volatility. Because natural gas units are Aquila's primary source
5 for peaking power and most of our spot purchase power prices tend to be driven
6 by natural gas as a fuel source, the impact on IEC fluctuations is more significant
7 in summer months.

8 Q. Is an alternative solution to this problem available?

9 A. The only viable alternative to an AAO currently available to Aquila would be an
10 immediate filing for an increase in rates.

11 Q. Is Aquila precluded from filing an increase in rates that would be effective prior
12 to April 21, 2006?

13 A. Yes. The Stipulation and Agreement in Aquila's last rate case contains
14 moratorium provisions that are to remain in effect unless there is a significant,
15 unusual event that has a major impact.

16 Q. Do factors exist that would meet this standard?

17 A. In my opinion, they do. Since the time of that agreement, gas prices have risen
18 and consistently remained well above even the highest level anticipated at the
19 time of the IEC development. Crude oil prices have recently been at
20 unprecedented levels. The recent rise in oil prices has been attributed to concerns
21 over the risk of supply disruption due largely to concerns regarding terrorist
22 activities and security of oil supply infrastructure. Because natural gas costs are
23 correlated to the cost of oil, the price of natural gas is similarly impacted. At the

1 time the Stipulation and Agreement was executed, the Parties were
2 recommending that a natural gas price of anywhere from OPC's \$3.99 to Aquila's
3 \$5.64 be used to set Aquila's rates.

4 Q. Does Aquila suggest that these events would support the issuance of an AAO?

5 A. Yes. The current negative financial impact on Aquila is significant, the
6 underlying cause is unusual, and the events leading to this result are clearly
7 outside the control of the Company.

8 Q. Why didn't the Company file a request for a permanent increase in rates?

9 A. Aquila recognizes that the full impact of the IEC will not be known for almost
10 two years. Aquila would like to allow the IEC to run its course so that its
11 provisions can be allowed to work over time. Without an AAO, an immediate
12 increase in rates may be justified. Yet, if the impacts of international security
13 risks diminish and gas prices begin to fall, circumstances at the end of the two-
14 year period may change.

15 Q. Does Aquila know what the result will be after the IEC runs its course?

16 A. No. We continue to see high price volatility resulting from factors not previously
17 encountered. However, an intended benefit of the IEC mechanism was to levelize
18 the impact of volatile energy costs and avoid more frequent increases and/or
19 decreases in rates. Without an AAO, this intended benefit will not be achieved.

20 Q. Does Aquila believe that the AAO it has requested is a viable alternative to filing
21 a rate case?

22 A. At this time, yes.

23 Q. How does Aquila propose that the requested AAO operate?

1 A. Aquila is proposing that the monthly IEC under/over collection be charged to
2 Other Regulatory Assets (Account 182.3) until the IEC expires in April of 2006.
3 This will defer the impacts until the IEC has had the opportunity to run its course.
4 The regulatory asset (or liability) would then remain on Aquila's books until the
5 effective date of the Report and Order in Aquila's next general rate proceeding
6 following April 21, 2006.

7 Q. Is Aquila asking that the Commission address in this case what will happen to any
8 under-recovery?

9 A. No. Aquila has recommended the use of the following condition in order to
10 preserve ratemaking decisions for a rate case after the completion of the IEC:
11 "The Commission makes no findings or inferences as to whether the deferred
12 expenses are reasonable, or whether Aquila would have suffered financial harm
13 (i.e. whether earnings during the period were adequate to compensate Aquila for
14 the costs incurred) absent deferral. The Commission reserves the right to consider
15 the ratemaking treatment of the costs deferred and any assertions by parties
16 related to these issues to a future rate case."

17 **TREATMENT OF HEDGE COSTS**

18 Q. Are there any other items pertaining to the requested Accounting Authority Order
19 that should be addressed?

20 A. Yes. Aquila is also requesting clarification that the NYMEX natural gas hedge
21 settlements used to mitigate price exposure be reflected as part of the computation
22 of the cost of fuel under the IEC. It is my understanding that this was the intent of
23 the parties to the Stipulation and Settlement Agreement in the last rate case.

- 1 However, under the FERC Uniform System of Accounts, hedge settlements are
2 recorded in account 417.1, Expenses of Non-utility Operations. Missouri
3 Commission authorization is required to allow accounting treatment within the
4 accounts considered for the IEC computation.
- 5 Q. Does this conclude your direct testimony?
- 6 A. Yes.