Exhibit No.:
Issues: Policy and Corporate Allocations
Witness: Jon R. Empson
Sponsoring Party: Aquila Networks-MPS & L&P
Case No.: ER-

Before the Public Service Commission
of the State of Missouri

Direct Testimony

of

Jon R. Empson

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DIRECT TESTIMONY OF JON R. EMPSON
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
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Q. Please state your name.

A. My name is Jon R. Empson.

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

A. I am employed by Aquila, Inc. ("Aquila," or "the Company") as Senior Vice President, Regulated Operations. I assumed this position in January 2004.

Q. What are your primary responsibilities?

A. With the exception of generation, I have overall responsibility for Aquila's utility operations which currently consist of three electric utility operations located in Colorado, Kansas, and Missouri and four natural gas utility operations located in Colorado, Nebraska, Iowa and Kansas. Our natural gas utility operations in Michigan, Minnesota, and Missouri were sold during the first half of 2006, and our electric utility operations in Kansas should be sold during the third quarter of 2006. I am also responsible for the regulatory, legislative, gas supply and central service functions, including billing and the call center.

Q. Please describe your educational background and professional experience.

A. I graduated from Carleton College in 1967 with a B.A. in economics and from the University of Nebraska at Omaha in 1971 with a M.B.A. with a major focus in economics. My working career has included two years in the U.S. Army Infantry; one year as an economist for the U.S. Department of Housing and Urban Development; seven

years with the Omaha Chamber of Commerce in economic development; seven years with Northern Natural Gas and its successor companies in several different management and officer positions; and the last twenty years with Aquila and its predecessor companies. During my tenure with Aquila, I have held a series of different officer positions overseeing utility operations, regulatory, legislative, accounting, human resources, gas supply, billing, measurement, call center, legal and facilities.

EXECUTIVE SUMMARY

Q. What is the purpose of your direct testimony in this case before the Missouri Public Service Commission ("Commission")?

A. The purpose of my direct testimony is fourfold: first, to provide an overview of the case and the witnesses providing direct testimony; second, to describe the steps Aquila has taken to comply with its commitments to this Commission that its utility customers would be insulated from Aquila's repositioning process; third, to identify reductions in central support overhead costs; and fourth, to describe the specific costs that were excluded from this request.

OVERVIEW OF FILING

Q. What is the level of increase being requested by Aquila?

A. Aquila is filing for a $94.5 million or 22% increase in base rates for its Missouri Public Service division ("MPS") and a $24.4 million or 22.1% increase in base rates for its St. Joseph Light & Power division ("L&P").

Q. What are the primary drivers for the MPS rate increase filing?

A. Eighty percent, or about $75 million of the MPS increase, is driven by two factors: the need for additional long-term electric generation capacity and the increase in fuel and

purchase power prices and volumes. As will be explained later in my testimony and the testimony of Aquila witness H. Davis Rooney, the significant increase in demand driven by usage per customer and natural growth on our system requires us to invest in more generation capacity. The remaining twenty percent relates to the recovery of the costs to support the growth in investment, the proposed demand-side management programs, and general inflationary increases in operating costs. As part of this filing, Aquila is requesting the implementation of an energy or fuel adjustment mechanism ("FAC"). The details on the FAC proposal will be explained by Aquila witness Dennis R. Williams. As will be explained in greater detail later in my testimony, Aquila has not included in this filing costs related to executive bonuses and incentives; repositioning costs such as consultants, advisors, and transaction fees; bonus and incentive components for calculating the Company's supplemental executive retirement plan ("SERP"); certain costs related to the South Harper peaking facility including the purchase of several homes and non-property related aesthetic and civic investments; and costs that resulted from Aquila being non-investment grade, such as higher interest costs and prepayments. The revenue increase being requested is to recover only those costs necessary for Aquila to continue to provide safe and reliable electric utility service to its Missouri customers.

Q. Can you put the requested rate increase into a historical perspective?

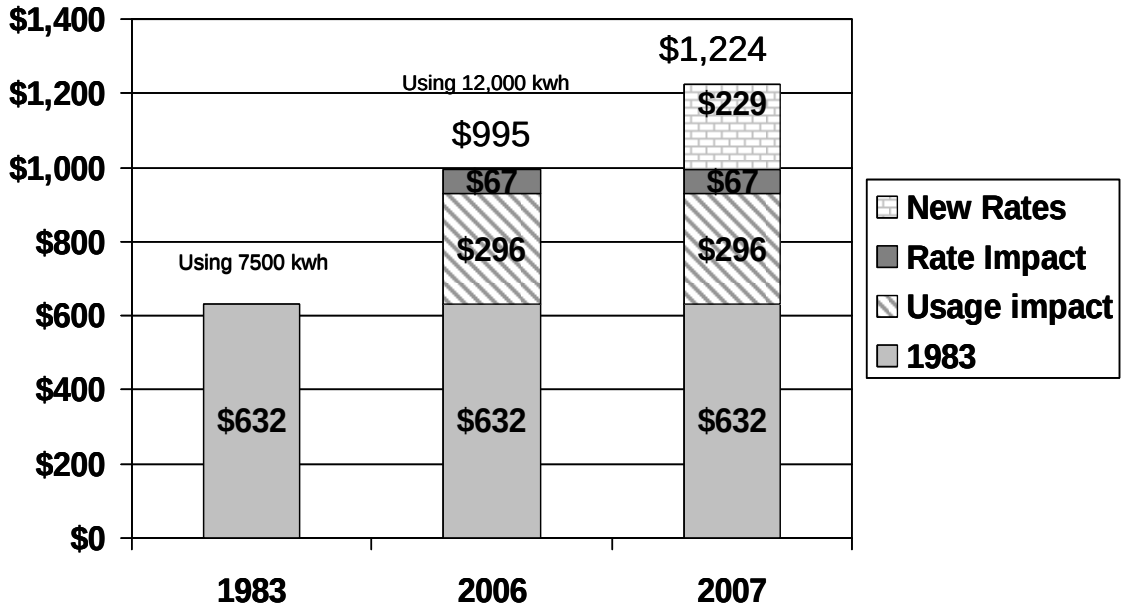
A. Yes. I have included in my testimony a series of graphs (Schedules JRE-1, JRE-2, and JRE-3) that provide a historical perspective on what is impacting an average residential customer's bill on the MPS system. As shown in the graph below, 82% of the increase in the average residential customer's bill from 1983-2006 has been driven by the increase in usage per customer, while only 18% has been driven by the increase in rates (or our

price). Even after the proposed rate increase (assuming that the entire requested increase is granted), the average residential customer bill will still have increased 50% by usage and 50% by rate changes during the past 24 years. This significant increase in usage is an important factor in evaluating the benefit of implementing the demand side management programs described by Aquila witness Matthew E. Daunis.

Finally, if we start with the 1983 actual average residential customer's annual bill of $632 and apply the CPI and increase in per customer usage from 1983 to 2007, the projected annual bill, assuming the inflation rate, would be $1,580 compared to the $1,224 estimate if the entire increase requested in this case is granted.

Q. Why did you start the comparison in 1983?

A. In 1983, Aquila added its last base load power plant into rates. Aquila is now at the point



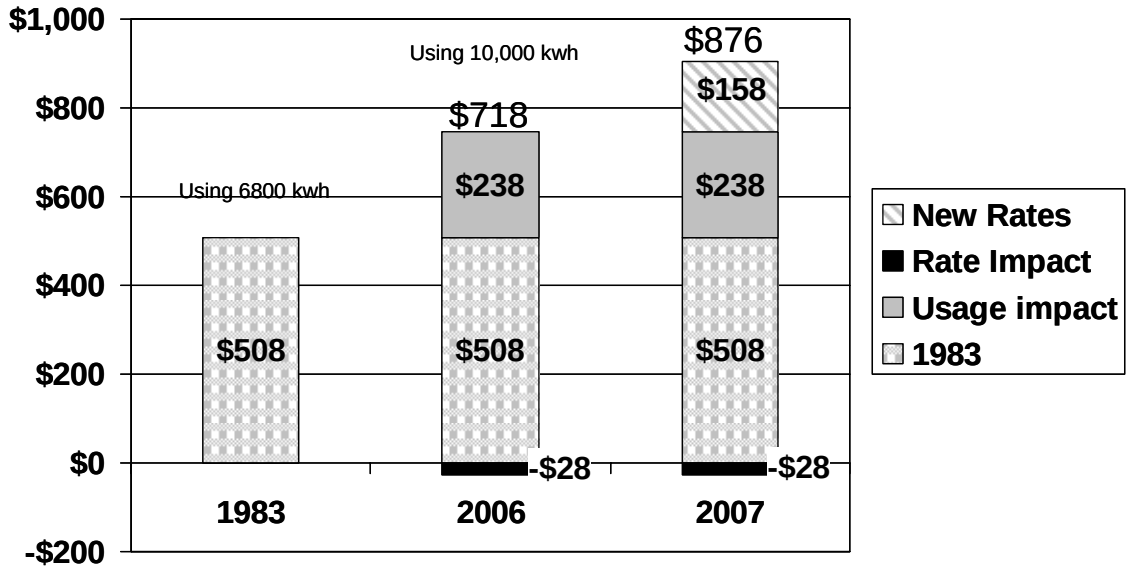
of adding significant capacity to its generation portfolio which is creating the need for further increases in rates.

Q. What are the primary drivers for the L&P rate increase filing?

A. There are three major drivers for the L&P filing. First, about 59% or $14.4 million is for fuel, purchase power, and lower level of offsystem sales credited to L&P. Second, about 28% or $6.7 million is to recover the costs for the investments in plant and equipment necessary to serve our customers. Third, about 13% or $3.3 million is for the general increase in costs, including the demand side management program proposal. As stated earlier, 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.

Q. Can you also put this requested rate increase into a historical perspective?

A. Yes I can. The series of comparable graphs (Schedules JRE-4, JRE-5, and JRE-6)



provide the historical perspective on what is impacting an average residential customer's

bill on the L&P system. As shown in the graph below, 113% of the increase in the average residential customer's bill from 1983-2006 has been driven by the increase in usage per customer. This means that if the electric usage had been the same in 2006 as it was in 1983, the customer's bill would actually be lower today than it was 23 years ago. If we consider inflation and the increased usage, the projected annual bill would be $1,270 compared to the $876 estimate if the entire increase requested in this case is granted.

Q. Who are the Aquila witnesses that will be presenting direct testimony?

A. The witnesses and their primary testimony content are as follows:

Susan K. Braun	Test Year, True-up, Allocation Factors and Various Rate Base and Cost of Service Accounting Adjustments and Schedules
Robert D. Adkins	Revenue Normalization and System Hourly Loads
Block M. Andrews	Environmental Planning
Philip M. Beyer	SERP
Matthew E. Daunis	Demand-Side Management
Gary L. Gottsch	Hedging Program
Samuel C. Hadaway	Cost of Capital
Ronald A. Klote	Various Rate Base and Cost of Service Accounting Adjustments
Carol A. Lowndes	Transition Costs
Kevin T. Noblet	Purchased Power Capacity Contract
H. Davis Rooney	Resource Planning, Joint Dispatch and Fuel & Purchased Power Prices
Jeffrey J. Stamm	Straight-Line Tax Depreciation and IRC Section 199 Deduction
J. Matt Tracy	Rate Design and Tariff Issues
Ivan Vancas	Missouri Operations
Dennis R. Williams	Fuel Adjustment Clause, A. R. Program and DSM Recovery

PROTECTION OF REGULATED CUSTOMER

Q. What commitments has Aquila made, to not only this Commission but all of the state regulatory bodies with jurisdiction over its utility operations, concerning the business

principles designed to insulate its regulated customers while the Company's financial repositioning plan is being implemented?

A. I will provide more detail later in my testimony about Aquila's repositioning plan, but the important considerations are how Aquila is managing the process to protect the customers of its regulated utility operations consistent with its commitment to maintain its focus on the following three key business principles:

1. Protect utility customers from potential adverse financial impacts.

- Maintain the Aquila capital allocation process that utilizes "hypothetical" capital structures and long-term debt assignments.
- Price new/replacement debt to utility divisions at comparable BBB credit rating.

2. Maintain quality customer service.

- Continue appropriate funding of capital expenditures.
- Ensure adequate staffing
- Set and monitor customer service performance metrics.

3. Enhance regulatory transparency.

- Transition to a state-based organization
- Maintain open communications with regulatory commissions
- Maintain a Corporate Cost Allocation Manual
- Maintain Affiliate Transactions Policy and Procedures Manual
- Continue Code of Business Conduct education/training

Q. Please discuss these three key business principles.

A. With regard to how Aquila protects its utility customers from potential adverse financial impacts, the Company's capital assignment process is an important factor.

Q. Please explain.

A. Aquila has maintained a capital assignment process since 1988 that was specifically designed to insulate and separate each of its utility divisions from the other activities of the Company. Aquila has not changed this practice. Aquila's regulated utility operating units are assigned and receive capital based upon what a comparable utility would receive, and this process has been presented to the Commission in every rate case since 1988. The intent has always been to financially and operationally "ring-fence" the utility operations from Aquila's non-utility business.

Q. Why does Aquila "ring-fence" in this manner?

A. Very simply, "ring-fencing" enables one entity within a corporation to be isolated from the impacts of its parent or another entity within the same corporation.

Q. How was the financial "ring-fencing" achieved?

A. Each business unit is internally financed with the proper mix of capital reflecting economic activities, profiles, and market-based comparative capital structures. For electric distribution, the assigned capital structure was 47.5% equity/52.5% long-term debt, and for gas distribution, 50% equity/50% debt. UtiliCorp United ("UCU") and later Aquila assigned, based upon need, specific debt issuances to those business units receiving the proceeds of the issuance and that assignment is not changed until corporate retires the series. In essence this assignment process results in a "hypothetical" capital structure for each business unit.

Q. Has the divisional or hypothetical capital structure approach been acknowledged by any

of the state regulatory commissions in which Aquila has operations as an effective mechanism to help shelter utility operations from non-utility operations?

A. Yes. In investigations completed by the staffs of this Commission and the Kansas Corporation Commission respectively, the following statements were made:

Missouri Public Service Commission's Staff Report on Aquila, Inc. ("Report"), dated December 2002, pages 21, 22, and 27:

> To prevent or mitigate Aquila's higher cost of capital from being charged to Missouri's ratepayers, the Commission can order the use of a hypothetical capital structure for rate making purposes to determine the mix of debt and equity that is appropriate for MPS and for L&P. The capital structure would not be dependent on the capital structure currently in effect for Aquila.
>
> Instead of using Aquila's actual cost of debt and equity, the Commission could impute debt and equity rates that it considers reasonable for Aquila's Missouri utilities.
>
> Specific examples of mechanisms that can be used to help prevent increased capital costs being passed onto the MPS and SJLP rate payers are: use of a hypothetical capital structure, adjustments to embedded costs of debt and preferred stock, adjustments to cost of equity estimates, use of comparable companies (to more closely reflect the cost of capital for a regulated utility versus a diversified energy company).
>
> Kansas Docket No. 02-UTCG-701-GIG: Staff Report, page 14, paragraph 43:
>
> How are Aquila's utility customers protected from the risks associated with UCU's investments in or relationships with unregulated activities, whether such protections are adequate and, if not, what protections should be instituted?
>
> 43. <u>Hypothetical Capital Structures and Rate of Return in Rate Cases</u>
> The purpose of using hypothetical capital structures is twofold; a) establishes capital costs that are not influenced by the risks of non-regulated businesses, and b) determines a rate of return that is adequate to provide sufficient and efficient utility services."

Q. Do you agree with these specific comments contained in both the Missouri and Kansas

reports?

A. Yes. The statements made are consistent with the capital assignment process Aquila has been using for the past 18 years. The reports are also consistent with how Aquila plans to continue to operate in the future.

Q. Has Aquila maintained this assigned capital structure process during this period of transition?

A. Yes. Aquila has maintained, and intends to continue to maintain, the comparable company debt/equity ratios and its current long-term debt assignment process. Aquila has never intended to assign more debt or debt costs to its utility operations than what can be supported by its comparable utilities analysis.

Q. If Aquila has to retire a debt issuance currently assigned to the utility operations, how will Aquila price the replacement debt assigned?

A. Consistent with past practices, it is Aquila's intent to maintain capital costs that reflect comparable utilities. It is Aquila's position that its customers should continue to be charged long and short-term debt costs that reflect representative costs for comparable utilities with a BBB investment grade credit rating. Aquila has essentially declared its utility properties investment grade. In other words, while Aquila as a corporation might be non-investment grade, it is treating all of its utility properties as if they were investment grade. Aquila is behaving as if an outside credit rating agency has determined that a ring-fence exists and the credit risk of Aquila's utility properties had been insulated from the credit risk of the Company.

Q. Are the financial "ring-fencing" mechanisms you have described consistent with what is typical in the industry?

A. Normally, ring-fencing is described in terms of structural protections and holding company organizations. Aquila is not a holding company, but instead operates all of its utility properties as operating divisions. However, a paper published by a NARUC Subcommittee entitled "Ring Fencing Mechanisms for Insulating a Utility in a Holding Company System" ("Paper") (Schedule JRE-7) provides instructive insights about the issue.

> Because of the recent trend of rating agencies to consolidate utilities and non-regulated affiliated companies when evaluating risks, there has been increasing concern over the impact of non-regulated ventures upon the utility's access to debt and equity capital and the corresponding cost of such capital as well as the prospect of the utility being pulled into bankruptcy by its parent's insolvency. As a consequence, ring-fencing techniques are gaining the regulators' attention. (Pages 2-3)

Aquila's commitment to the earlier stated business principles was designed to provide the capital and capital cost protections.

Q. How do you characterize Aquila's commitment to the business principles?

A. Very important.

Q. Please explain.

A. Again, as stated by the NARUC Paper,

> Financial restrictions imposed solely through internal corporate policies are a weaker method of isolating issuer risks relative to those mandated by law, regulation or contract because the corporation may adjust its policies at will. Nevertheless, corporate policies are helpful indicators of management intent. (p. 3).

The commitment to the business principles is a clear and concise statement of intent on the part of Aquila's management that has guided its decisions during the repositioning of the Company.

Q. Would you now please discuss the second key business principle and the commitments Aquila has made to service quality?

A. Aquila remains committed to continue delivering quality services to its customers. Towards this goal, Aquila has developed internal service quality metrics which are maintained on a monthly basis on our intranet dashboard. These metrics, which are defined by Aquila witness Ivan Vancas, include such functions as meter reading accuracy, emergency response time, safety, SAIDI, SAIFI, CAIDI, generation availability, heat rates, and call center performance. Every state operating vice-president provides status reports on a monthly basis which are published on the intranet and reviewed by Aquila's senior management. Detailed reviews of service quality performance for the state are conducted with me on a quarterly basis. Ivan Vancas, Aquila's Operating Vice President for the Missouri electric operations, has filed detailed testimony relating to this second principle.

Q. Turning to the third key business principle, what do you mean by enhancing regulatory transparency?

A. In the mid-1990s Aquila made the decision to centralize its utility operations in order to gain economies from transitioning to common accounting and billing systems, standardized operational practices, and common executive management. Having achieved these economies, Aquila has now implemented a state-based utility organization that is benefiting from the common platforms and is focused on providing excellent service to its customers. Aquila continues to enhance the transparency of its utility structure, which should ultimately further facilitate the Commission's understanding and review of our operations.

Q. Can you provide more information about Aquila's cost allocation manual?

A. Yes. Aquila maintains a detailed Cost Allocation Manual ("CAM"), which is revised annually (or more frequently if a material change takes place within Aquila). Kiesling and Associates, an independent auditing firm, also audited this CAM in 2002 for the Kansas Corporation Commission. On page 3 of this audit, the statement is made that "it is evident that appropriate cost allocation is high on the Company's list of priorities. A great amount of time and money has been invested so that this can be done in the most accurate and timely manner possible."

Q. Were there any changes to the allocations process during the test year as compared to the process utilized in prior cases?

A. There were no fundamental changes to the allocation process during the test year. However, effective January 1, 2006, the calculated percentages based upon the process described above were modified to reflect the elimination of the business units where Aquila has either successfully completed the sale of utility assets, or where Aquila anticipates the successful completion of the utility sale during 2006. These sales include the gas assets in Michigan, Minnesota, and Missouri and the electric assets in Kansas. The asset sales that have closed as of the date of this filing include:

- Michigan Gas April 1, 2006
- Missouri Gas June 1, 2006
- Minnesota Gas July 1, 2006

Sales pending completion later in 2006 and estimated closing dates include:

- Kansas Electric Third quarter 2006

- Everest Communications Third quarter 2006

Q. Why were the allocation percentages, changed effective January 1, 2006, when the actual sales dates were later?

A. The changes were made effective January 1, 2006 for greater transparency and simplicity of our accounting records for both internal and external users of the financial statements. Ronald Klote discusses this accounting change in more detail in his direct testimony.

Q. What about Aquila's affiliate transaction practices?

A. Aquila initiated detailed affiliate transaction procedures, monitoring, and reporting in 2000 in response to a new regulation in Missouri. As Aquila executes its financial plan and reaches its "end-state" as basically a five-state domestic utility, Aquila will continue to maintain and update its current affiliate transaction policy and procedures process to assure compliance with state law.

Q. What is Aquila's Code of Conduct education and training process?

A. Aquila has developed a Code of Business Conduct ("Code") to provide employees essential guidelines to help understand behavioral responsibilities. Employees acting ethically and with integrity help Aquila become a good place to work for employees, a good provider of products and services for our customers, a good citizen in our communities, and a good investment for our shareholders. The Code is on the Company's intranet so that all employees can access this information. In order to emphasize key elements of the Code, Aquila also initiated required on-line, computer-aided training. All new employees are required to complete this training, and a series of updates are provided periodically each year. All employees are also required to complete the update training in a specified time. Required training includes seven modules for

new nonexempt employees and ten modules for new exempt employees covering such areas as Code of Conduct, Affiliate Rules, FERC Standards of Conduct, Environmental, Health & Safety, and Insider Trading. A total of 25 training modules have been developed since June, 2001.

Q. Do you have any final comments concerning the Company's commitment to financially and operationally protect its regulated customers?

A. Yes I do. Aquila understands and appreciates the sensitivity the Commission has about the potential repositioning impact on Missouri utility customers. Aquila has accepted full responsibility for its past strategy and is also taking full responsibility for restoring financial stability while insulating the impacts on its customers. Aquila believes that the guiding principles we outlined in the original financial plan and restated in my testimony today provide the appropriate protection.

ESTIMATED REDUCTION IN CENTRAL SUPPORT OVERHEAD COSTS

Q. Does the Company plan to eliminate central support corporate overhead costs following the asset sales?

A. Yes, as described in our annual report, the Company is developing and is in the process of executing a comprehensive plan to eliminate the majority of these costs that were previously allocated to the sales states.

Q. When does Aquila expect the central support overhead costs to decline?

A. Our goal is to achieve the cost savings by January 1, 2007.

Q. If the sales of utility properties that you discussed earlier in your testimony are anticipated to be completed before year-end 2006, why won't Aquila have achieved the cost reductions sooner than January 1, 2007?

A. Although it is anticipated that the actual sales will be closed prior to year-end, these savings cannot be eliminated immediately upon closing of the asset sales because there is continued work required for most of the assets being sold during a transition period. There are also financial closing true-ups that occur ninety days following the initial closing of the sale. Therefore, the actual cost reduction opportunities will lag behind the actual sale closing dates.

Q. What is the amount of 2005 costs previously allocated to the discontinued utility operations?

A. The costs previously allocated to the gas operations in Michigan, Missouri and Minnesota and the electric operations in Kansas for 2005, disclosed on page 99 of our annual report, was $42.3 million.

Q. What is your current estimate for how much the Company can eliminate from the allocated cost pool?

A. Our current estimate for reduction is $37.2 million of the $42.3 million previously allocated.

Q. Please describe the composition of this $37.2 million targeted cost reduction.

A. The composition of this targeted reduction consists of the following:

Labor (including payroll and taxes)	$10,841,000
Benefits	$ 4,021,000
Other non-labor	$22,322,000
Total	$37,184,000

Q. How was the $37.2 million target determined?

A. Once the Purchase Sales Agreements ("PSA's) were signed, Aquila began looking at the

types of costs originating from central support groups, the applicable cost drivers, and the amount allocated to the business units being sold. The goal was to eliminate to the greatest extent possible the amounts previously allocated to the sale units from the total corporate allocation cost pool. Each leadership team owner was asked to review and confirm these targeted savings as being reasonable and then to begin developing their own plan to achieve these targets. These amounts represent targeted savings and actual results may vary.

Q. Why is the Company not targeting the full $42.3 million?

A. The Company did target and would like to eliminate all of the allocated costs if possible. However, there are certain costs that are more fixed versus variable so they do not decrease ratably with the reduction in customers, plant in service, and employees.

Q. Can you provide some examples of these types of costs?

A. Yes, an example would be the costs associated with SEC reporting requirements. The costs to support the quarterly and annual reporting requirements as well as Sarbanes Oxley compliance are not reduced ratably by the percentage of assets sold or increased ratably as assets are acquired because these corporate reporting requirements are virtually the same for a smaller or larger public entity. The Corporate Treasury function is another example of a cost that does not shrink ratably as the company becomes a smaller entity.

Q. Is it appropriate for the remaining customers of the utility operations to absorb the costs that could not otherwise be eliminated?

A. Yes, these costs are necessary to support the remaining enterprise. The costs are incurred only for the benefit of the remaining customers.

Q. Did Aquila and Empire represent in the stipulation agreement to the sale of the Missouri

Gas operations that this transaction would have no detrimental effect on either Empire's or Aquila's Missouri utility customers, including but not limited to increased rates or any effect on customer service?

A. Yes.

Q. Will the change in operating and maintenance expense allocations due to the sale of the Missouri gas operations have an impact on rates?

A. No. In fact, Aquila intends to account for the impact during the true-up once the extent of the cost pool is known. The allocation of operating expenses to Missouri gas was only 2.75%. This percentage applied to the current estimate of $5.1 million of costs previously allocated to the sales states that are not currently planned to be eliminated is $140,250.

Q. How much of this $140,250 would be reallocated to MPS and L&P based upon the revised 2006 allocations?

A. Based upon the revised allocation percentages for MPS and L&P the $140,250 would be redistributed to the Missouri electric utilities as follows:

	Allocation %	Allocated Cost to MO
MPS	30.46%	$42,720
L&P	10.25%	$14,376

Q. Are headcount reductions included in the central support targeted overhead costs?

A. Yes. A targeted headcount reduction of 220 from the 2005 budget has been estimated. A recent examination of FTE's in the ESF/IBU allocation pool shows that an approximate headcount reduction of 140 has already been achieved through attrition. The estimated additional 80 FTE reduction has been incorporated into the payroll adjustment and

associated benefits reduction in this filing as described more fully by Aquila witness Ronald Klote. Since actual results that the Company achieves may vary, it is recommended that a payroll annualization true-up also be performed in this case.

Q. Is the Company requesting recovery of the severance associated with these reductions in personnel in this case?

A. No. The severance is being incurred to restructure the company to the size of organization needed to serve the remaining utility customers. The severance cost is being retained as a corporate cost.

Q. What types of cost savings are included in Other Non-labor?

A. This includes projects to reduce our facility space, telecommunication charges, software licenses, etc.

Q. Is the allocation of shared corporate assets similarly impacted by Aquila's restructuring?

A. Yes.

Q. What is included in the corporate allocated assets?

A. The corporate allocated assets include the following types of assets: 1) facilities used by central support groups like the call center and corporate functions; 2) system investments for accounting, property records, customer billing, human resource systems, SCADA, dispatch, and work management; and 3) personal computers, servers, and other technical equipment.

Q. Were any of these assets included in the utility sales process?

A. No. While Aquila will be eliminating the variable costs associated with operating these systems, Aquila needs to retain these systems in order to continue to operate a safe and reliable electric utility in Missouri.

Q. Please describe the accounting process for these assets.

A. The corporate assets are maintained on the books of the Aquila corporate business unit. They are depreciated using rates determined from our most recent corporate depreciation study. The gross plant, accumulated depreciation reserve and depreciation expense are then allocated to the various utility jurisdictions based upon cost drivers similar to other allocated expenses as previously discussed.

Q. What happens if a utility jurisdiction approves a depreciation rate that differs from the corporate asset depreciation study?

A. If the authorized depreciation rate is different from the corporate depreciation rate, an adjustment is made on the jurisdiction's books and records to adjust the depreciation expense and accumulated depreciation reserve to reflect the authorized rate multiplied by the allocated gross plant balance. This assures that each jurisdiction has depreciated the asset pool based upon that jurisdiction's approved rates.

Q. Has there been any change in the allocation of depreciation expense between the test year and 2006?

A. Yes.

Q. Please describe this change.

A. Similar to the treatment of allocated expenses discussed above, the allocation factors for the shared corporate assets and associated depreciation expense have been modified in 2006 to reflect the sale of the utility properties.

Q. How much does rate base for MPS and L&P change as a result of these changes in allocation percentages?

A. The total increase in jurisdictional rate base is $3.9 million for MPS and $1.0 million for L&P.

COSTS NOT INCLUDED

Q. Has Aquila taken actions to ensure to the greatest extent possible that only costs necessary to operate a safe and reliable electric utility have been included in this case?

A. Yes. Corporate accounting has been and continues to be very careful about properly coding all repositioning related costs to avoid any direct charges to the utility operations or any inadvertent coding that might result in a cost being included in a department that would be allocated to utility operations. The regulatory accounting group also reviewed each corporate and Intra Business Unit ("IBU") department to ensure that charges were appropriate. Adjustments were also made to expense items to reflect the fact that our non-investment grade status might have increased our costs. The end result was that $22,933,802 of test year expense has been retained at the "corporate" level and not allocated or charged to utility operations.

Q. Does Aquila have a team of executives that are responsible for the overall operations of the Company?

A. Yes it does.

Q. Has the composition of that executive management team changed over the past few years?

A. Yes it has. As we entered 2002, the executive management team consisted of nine people which included Rick Green, Chairman of the Board; Bob Green, President and Chief Executive Officer; Keith Stamm, President and Chief Operating Officer, Global Networks; Ed Mills, President and Chief Operating Officer, Aquila Merchant Services; Dan Streek, Chief Financial Officer; Leo Morton, Senior Vice President and Chief Administrative Officer; Leslie Parrette, Senior Vice President, General Counsel and Corporate Secretary; Cal Payne, Senior Vice President and Chief Risk Officer; and Paul

Perkins, Senior Vice President, Corporate Development. Since the announcement of the repositioning plan and the change in business strategy, six of the nine members have left the Company. Only Rick Green, who reassumed the position of Chairman, President, and Chief Executive Officer; Keith Stamm, who became Senior Vice President and Chief Operating Officer; and Leo Morton, who maintained his same position, remained at Aquila.

Q. Were any of the six departing members of the executive management team replaced?

A. Yes. During the 2003-2004 timeframe, certain positions were replaced and others were restructured. Chris Reitz was promoted to the position of General Counsel and Rick Dobson to the position of Chief Financial Officer. In addition, Sally McElwreath, Bob Poehling, Brock Shealy, and I became members of the executive management team in positions overseeing communications, energy resources, corporate compliance, and regulated operations, respectively.

Q. Have there been further changes?

A. Yes. With the virtual completion of the sales process of the international and merchant assets and the pending sale of the four utility properties, the composition of the executive management team was reviewed again and has been reduced during 2005-2006 from the nine members that existed in 2004 to five members today to reflect the smaller size of the Company. The smaller sized executive management team is either directly reflected in the case or will be captured in the true-up period.

Q. Has Aquila paid retention bonuses to the executive management?

A. Yes.

Q. Are the bonus costs included in this case?

A. No. The executive bonuses were not included in this case and were never intended to be recovered through rates.

Q. Is Aquila paying annual or long-term incentives to the executive management?

A. No. The executive management has chosen to not participate in either the annual or long-term incentive plans.

Q. Has the composition of Aquila's Board of Directors ("Board") also changed over the past few years?

A. Yes. In 2001, the Board consisted of eleven people, including two employee members, Rick Green as Chairman and Bob Green as president and Chief Executive Officer. Of those eleven Board members, only five remain today. Three new Board members were added in the period from 2003-2005. Rick Green is the only employee member of the Board.

Q. Are any of the Aquila Board costs included in this case?

A. Yes. However, the costs were reviewed and normalized to eliminate costs associated with specific meetings on the repositioning plan and assuming that a typical utility board might only meet quarterly. It is likely that many utility boards meet more often than this due to the increased scrutiny that all utilities face, but Aquila is attempting to project what an ongoing cost might be. There are also three fewer Board members today than existed in the test year, so those costs were eliminated. The end result was that the total Board costs were reduced by 35%.

Q. Were any adjustments made to the building or facility requirements?

A. Yes. Aquila is downsizing its support staff organization as it sells four of its utility properties. Aquila has announced its intention to sell one of its office buildings in

Raytown in an effort to "right-size" its facility requirement. While we have not yet sold the facility, the cost for the building has been eliminated from this case in an attempt to include a "going forward" cost.

Q. Has Aquila made any adjustments to the calculation of its Supplementary Executive Retirement Plan ("SERP") expense?

A. Yes. As detailed by Aquila witness Philip M. Beyer, incentive pay and discretionary bonuses have not been included in the base expense calculation. One-time discretionary bonuses never were included in the calculation but it is important to restate that the SERP expense in this case does not include any incentive pay or one-time discretionary bonuses for executives. Also, the base expense excludes the former merchant employees and Robert Green.

Q. What about the cost to build the South Harper peaking facility?

A. In this filing, the costs associated with South Harper that were recognized by Staff and Aquila in the last rate case have been included. The base cost is approximately $138 million. Additional South Harper costs have been incurred since the last rate case and have been carefully reviewed for inclusion in the 2006 update. Excluded from recovery in this case are the costs to acquire houses adjacent to the South Harper site, specifically identified outside legal expense to litigate the related Circuit and Court of Appeals cases, the aesthetic improvement projects not on the South Harper site, and the specific incremental costs for the neighborhood meetings.

CONCLUSION

Q. Why do you go into such great detail in this testimony about all of the steps that Aquila has taken to ensure that its Missouri utility customers have been and continue to be

protected during this repositioning period?

A. While Aquila has always been focused on this commitment to its customers, I wanted to stress that fact again with this Commission and the public so there was no confusion about the costs that are and are not included in this filing. In the Aquila 2002 Annual Report, Richard C. Green, Chairman and Chief Executive Officer, made the following statement:

> During the past 16 years, we had actively pursued a merchant energy strategy that contributed significant profits, growth and diversification to the company. However, with the sudden deterioration of wholesale energy markets, increased credit rating standards and tightening capital markets, we saw in mid-2002 that the merchant business was no longer a viable area for Aquila. As fallout from the collapse of energy trading continued, we pushed to make rapid and radical changes to our business strategy.

At the same time we were announcing the repositioning, we formally restated our commitment to the guiding business principles I discussed earlier. It is important for the Missouri Public Service Commissioners to understand that we have never wavered from our commitment to our customers. We have maintained a consistent focus on the financial and operational insulation of our customers from the repositioning process. The testimony filed today by Aquila's witnesses further documents that commitment.

Q. Has the Commission Staff addressed the potential implications of Aquila's repositioning process?

A. Yes. In the December 2002 Report, the Staff stated:

> The Staff does not know the ultimate impact of Aquila's financial troubles, but will address, in this report, the options the Commission has available to it to effectively handle any potential negative impacts that Aquila's financial troubles may have on its Missouri operations (Page 2).

As part of this 57- page report, the Staff provided a 13-page background summary

of Aquila with an emphasis on the 1985-2002 period.

Q. Did Staff identify potential areas of concern?

A. Yes. For example, on page 17 of the Report, Staff identified the higher capital and interest costs as possible negative impacts on Aquila's Missouri regulated utility. As stated earlier, however, Aquila has addressed this concern through the use of a hypothetical capital structure and assignment of investment grade debt. A second potential negative was the repositioning costs. As stated earlier, Aquila is retaining these costs at corporate and not including them in the utility cost of service. A third possible negative impact was the accounting treatment for losses related to non-regulated property. While these losses have eroded Aquila's equity, the continuing proposal to use a hypothetical capital structure has ensured that customer rates can always be based upon a comparable, investment grade utility capital structure. Staff concluded that the "Commission has the regulatory tools to address the inclusion or exclusion" of costs.

Q. Did Staff also address other concerns?

A. Yes. Staff spent considerable time reviewing key customer service-related metrics. Aquila is providing Staff with monthly updates on key metrics so that Staff can continually monitor our performance. Staff also completed a very comprehensive customer service audit of Aquila in 2005 which Aquila witness Vancas discusses in more detail.

Q. Do you have any concluding comments?

A. Yes. Aquila has made significant progress in repositioning the Company. While the factors that created this need to reposition may continue to be publicly debated for years, the important fact is that Aquila has assumed the responsibility for where we were, where

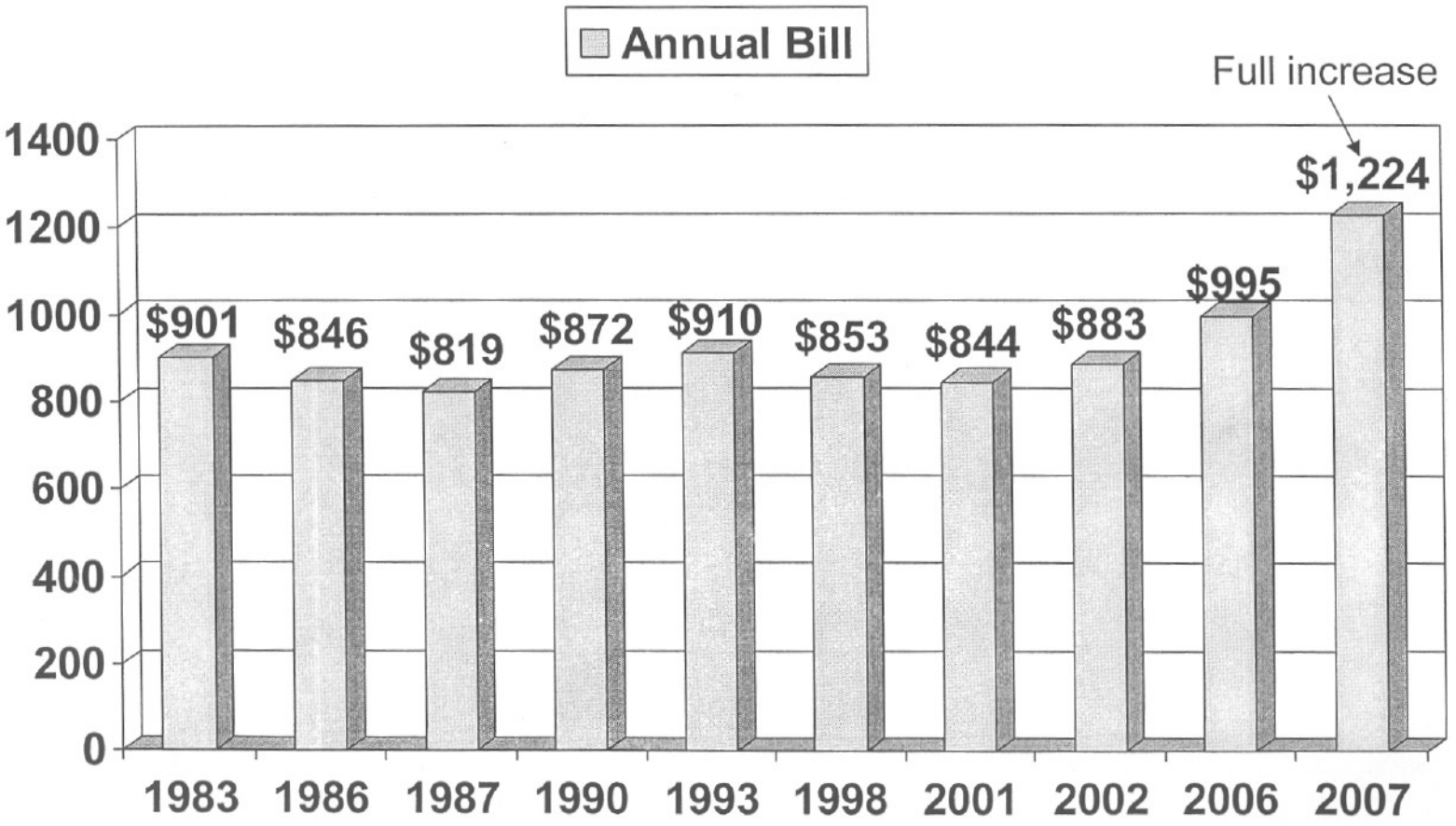
we are, and where we will be. We are committed to rebuilding the financial position of the Company while never losing focus on the importance of ensuring that our customers are insulated from the process.

Q. Does that conclude your direct testimony?

A. Yes it does.

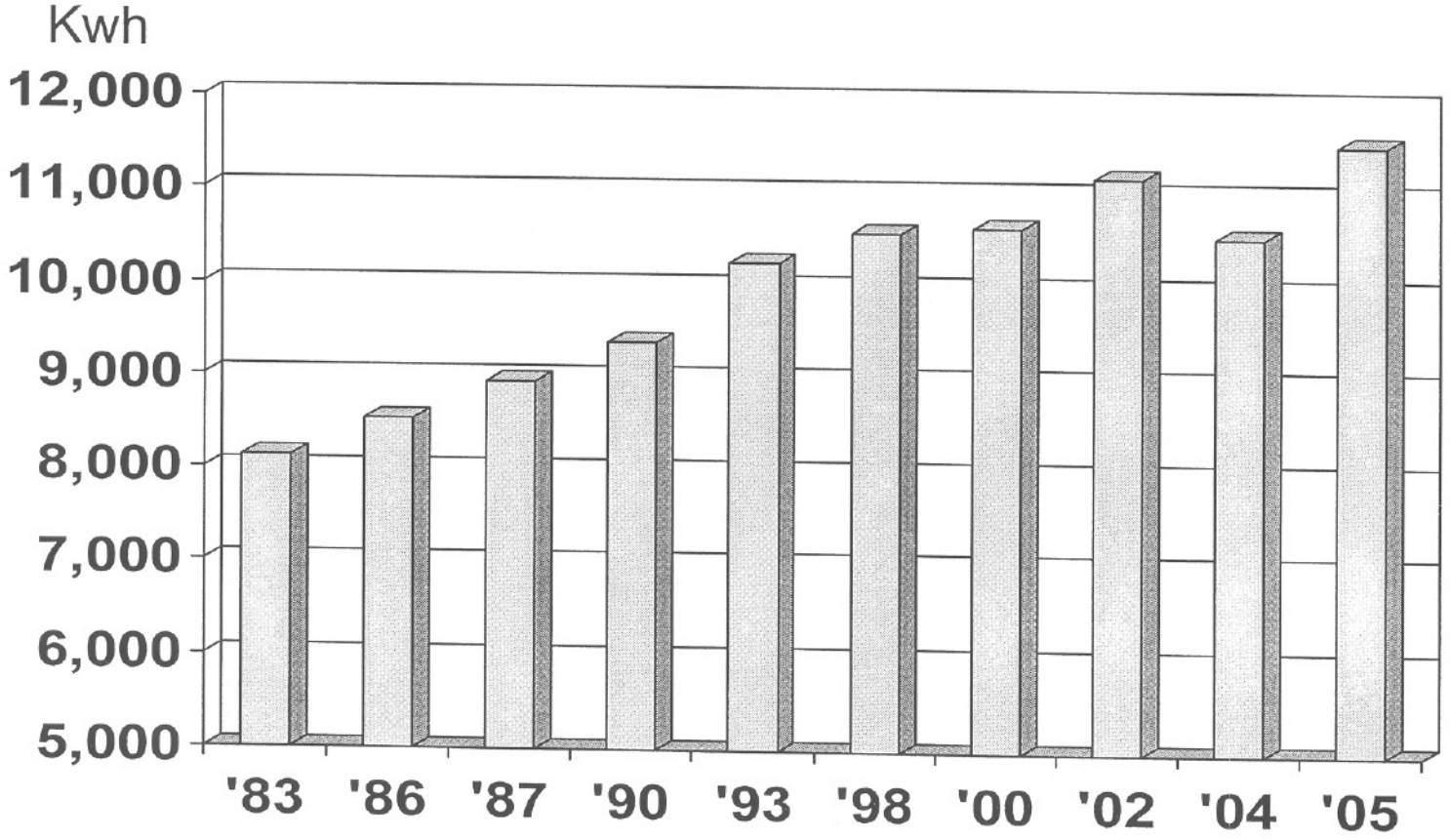
Average Annual Residential Bill
MPS 1983 to Current

12,000 kwh annually



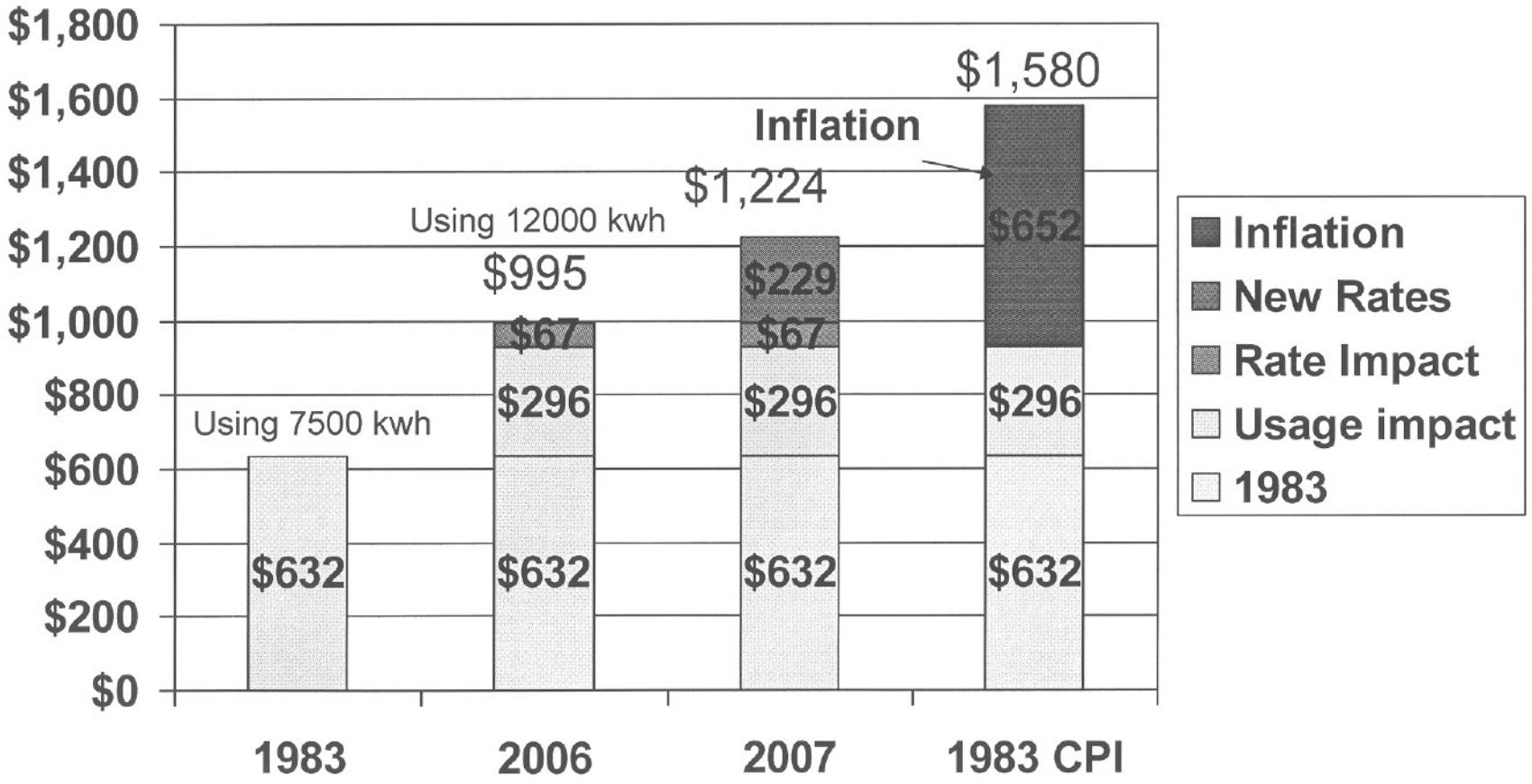
SCHEDULE
JRE-1

Annual Kwh per Customer
MPS Service Territory



SCHEDULE
JRE-2

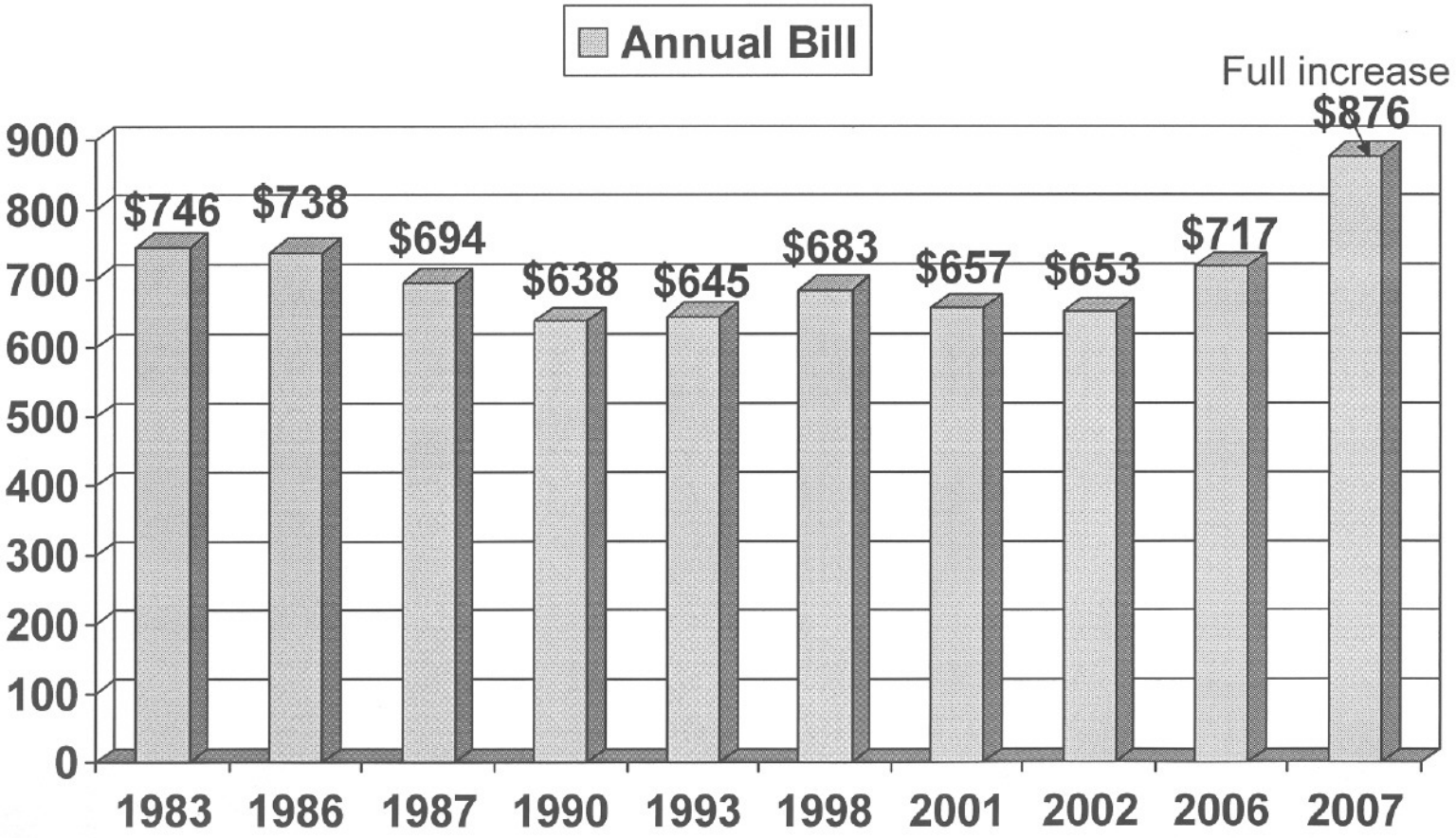
Average Annual
MPS Residential Bill Analysis



SCHEDULE
JRE-3

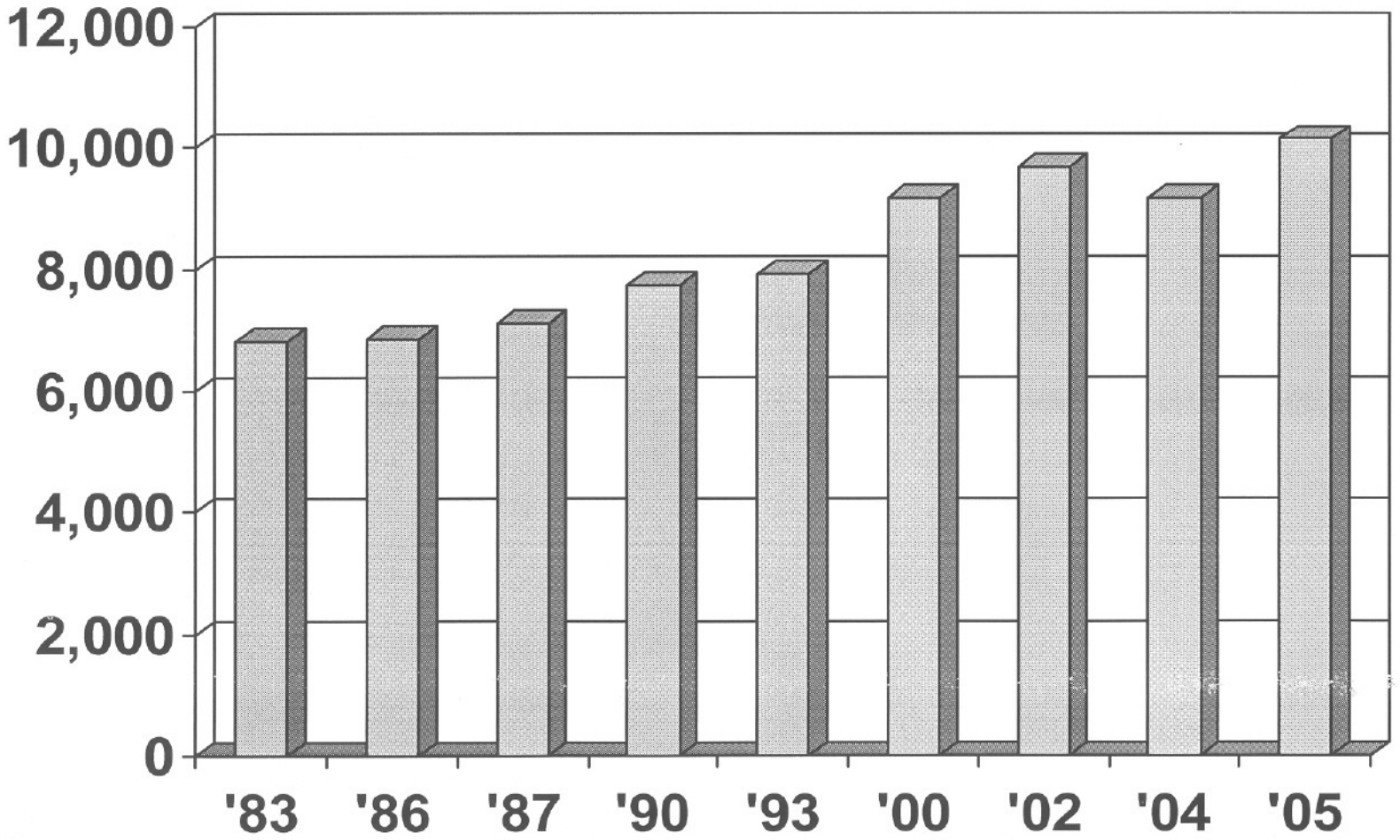
Average Annual Residential Bill
L&P 1983 to Current

10,000 kwh annually



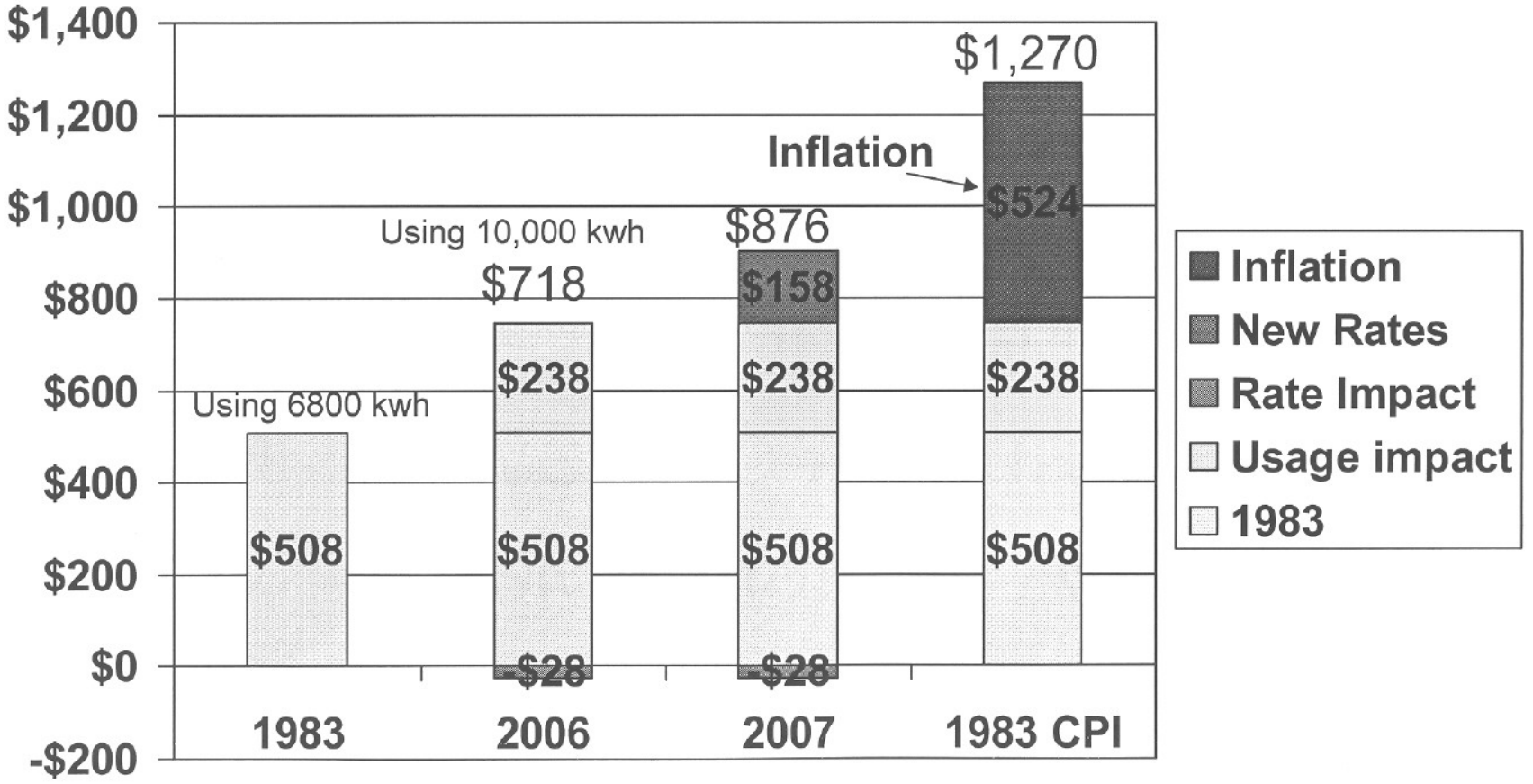
SCHEDULE
JRE-4

Annual Kwh per Residential Customer
L&P Service Territory



SCHEDULE
JRE-5

Average Annual
L&P Residential Bill Analysis



SCHEDULE
JRE-6

Ring Fencing Mechanisms for Insulating a Utility in a Holding Company System[1]

INTRODUCTION AND BACKGROUND

On March 27, 2003, in Reno, Nevada, the Subcommittee on Accounting and Finance (Subcommittee) initiated a project to study "ring fencing" mechanisms and how such mechanisms can affect utility regulation. This paper represents an analysis of our findings.

Ring fencing has been defined in different ways but generally involves techniques used to insulate the credit risk of an issuer from the risks of affiliate issuers within a corporate structure.[2] Our interests in this project are directed toward identifying and analyzing the various ring fencing mechanisms that can be employed to insulate the regulated utility from the business practices and credit risks of sometimes highly speculative, non-regulated affiliates.

The Subcommittee has addressed the interrelationship of regulated utilities and non-regulated affiliates before. First, in 1999, the Subcommittee developed "Guidelines for Cost Allocations and Affiliate Transactions" (Guidelines) for energy utilities, which were adopted by NARUC at its Summer Meetings, San Francisco, California July 22, 1999. The adopted Guidelines are intended to "provide guidance to jurisdictional regulatory authorities in the

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[1] Prepared by Timothy Devlin, Florida Public Service Commission, Rebecca Phillips, Kentucky Public Service Commission, and Thomas Ferris, Wisconsin Public Service Commission with the assistance of Chancy Bittner of the Iowa Utilities Board, David Hodgden and Joseph Buckley of the Ohio Public Utilities Commission, Charles Christiansen, California Public Utilities Commission, and Terri Carlock, Idaho Public Utilities Commission. This paper was prepared on behalf of the NARUC Staff Subcommittee on Accounting and Finance. Any views or opinion expressed by the authors are not necessarily those of NARUC, the Florida, Kentucky, and Wisconsin Public Service Commissions, or any other particular state utility regulatory commission.

[2] Bonelli, Sharon, Yee, Mona, CFA, and Lapson, Ellen, CFA (2003). Corporate Finance, Rating Linkage Within U.S. Utility Groups, Utilities, Holding Companies and Affiliates. Fitch Ratings: Global Power/North America Special Report, April 9.

development of procedures and the recording of transactions for services and products between a regulated entity and affiliates."[3] Essentially, these Guidelines address cross subsidization issues between affiliated companies.

Additionally, in 2000, the Subcommittee prepared a white paper, "Codes of Conduct Governing Competitive Market Developments in the Energy Industry: An Analysis of Regulatory Actions." The purpose of the White Paper was to study the various codes of conducts in place around the country and to analyze the application and effectiveness of the various components of such codes.

CURRENT FINANCIAL ENVIRONMENT

Due to recent events in the energy industry, including the implosion of Enron in late 2001, investigations into the trading activities of numerous marketers and the general glut of electricity in the marketplace, there has been a general trend towards electric utility bond downgrades. These downgrades have been most notable for electric utility companies operating within larger corporate structures and for those operating in states that have, or are in the midst of, restructuring. Although utilities that remain fully bundled may not appear in and of themselves to be riskier, bond rating agencies are more inclined to rate utility bonds at a rating similar to that of its parent company.

Because of the recent trend of rating agencies to consolidate utilities and non-regulated affiliated companies when evaluating risks, there has been increasing concern over the impact of non-regulated ventures upon the utility's access to debt and equity capital and the corresponding cost of such capital as well as the prospect of the utility being pulled into bankruptcy by its

[3] NARUC Resolution Regarding Cost Allocation Guidelines for the Energy Industry, dated July 22, 1999.

parent's insolvency. As a consequence, ring fencing techniques are gaining the regulator's attention.

RING FENCING MECHANISM

There are several techniques that can be employed separately, or together, to insulate a utility from the risks of affiliate issuers within a holding company system. These include pro-active regulatory oversight, financial restrictions, structural separations, and operational controls.[4]

In ring-fencing, a shell is built around the utility by employing techniques to create a "package of enhancements." According to Standard and Poor's (S&P), a properly structured package of enhancements consists of three elements:[5]

1. A special "Structure," often including a "special purpose entity," structured in a way that reduces the risk of a subsidiary being pulled into bankruptcy along with its parent.
2. A tightly drafted set of covenants, including dividend tests, negative pledges, non-petition covenants, prohibitions from creating new entities, restrictions on asset transfers and inter-company advances, that preserve the financial well-being and autonomy of the ring-fenced subsidiary.
3. The third element is collateral. If the debt is fully secured by a pledge of all or substantially all of the assets of the subsidiary, the parent, in principle, has less freedom to deal with the assets of the subsidiary.

According to Fitch,[6] "Financial restrictions imposed solely through internal corporate policies are a weaker method of isolating issuer risks relative to those mandated by law, regulation or contract because the corporation may adjust its policies at will. Nevertheless, corporate policies are helpful indicators of management intent. While there are cases in which a

[4] Bonelli, Yee, & Lapson, page 4.
[5] Venkataraman, Swami, Standard and Poor's (2003). Holding Company Diversification and Its Impact on Regulated Operations. Speech before the NARUC Staff Subcommittee on Accounting and Finance, Reno, Nevada, March 26.
[6] Bonelli, Yee, & Lapson, page 2.

financially stressed parent has extracted dividends, inter-company loans or assets from its regulated utility subsidiaries, there are numerous cases illustrating voluntary restraint by a financially stressed parent holding company. Xcel and Allegheny Energy are two recent examples of holding companies that have refrained from transactions that impair the financial condition of their utility subsidiaries."

Structural separations are another way to insulate the utility from the risks of non-regulated affiliates. One such structural separation is multiple ownership. When a utility is controlled by at least two parents or is the subject of a joint venture, the financial problems of any one of the parents is less likely to have consequences for the credit quality of the utility. Generally, the utility will be better insulated if credible owners are on equal footing and are able to prevent each other from harming the credit quality of the utility.[7]

Holding Companies are generally structured in one of two ways. The first, more common structure, involves a nonregulated shell holding company, which owns the equity of both the regulated and nonregulated subsidiaries. In the second structure, the regulated utility operates as the parent holding company owning stock in various subsidiary companies.[8] It may prove to be easier to insulate a utility if it is held as a subsidiary in a holding company structure instead of a structure in which the utility holds the equity (and therefore the equity risk) of various subsidiaries.

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[7] Venkataraman.
[8] Bonelli, Yee, & Lapson, page 3.

In some instances, the utility is held as a division of a parent company, without a separate capital structure. In these instances, the regulator might want to consider requiring utility operations be held as a separate subsidiary instead of being operated as a division so that a clearly separate capital structure can be defined. As Fitch notes, the holding company structure aids in the construction of a strong ring fence. A regulated utility operating as a division of the parent company results in a higher risk profile for the utility than if held as a separate subsidiary.[9]

The final way to achieve insulation is the imposition of restrictions from the outside -- from regulation, or even legislation, particularly at the state level. The strongest form of regulatory insulation exist where there are tight, statute-based restrictions on cash and asset transfers coupled with active and pre-emptive oversight by the regulatory body. [10]

State Commissions generally have broad powers to protect utilities from any adverse actions of affiliated companies. Some of these powers are explicitly provided for by statute, including prohibitions on the use of debt for non-utility purposes and encumbering utility assets for non-utility purposes. The regulator might also be proactive in encouraging a properly structured package of ring-fencing enhancements as discussed above. That is to say, the regulatory entity might require the insertion of a special purpose entity between the utility and the holding company, structured in a way that reduces the risk of the utility being pulled into bankruptcy along with its parent or other affiliated company. This could also require a tightly drafted set of covenants subject to commission review.

[9] Bonelli, Yee, & Lapson, page 3..
[10] Venkataraman.

Additionally, many Commissions have codified Codes of Conduct and Cost Allocation Rules as the energy market has evolved toward a more competitive market. Other tools employed by Commissions to safeguard utility assets have been established through Orders under the Commissions' broad power of ensuring that utilities provide safe, adequate, and reliable services at just and reasonable rates (or prices).

S&P states that "insulation brought about by legislative statutes is a great deal more certain than state utility commission rulemaking and will provide for greater ratings separation." S&P also states that, "Notably, most state regulators maintain their state or commission has explicit laws or regulations in place that provide sufficient authority to prevent the financial condition of the utility from being adversely affected by the activities of nonregulated affiliates. However, from a credit perspective, Standard & Poor's believes most of these laws and regulations to be reactive measures; they do not prevent the diversified businesses from weakening the regulated business. These rules typically enable state regulators to take action only after the damage has occurred."[11]

In a recent presentation to the Subcommittee, S&P named three states that they believe have adequate regulatory insulation mechanisms. Interestingly, one example involves a Commission Order, not a definitive statute. These states and mechanisms are:[12]

1. The Wisconsin Commission has explicit statutes governing the energy utility/affiliate relationship. Statute 196.795(5)(g) requires that "no holding company system may be operated in any way which materially impairs the credit...of any public utility affiliate." Statute 196.795(5)(c) and (d) prohibit a utility from lending money to or guaranteeing any obligations of its parent holding company or any nonutility affiliates. Statute 196.795(6m)-Asset Cap, limits nonutility investments to 25 percent of public utility assets with certain exceptions. Statute

[11] Ferara, William (2002). Research: Is State Utility Regulation Coming Back Into Vogue?. Standard & Poor's Ratings Direct, October 4.
[12] Venkataraman.

196.795(5) also includes provisions limiting subsidies between the utility and nonutility affiliates. Statute 196.52 relates to relations with affiliated interests and Commission control of affiliate contracts. Statute 196.80 requires Commission approval for an energy utility to merge, consolidate, acquire the stock of any other public utility, or sell, acquire, lease, or rent any public utility plant or property constituting an operating unit or system. Statute 196.795(3) regarding "takeovers" requires commission review and approval before allowing anyone to own more than 10 percent of the outstanding voting securities of the holding company.
Statute 201.03 requires that utility security issuances be approved by the Commission prior to the issuance of such securities. The use of proceeds has to be related to utility operations. Finally, Statute 196.795(4), for utilities in an energy holding company system, and 201.11 authorize the Commission to order a utility to cease paying dividends on its common stock when there is a finding of capital impairment.

2. The Oregon Commission placed certain conditions in its Order approving the Portland General Electric Company (PGE)/Enron merger. Most notable, "PGE must maintain the common equity portion of its capital structure at 48% or higher unless the Commission approves a different level, and must notify the Commission of certain dividends and distributions to Enron." The 8-notches bond rating differential between PGE and Enron would seem to indicate successful ring fencing.

3. The Virginia Commission also has explicit statutes regarding utility/affiliate relationships. Chapter 3 (§56-58) of Title 56 of the Code of Virginia requires that utility security issuances be approved by the Commission prior to the issuance of such securities. The use of proceeds has to be related to utility operations. Additionally, Chapter 3 (§56-59) and Chapter 4 (§56-82) require that utilities, prior to assuming obligations as a guarantor, seek Commission approval for such guarantees. Chapter 4 (§56-82) requires utilities to gain Commission approval for affiliate loans. Chapter 4 (§56-83) authorizes the Commission, under certain circumstances, to prohibit a utility from paying dividends to an affiliate. Chapter 5 requires that prior to the change in ownership or control of : (1) a utility operating in Virginia, (2) any utility asset located in Virginia, or (3) utility securities occurs, Commission approval must be obtained. Under SEC Rule 53(c) of the Public Utility Holding Company Act, the Virginia Commission has been able to get utilities to agree that measures will be taken if bond ratings fall to certain levels. These conditions were based on the above mentioned statutes.

In summary, of the three states that S&P mentioned, two rely upon state statutes for their regulatory insulation. The third relied on conditions in a merger that indirectly is dependent upon state authority over mergers.

FEDERAL ROLE

As noted by Fitch, the Public Utilities Holding Company Act of 1935 (PUHCA) has some positive effect on the credit quality of subject utilities by regulating holding companies on matters including company structure, intercompany loans, reporting, acquisitions, and issuance and sale of securities.[13] Furthermore, according to the American Public Power Association (APPA), the financial problems of many electric utilities and utility holding companies today can be traced directly to the partial repeal and weakened safeguards of PUHCA via the enactment of the 1992 Energy Policy Act.[14] If PUHCA is totally repealed despite concerns (as is being seriously considered), it becomes increasingly important for the states to augment their own ability to monitor and regulate holding companies.[15] There is some concern that the Commerce Clause could severely constrain the ability of a state to regulate a multi-state holding company.[16] In any case, the importance of oversight will only increase if the repeal sets off, as some expect, another major merger wave.

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[13] Bonelli, Yee, & Lapson, page 2.
[14] APPA, "The Public Utility Holding Company Act—Its Protections Are Needed Today More Than Ever," February 2003, p. 4.
[15] In this regard, also see the January 30, 2002, letter of John D. Dingell and Edward J Markey to Harvey L. Pitt, then Chairman of the SEC, at http://www.house.gov/commerce_democrats/press/107ltr129.htm.
[16] Anderson, John, "Commentary: Pro & Con," Public Utilities Fortnightly, July 15, 1995, p. 38.

The Federal Energy Regulatory Commission (FERC) has recently undertaken steps to increase its active oversight of utility/holding company relationships for those utilities under its jurisdiction. These steps include an on-going rulemaking initiative into cash management practices[17] and a recent decision to impose new conditions to all future public utility issuances of secured and unsecured debt authorized by the commission. These conditions are:[18]

1. Public utilities seeking authorization to issue secured debt backed by a utility asset must use the proceeds of the debt for utility purposes only.
2. If any utility assets that secure debt issuances are "spun off," the debt must follow the asset and also be "spun off."
3. If any of the proceeds from unsecured debt are used for nonutility purposes, the debt must follow the nonutility assets. If the nonutility assets are "spun off," then a proportionate share of the debt must follow the "spun-off" nonutility asset.
4. If utility assets financed by unsecured debt are "spun off" to another entity, then a proportionate share of the debt must also be "spun off."

There is also an amendment to the national Energy Bill that addresses corporate and financial separation. If passed into law, this would presumably increase FERC's authority and articulate a needed mandate to protect public utilities from the financial distress caused by risky investments made by utility parent companies in nonutility businesses. However, the proposed legislation does not provide states with the additional authority needed to better ensure that consumers are protected from potential abuses by large, unrestricted holding companies. Such additional authority would include the right of the states to form joint oversight bodies to conduct financial and managerial audits of multi-jurisdictional utilities, including those operating within a larger corporate structure. This authority would provide for such audits and other oversight actions as states deem necessary with or without federal agency involvement.

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[17] FERC, "Regulation of Cash Management Practices," Docket No. RM02-14-000.
[18] FERC, "Commission Sets New Conditions for Utility Debt Acquisition," Docket No. ES02-51-000, News Release, February 20, 2003.

RING FENCING AND BANKRUPTCY

As previously mentioned, ring fencing aids in protecting the utility from the financial problems of non-regulated affiliates. The extreme case would be one of bankruptcy. In California, Edison International and Pacific Gas & Electric Corp. attempted to protect its subsidiaries from insolvency by implementing the following ring fencing measures:[19]

1. Making certain subsidiaries into special purpose entities (SPE) or "limited purpose operating entities" similar to an SPE;
2. Providing a nonconsolidation opinion between subsidiary and parent (upon insolvency of the parent, the assets of the subsidiary would not be consolidated with the parent's);
3. Securing legal comfort that the ring-fencing did not contradict any law, regulation, order, or contract; and
4. Securing other legal comfort that the ring-fencing would not invoke any of the "recharacterization" provisions of the Federal Bankruptcy Code.

Since a parent may have the incentive to file a subsidiary utility into bankruptcy, there are other economic measures that could be undertaken. These include termination provisions in certain contracts (i.e. commodity hedge) in the event of non investment grade rating.

On April 23, 2003, several state commission staff members and analysts at Fitch discussed ring-fencing. Fitch pointed out there is no perfect ring fence that can completely insulate a utility. They question certain techniques such as the "golden share" where an independent director for a utility has certain powers. More importantly, according to Fitch, companies have an inalienable right to file a subsidiary into bankruptcy. A company cannot waive this right according to the General Counsel at Fitch. Regardless, Fitch mentioned several measures that aid in the insulation of the utility and include: (1) minimum equity ratio, (2) separate books and records, (3) separate subsidiaries, and (4) limitation on upstream loans.

[19] Rigby, Peter (2001). Ring Fencing Subsidiaries From Parents' Bankruptcies in California. Standard & Poor's Project & Infrastructure Finance, October, 121-123.

The filing of a bankruptcy creates an automatic stay that halts all attempts by creditors to collect their claims from debtors. Creditors who willfully violate the automatic stay are subject to sanctions. However, federal, state and local government agencies are not subject to the automatic stay in the exercise of certain police or regulatory powers.[20] Regulatory actions of an economic nature would probably not be exempted from the automatic stay. Most state commission actions are of an economic nature and therefore, are mooted by bankruptcy filing.

POSSIBLE RING FENCING MEASURES

While according to the ratings agencies, state statutory authority is the preferable tool to properly insulate the regulated utility from non-regulated affiliate activities, any action that state regulators take that provides support (whether legal, regulatory, financial, or operational) to the utility and/or isolates the utility (most importantly financial obligations) from its parent company will be positive from a credit rating standpoint. Only when sufficient regulatory insulations exist will the corporate credit rating (risk of default) of an operating company be separated from that of the holding company.[21]

To the extent permitted under its state statutes and depending on the specific circumstances, in any rate case proceeding, approval of mergers, approval of affiliated interest contracts, approval of securities, or any other similar proceedings, a state commission may want to consider ways to insulate a utility in a holding company system by restricting the flow of the utility's cash to its parent company, such as overhead

[20] Overview of Bankruptcy and the Impact of Bankruptcy on the Regulatory Process, United States Trustee for Region 21, Northern District of Florida, Tallahassee, Florida.
[21] Ferara.

allocation, loan and dividend restrictions, and stringent equity-maintenance requirements.[22]

The following are suggested areas to be considered ring fencing measures (some are more strenuous forms of others given):

1. Commission authority to restrict and mandate use and terms of sale of utility assets. This includes restriction against using utility assets as collateral or guarantee for any non utility business.

2. Commission authority to restrict dividend payments to a parent company in order to maintain financial viability of the utility. This may include, but is not limited to, maintenance of a minimum equity ratio balance.

3. Commission authority to authorize loans, loan guarantees, engagement in money pools and large supply contracts between the utility and affiliate companies.

4. Commission authority over the establishment of a holding company structure involving a regulated utility.

5. Expand commission authority over security applications to include the ability to restrict type and use of financing.

[22] Ferara.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P, for authority to file tariffs increasing electric rates for the service provided to customers in the Aquila Networks-MPS and Aquila Networks-L&P area	))))))	Case No. ER-_____

County of Jackson)
) ss
State of Missouri)

AFFIDAVIT OF JON R. EMPSON

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

Jon R. Empson
Jon R. Empson

Subscribed and sworn to before me this 3rd day of July, 2006.

Terry D. Lutes
Notary Public
Terry D. Lutes

My Commission expires:

8-20-2008

Notary Public Notary Seal State of Missouri

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