

Exhibit No.

Issue:

Financing &

Affiliate

Transaction

Witness:

Dennis R. Williams

Sponsoring Party:

Aquila, Inc.

Type of Exhibit:

Surrebuttal Testimony

Case No.:

EO-2005-0156

Date Testimony Prepared:

June 27, 2005

MISSOURI PUBLIC SERVICE COMMISSION

SURREBUTTAL TESTIMONY

OF

DENNIS R. WILLIAMS

ON BEHALF OF

AQUILA, INC.

June 27, 2005

Exhibit No. 3
Case No(s). EO-2005-0156
Date 8-21-05 Rptr 45

**BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
SURREBUTTAL TESTIMONY OF DENNIS R. WILLIAMS
ON BEHALF OF AQUILA, INC.
CASE NO. EO-2005-0156**

1 Q. Please state your name and business address.

2 A. Dennis R. Williams. 10700 East 350 Highway, Kansas City, Missouri.

3 Q. Are you the same Dennis Williams who caused to be filed direct testimony on
4 behalf of Aquila, Inc. ("Aquila" or "Company") in this proceeding.

5 A. Yes, I am.

6 Q. What is the purpose of your surrebuttal testimony?

7 A. I will address a number of items raised in the pre-filed rebuttal testimonies of
8 Cary Featherstone of the Missouri Public Service Commission Staff ("Staff") and
9 Ted Robertson of the Office of Public Counsel ("OPC"). These items include: 1)
10 the Affiliate Transaction rule and purpose of Aquila's initial filing; 2) acquisition
11 of the turbines and related equipment by Aquila Networks; 3) condition of the
12 equipment; 4) Chapter 100 financing; and 5) the scope of the R.W. Beck appraisal
13 study.

14 **Affiliate Transaction Rule**

15 Q. Both Staff Witness Featherstone and OPC Witness Robertson contend that it
16 would be more appropriate to defer a decision in this case to Aquila's next rate
17 case. Do you agree?

18 A. No. Aquila is not seeking any ratemaking determination in this proceeding so it is
19 not necessary to defer a decision to a rate case. To the contrary, Aquila needs

1 guidance outside of a rate case to insure that we are complying with the Affiliate
2 Rule.

3 Q. Why is this guidance necessary?

4 A. The Commission's Affiliate Transaction rule, 4 CSR 240-20.015(2), prohibits a
5 regulated electrical corporation from providing "a financial advantage to an
6 affiliated entity". Because of the nature of the transaction described in the
7 Application, Aquila Networks – MPS needs to know that it is taking action that is
8 consistent with the standards established by the Commission.

9 Q. What type of guidance is required?

10 A. As noted in its initial application, Aquila is seeking a determination that the
11 acquisition of three combustion turbines and related equipment at a value of
12 \$70,796,850 from an affiliated company does not provide a financial advantage to
13 that affiliate and is thus in compliance with the Affiliate Transaction rule.

14 Q. Beginning at page 13 of his rebuttal testimony, OPC Witness Robertson suggests
15 that the purpose of the Affiliate Transaction rule is to set certain standards and
16 recordkeeping requirements, and that a utility may file for a variance only if it is
17 not in compliance with those standards. Do you understand this reasoning?

18 A. No. Mr. Robertson's comments are counter-intuitive. On the one hand he argues
19 that Aquila should not have filed this application because it can only do so if
20 Aquila is "not in compliance" with the Affiliate Transaction rule, implying, that
21 Aquila is in compliance. He then argues that the value at which we have recorded
22 the subject affiliate transaction is overstated and therefore is not in compliance
23 with the Affiliate Transaction rule. Although he arrives at a different valuation,

1 Staff Witness Featherstone also suggests that the value at which Aquila Networks
2 – MPS has recorded the acquisition of the combustion turbines from its affiliate is
3 overstated. Obviously, there are various opinions as to whether this transaction is
4 in compliance with the Affiliate Transaction rule.

5 Q. Does the Company believe that it is in compliance with the Affiliate Transaction
6 rule?

7 A. Aquila Networks – MPS believes the actions it has taken are in compliance with
8 the Affiliate rule and has proposed to record the acquisition of combustion
9 turbines from its affiliate at a value that does not provide a financial advantage to
10 that affiliate. The fact that both Mr. Featherstone and Mr. Robertson have stated
11 their disagreement illustrates the need for a determination by the Commission.

12 Q. What about the fact Mr. Robertson states on page 9 of his rebuttal testimony, that
13 no party challenged your most recent Cost Allocation filing, in which this
14 transaction was reported?

15 A. It is correct that there have been no challenges to our report. It is apparent,
16 however, that Staff and OPC do not truly believe that the failure to challenge a
17 Cost Allocation Manual (CAM) filing results in automatic compliance with the
18 Affiliate rule requirements. If that was the case, there could be no challenge to
19 Aquila's valuation in this proceeding.

20 Q. At page 27 of his rebuttal testimony, Mr. Robertson suggests that another reason
21 to postpone a decision for the proper amount at which to transfer these assets to
22 its next rate case would be to give the parties an opportunity for a complete audit

1 and to provide Aquila's management with a reasonably quick decision. Do you
2 agree?

3 A. No. Aquila filed its initial Application on January 13, 2005. There was adequate
4 opportunity for intervention and thorough examinations have been conducted by
5 both Staff and OPC. Over 150 data requests, many of which were multi-part
6 questions, were received and responded to by Aquila. That represents more than
7 ten percent of the average of all data requests received in a comprehensive rate
8 case. It would provide no useful purpose in the context of a rate case to re-
9 investigate this issue, which is limited to the questions of the proper amount at
10 which to record assets transferred from an affiliate, and whether a Chapter 100
11 Bond financing is in the public interest.

12 Q. Does Aquila Networks – MPS have a rate case request on file?

13 A. Yes. Aquila Networks – MPS filed its Application to change rates on May 23,
14 2005. The statutory law date for a decision in that case is April 22, 2006.

15 Q. Do you believe that a decision on the current Application, if deferred to April 22,
16 2006, would result in a "reasonably quick answer" to Aquila's request in this
17 docket?

18 A. No, I do not.

19 **Acquisition of Combustion Turbines by Aquila Networks**

20 Q. Is it correct that Aquila's regulated utility acquired these combustion turbines
21 from an affiliate?

22 A. Yes. These turbines were part of a fleet of turbines originally purchased by
23 Aquila Energy Merchant. When Aquila exited the energy merchant business,

1 these turbines were transferred to a nonregulated special purpose entity, Aquila
2 Equipment LLC., where they were held for future sale. The recorded value of the
3 turbines on the books of Aquila Equipment LLC., was \$78,716,233 plus an
4 additional approximate \$3,000,000 of other charges such as survey costs. In
5 November 2004, Aquila's regulated utility acquired the turbines at a value of
6 \$70,796,850 based on an appraisal by R.W. Beck and Aquila recorded an
7 impairment charge of over \$10 million.

8 Q. Why were these turbines acquired by the regulated utility?

9 A. As noted in Aquila's response to OPC Data Request No. 1014, Aquila's Energy
10 Resources group issued a request for competitive bids for peaking power and
11 selected from the bids submitted, the self-build option utilizing Siemens
12 Westinghouse 501D5A turbines. The self-build option was developed and
13 submitted by Aquila's internal engineering group. To insure that all bids are
14 fairly evaluated, Aquila maintains distinct separation between its Energy
15 Resources and Engineering departments. One advantage that this particular self-
16 build option entailed was early implementation due to the ready availability of the
17 turbines through Aquila Equipment LLP.

18 Q. Is Mr. Robertson's complaint that Aquila did not competitively bid these turbines
19 a fair criticism?

20 A. I believe the criticism is misplaced. In the broader context of Energy Resources,
21 this option was competitively bid against a number of energy supply options and
22 was found to be a low-cost option for delivering power to our customers. In the
23 more narrow context of responding to Energy Resources' Request for Proposal

1 (RFP), there would not have been time for Engineering Services to issue its own
2 formal RFP for the turbines and other myriad pieces of equipment and services
3 comprising the self-build option, nor would such a procedure have been
4 customary. Instead Engineering Services obtained indicative pricing information
5 to prepare its self-build option bid. This indicative pricing information included
6 verification of prices for turbines available from Siemens Westinghouse, review
7 of existing industry pricing publications, and review of equipment available on
8 the gray market, with appropriate consideration of adjustments necessary for all of
9 these options to comply with the specifications of Energy Resources RFP.
10 Engineering Services' indicative bid process was sufficient to determine that the
11 recorded value for turbines and equipment on the books of Aquila Equipment
12 LLC., were within a reasonable range of other available equipment. While it was
13 recognized that the Commission's Affiliate Transaction rule would require a fair
14 market value determination and the equipment was subject to write-down, the
15 operational advantages of this equipment, its immediate availability and
16 recognition that Aquila could be criticized if it did not utilize equipment held by
17 an affiliate, made the decision to acquire the turbines from Aquila's affiliate
18 appropriate.

19 Q. Would there have been any effect on the valuation of the turbines if Aquila had
20 competitively bid or issued a formal RFP for the turbines?

21 A. No. As pointed out in the surrebuttal testimony of Mr. Suess, care must be taken
22 in utilizing information when employing a market approach. Solicitation of bids
23 from the open market, for example, when it is widely known in the industry that

1 turbines are already owned by an affiliate of the requesting party, would limit the
2 number of bids and the quality of bids received. A seller of equipment is simply
3 not going to take the time to develop a comprehensive bid on which much
4 reliance can be placed if the seller believes that the inquiry is not coming from a
5 motivated buyer.

6 The turbine valuation that Aquila Networks – MPS recorded on its books was
7 based upon an independent appraisal, a key element of which took into account
8 alternative equipment available from the open market. Whether Aquila Networks
9 – MPS conducted a formal competitive bidding process, an indicative pricing
10 review or no review at all, the results of the independent appraisal on which the
11 turbine valuation is based would not likely have been impacted.

12 Q. You indicated that the turbines and related equipment were acquired by the
13 regulated utility in November 2004. Why was that date selected for their
14 acquisition and transfer?

15 A. That is the approximate date that construction of the South Harper peaking facility
16 began and is further supported by Staff Witness Featherstone as the date that
17 delivery needed to be made (Featherstone Rebuttal, page, 40, line 9).

18 Q. When did the regulated utility begin recording allowance for funds used during
19 construction (“AFDC”) associated with these turbines?

20 A. In November 2004.

21 Q. What is the date of valuation of the R.W. Beck appraisal?

22 A. November 2004.

1 Q. If Aquila Networks – MPS had entered into a conventional purchase from a
2 manufacturer, would payments have been made before delivery?

3 A. Yes. Generally a down payment is required in addition to progress payments.
4 This is also the testimony of Staff Witness Featherstone at page 40, lines 14 – 17
5 of his testimony. In fact, it is not unusual for 70 to 95 percent of the turbine price
6 to be fully paid in advance of delivery.

7 Q. If payments were made in advance of delivery, when would interest during
8 construction begin?

9 A. Interest during construction would begin with the first payment and increase with
10 each progress payment until the plant is placed in service.

11 Q. On what date did Staff Witness Featherstone assume acquisition of the turbines?

12 A. The date of acquisition did not directly impact Mr. Featherstone's valuation. He
13 based the turbines and related equipment valuation on an offer for sale of the
14 turbines by Aquila Merchant to a potential buyer. This offer is further described
15 in the testimony of Aquila witness Davis Rooney and was initially made on
16 August 9, 2002. Therefore, while Mr. Featherstone did not directly identify a
17 transaction date, he has effectively recommended that Aquila Networks - MPS
18 should have purchased the turbines at the offer price in August 2002.

19 Q. If Aquila's regulated utility had purchased the turbines in August 2002, when
20 would interest carrying costs have begun accumulating?

21 A. AFDC begins at the time of initial cash outlay so under Mr. Featherstone's
22 theoretical August 2002 delivery, interest during construction would have been
23 capitalized beginning on or prior to that date.

1 Q. Is it appropriate to impute carrying costs on top of the valuation estimated by Mr.
2 Featherstone?

3 A. Yes. The fact of the matter is that Aquila Networks-MPS did not consider
4 acquiring the turbines and related equipment in August 2002 because they were
5 not needed at that time. However, if it had been appropriate for the regulated
6 utility to acquire the turbines at the date of the transaction utilized by Mr.
7 Featherstone, the utility would be entitled to capitalize the interest on its
8 investment from the date of acquisition. That means that interest would have
9 accrued on the investment for an additional two years – the period between the
10 date of Mr. Featherstone's assumed transaction and the date that AFDC
11 accumulation actually began. Assuming, for illustration, an ROR of
12 approximately 9%, carrying costs for the two-year period would have been
13 approximately \$12 million.

14 Q. Would it be appropriate to add the imputed carrying cost to Mr. Featherstone's
15 stated valuation of \$66 million?

16 A. Yes.

17 **Condition of the Equipment**

18 Q. At page 53 of his testimony, OPC Witness Robertson states that the "CTs in
19 question are for the most part older used equipment". Do you agree with his
20 assessment?

21 A. No. Mr. Robertson makes his statement in the context of arguing that because the
22 equipment is old and used, some additional depreciation should be taken in
23 addition to the physical deterioration and functional obsolescence already

1 assessed by the R.W. Beck independent appraisal. Obviously this equipment had
2 never been used prior to its very recent deployment at our South Harper peaking
3 facility. Mr. Robertson's implication is, however, that this equipment has aged
4 and deteriorated while it has been in storage.

5 Q. What causes you to believe that the equipment has not deteriorated to the extent
6 implied by Mr. Robertson?

7 A. Great care was taken in the storage of this equipment. Specific detailed
8 compliance guidelines are published by Siemens Westinghouse regarding proper
9 maintenance performance and storage conditions. Aquila followed these
10 guidelines, detailing in logs the performance of maintenance activities. The
11 better proof of the attention to maintenance is demonstrated in the condition of the
12 turbines and related equipment when removed from storage. Since the turbines
13 deployment at our South Harper facility, these turbines have been subject to
14 inspection by appraisers, insurers, Siemens Westinghouse personnel and other
15 consulting engineers. I have heard nothing to indicate that anyone has found the
16 turbines to be in other than excellent condition. At various times, the turbines
17 have been described to me as "in pristine condition", "like new", and "better
18 maintained than any other similar equipment that I have seen".

19 **Chapter 100 Financing**

20 Q. Did the Company request authorization to enter into a sale and leaseback
21 arrangement with the City of Peculiar to facilitate the issuance of tax-advantaged
22 Chapter 100 bonds associated with the deployment of these turbines and
23 construction of a power generation station?

1 A. Yes. No party has raised any apparent objection to the Chapter 100 financing
2 mechanism and I would reiterate that the Chapter 100 bonds benefit our
3 customers by reducing the overall costs associated with this project. Although no
4 party specifically objects to the use of Chapter 100 bonds, OPC Witness
5 Robertson does suggest that requests enumerated as G through L in Aquila's
6 Application are "...completely unwarranted and unsupported...".

7 Q. What are requests G through L?

8 A. They are requests for necessary authorizations to Aquila as follows:

9 G. Authorizing Aquila to cause the Project to be pledged to the Trustee under
10 the terms of the Indenture as security for the holders of the Bonds;

11 H. Authorizing Aquila to enter into and perform in accordance with the terms
12 of the Agreement;

13 I. Authorizing Aquila to enter into and perform in accordance with the terms
14 of the Lease;

15 J. Authorizing Aquila to enter into and perform in accordance with terms of
16 the Indenture;

17 K. Authorizing Aquila to enter into and perform in accordance with any and
18 all other necessary agreements and instruments under the Act;

19 L. Authorizing Aquila to do any and all other things incidental, necessary or
20 appropriate to the performance of any and all acts specifically to be
21 authorized in such order or orders.

22 Q. To what do these requests relate?

1 A. Except for Request L ,which I understand to be a broad provision to Aquila of the
2 legal authority to carry out whatever it is ordered to do in this docket, including
3 performance of Chapter 100 Bond Agreements, the other requests are all
4 specifically related to the performance of agreements associated with the issuance
5 of the Chapter 100 Bonds. Without approval of these requests, the Chapter 100
6 financing mechanism will not take place.

7 **SCOPE OF R.W. BECK APPRAISAL**

8 Q. Who at Aquila was responsible for the employment of R.W. Beck as independent
9 appraisers of the combustion turbines and related equipment?

10 A. I was the individual who had that responsibility.

11 Q. Did you sign the engagement contract setting out the scope of their work?

12 A. I did on behalf of Aquila.

13 Q. Why did you select R.W. Beck as your independent expert appraisers?

14 A. For a number of reasons. The subject of appraisal first arose in a meeting among
15 Aquila, OPC and Staff regarding our Integrated Resource Plan. Aquila postulated
16 acquisition of the combustion turbines and a discussion regarding an appropriate
17 manner in which to establish market value ensued. A Staff member indicated that
18 R.W. Beck had recently sponsored a seminar pertaining to appraisal of generating
19 equipment which Staff members had attended and to which they had favorable
20 reactions. In response, I contacted the firm, researched their credentials and
21 interviewed their representatives. I was favorably impressed with their
22 experience, credibility and professionalism. The only characteristic that surfaced
23 during my review that was questioned internally were isolated comments that the

1 firm was "consumer oriented". In my view the fact that R.W. Beck was favorably
2 recommended by Staff and in some quarters viewed as having a consumer bent
3 were both advantages. It was my desire to obtain a reasonable, supportable and
4 fair value for the turbines that would be acceptable to all parties, and avoid a
5 contested hearing.

6 Q. On page 17 of his rebuttal testimony OPC Witness Robertson indicates that it is
7 his belief that the Company hired R.W. Beck to support the book value cost the
8 Company had recorded for the equipment. Is this true?

9 A. No. At the time R.W. Beck was employed by Aquila, the acquisition and transfer
10 of the combustion turbines had not taken place. I hired R.W. Beck only with the
11 instructions that I wanted a determination of fair value for transfer of the assets
12 from an affiliate consistent with the standard set forth in the Commission's
13 Affiliate Transaction rule. I gave them no other guidance or suggestions of a
14 preferred outcome. In fact, at the time R.W. Beck was employed, no book value
15 for the combustion turbines had been established for Aquila Networks – MPS.
16 The whole point of their employment was to establish a fair value and Aquila did
17 book the value that was determined by the appraisal report.

18 Q. At page 37 of his rebuttal testimony, Mr. Robertson refers to the R.W. Beck
19 appraisal as limited in its scope and preparation, and thus limited in its accuracy
20 and validity. Do you agree?

21 A. Not at all. During the selection process, representatives of R.W. Beck explained
22 to me that there were three accepted valuation approaches as I described in my
23 direct testimony. One of those approaches, the income approach, values property

1 by determining the net present worth of earnings using a discounted cash flow
2 analysis. R.W. Beck representatives explained that because these turbines were
3 not in service generating any cash flow, the income approach was not applicable
4 and could not be performed with any validity. While this may technically define
5 an appraisal as limited in scope, in my mind it certainly does not render it
6 inaccurate nor invalid.

7 Q. Do you agree with all aspects of the R.W. Beck appraisal?

8 A. No, as a layman there are areas with which I do not agree or understand.
9 However, I recognize the firm as experts in their field and it was my
10 recommendation after reviewing the R.W. Beck report to reflect their expert
11 valuation on our books and absorb the \$10 million write-down.

12 Q. Please summarize your testimony.

13 A. Consistent with the timing of transfer of turbines and related equipment from an
14 affiliate to Aquila Networks – MPS in November 2004, Aquila commissioned
15 R.W. Beck to perform an independent appraisal to determine the value at which
16 those assets should be recorded on the books of the regulated utility. While OPC
17 and Staff representatives have made recommendations as to alternative valuations,
18 their different approaches and rationale have been shown to be flawed for various
19 reasons. The most appropriate valuation is the one performed by independent
20 expert appraisers at the date of transfer. To select a valuation based on an
21 alternative date or using dissimilar equipment clearly lacks validity. Aquila
22 Networks – MPS has recognized in excess of a \$10 million loss to write-down the
23 turbines and related equipment to the value prescribed by independent appraisers.

Surrebuttal Testimony:
Dennis R. Williams

1 The question of valuation has been fully investigated by the parties and there is no
2 reason to delay a determination as to whether those accounting entries are in
3 compliance with the Affiliate Transaction rule. Finally, there has been no
4 challenge to the use of Chapter 100 bond financing. The requests made by Aquila
5 necessary to make use of the Chapter 100 financing mechanism should be
6 approved in their entirety.

7 Q. Does this conclude your surrebuttal testimony?

8 A. Yes, it does.

AFFIDAVIT

Dennis R. Williams, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of Dennis R. Williams;" that said testimony and schedules attached hereto were prepared by him and/or 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 test of his knowledge, information and belief.

Dennis R. Williams
Dennis R. Williams

State of

Missouri

County of

Jackson

SUBSCRIBED and sworn to before me this 27th day of June 2005.

Terry D. Lutes
Notary Public

Terry D. Lutes

My Commission Expires:

8-20-2008



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