Missouri Public Service Commission

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October 31, 2006

Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102

Dear Commission,

The Staff submits its Management Audit of Aquila, Inc., as ordered by the Commission in Case No. EO-2006-0356 and notes that there have been events that have occurred since the Staff finalized its report. The first is that Judge Dandurand has issued a judgment related to South Harper, finding the Commission was without jurisdiction to authorize the construction and operation of the South Harper Plant after it was constructed and, further, any certificate it could have issued would have to be conditioned on Aquila obtaining a special use permit or re-zoning from Cass County, Missouri.

The Missouri Public Service Commission has also recently brought suit against Aquila Inc., Aquila Merchant Services, Inc., and a number of other energy companies in the United States, seeking monetary damages based on allegations of natural gas price manipulation. Artificial inflation of natural gas prices detrimentally impacts Missourians.

Submitted with the report are Aquila's comments to the draft report that was provided to the company by the Staff on September 15, 2006.

Sincerely,

Lisa Kremer
Lisa Kremer
Manager
Engineering and Management Services Department
Missouri Public Service Commission

LK/amh

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Aquila

October 13, 2006

Ms. Lisa Kremer
Manager, Engineering and Management Services Department
Missouri Public Service Commission
Post Office Box 360
Jefferson City, MO 65102

Dear Ms. Kremer:

Thank you for providing us the opportunity to comment on the Staff's draft report entitled Management Audit of Aquila, Inc., which was prepared in response to the Commission Order issued on June 13, 2006 in Case No. EO-2006-0356. The Staff obviously spent an exhaustive amount of time in researching and developing this report. Aquila agrees with most of the general findings and believes the report reflects a very detailed, factual and objective review. Still, Aquila submits that the report could benefit from inclusion of greater detail regarding the historical environment that existed at the time key decisions were made, clarification of some Aquila positions and actions, and additional information that might not have been available to Staff at the time of its review.

As a result, Aquila has reviewed and made brief comments on each chapter contained within the Staff report. In particular, our attached response focuses on Aquila's philosophies regarding compensation and incentives; Aquila's perspective on the regulatory and operating environment at the time key resource planning decisions were made; and actions taken to insulate regulated activities from unregulated activities.

Attached is our response to the draft Management Audit Report. If you have any questions or concerns, please contact me. Also, there may be areas currently deemed as highly confidential which may no longer require that designation. I will call you next week to discuss these sections with you. Again thank you for the opportunity to make comment.

Sincerely,

Dennis R Williams

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Attachment 1-2

RESPONSE TO THE MISSOURI PUBLIC SERVICE COMMISSION'S STAFF REPORT ON AQUILA INC.

Aquila, Inc. ("Aquila" or the "Company") appreciates the opportunity to review and comment on the Staff's report entitled Management Audit of Aquila, Inc. dated September 15, 2006 ("Report"). As in the previous Staff review of Aquila performed in December of 2002, the Staff completed a detailed and objective review of the Company and its circumstances in a relatively short period of time.

Aquila wants to assure the Missouri Public Service Commission ("Commission") that despite the distraction of allegations such as the ones subject to this investigation, the Company continues to be committed to serving its customers and strengthening its financial profile. We continue to implement our financial plan as evidenced by the recent upgrades to our debt securities by all three of the major credit rating agencies.

EXECUTIVE SUMMARY

Aquila agrees with the overall conclusion reached by Staff that the Missouri customers have not been harmed as a result of the financial difficulties experienced by the Company. We believe, however, that the Report did not recognize a number of initiatives, beyond the three cited in the data request response, that were instituted by Aquila to provide service quality and ratemaking protections, along with the additional protection provided by effective regulatory authority, which have contributed to this result. Aquila acknowledges that the data request response could have been more extensive which would have most likely avoided this deficiency. We also believe that since the Commission's Order for the management audit focused on "Decisions Aquila Made To…." take certain actions, that framework or context in which Aquila did make these decisions should be further explained in order for the Commission to gain a better perspective. Therefore, Aquila has added significant detail about its perspective on the historical environment when key decisions were made.

The Report identifies five specific recommendations. Of these recommendations, four pertain to compensation and the fifth relates to future capacity planning. Aquila believes that a more thorough description of the Company's incentive and compensation philosophies and greater detail regarding the operating environment and decision making approach to resource planning would be beneficial to the Commission. In presenting this additional information, Aquila intends to further clarify its positions and provide additional information that may not have been available to Staff in their original review. Aquila has organized its comments according to the topics of inquiry as ordered by the Missouri Public Service Commission and as contained in Chapters 3 through 11 of the Staff's Report.

CHAPTER 3 - INCENTIVE COMPENSATION

We agree with the Staff that our customers have only funded incentive compensation awards that have benefited them. While this chapter of the Report provides a summary of the historical testimony and challenges of the particulars regarding the goals and measures of the annual "incentive" plan, it is also important to understand the plan in the context of Aquila's overall position in the relevant labor market and its role in Aquila's total compensation philosophy.

Aquila's compensation philosophy provides that: 1) Aquila's compensation and benefits practices will target the market 50th percentile of domestic regulated utilities most similar to Aquila; 2) Aquila's compensation and benefits practices will be sufficient to attract and retain the talent necessary to run the business and execute company strategies; and 3) Aquila's compensation and benefits' practices will support and reinforce important organizational goals and objectives. It is also important to understand that almost all domestic regulated utilities have incentive or variable compensation plans. Aquila's current plan is targeted below the market 50th percentile payments under such plans. The absence of a variable compensation plan, or something similar, would make Aquila's total compensation package significantly below the market for similar companies and reduce Aquila's ability to attract and retain employees.

Since 2003, Aquila has designed its variable compensation plans to reflect operational service metrics such as reliability, customer satisfaction, safety, and effective use of capital. The goal is that when Aquila is performing well for it's customers, employees will earn a little more money. Placing a portion of total compensation at risk serves to focus employees on key metrics of customer service, and to vary Aquila's overall compensation expense with its performance on critical measures.

Aquila believes that all of its "bonus" and variable compensation plans are designed to be cost effective motivational tools. While there are a variety of opinions among scholars and researchers on how effective these plans are in producing important organizational results, the general consensus is that where they are well communicated and understood by employees, they are effective management and motivational tools. It is clear that incentive or variable compensation plans do represent a common opportunity for utility employees in Aquila's relevant labor market. Aquila looks forward to continuing this discussion with Staff and providing further documentation on the motivational value of having incentive compensation programs.

CHAPTER 4 - EXECUTIVE COMPENSATION

Aquila believes that the Staff's recommendations are appropriate and Aquila is already engaged in the specified review process. Aquila will take this opportunity to briefly describe how it approaches determining the appropriate level of executive compensation and would be pleased to work with Staff to further document this process.

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Aquila has retained Hewitt Associates to advise its Board of Directors on Executive Compensation issues. The market data provided by Hewitt Associates indicates that among Aquila's peer companies base pay makes up only 44% of the CEO's annual compensation and 49% for all other senior executive positions excluding the CEO. As pointed out in the Report, with the exception of the recent performance/retention awards, Aquila's senior executives as a whole have not received any short or long term variable compensation since March of 2002, for 2001 performance. At this time, Aquila's executives' annual compensation opportunities are significantly below what they would earn if they had the opportunity to work somewhere else, or what it would cost Aquila to replace them with candidates from outside Aquila. Aquila recognizes this market gap exists and has made the decision to defer any actions to change Executive compensation until sufficient progress has been made on the repositioning plan.

Rick Green has announced that Aquila will continue to review the size of the executive team as Aquila successfully navigates it's restructuring and recovery objectives. Several executive positions have been eliminated or consolidated, and a few executives have left voluntarily. Functional accountabilities for the remaining executives have been expanded. Aquila reviews annually both the roles of the leadership team and their pay relative to the market for similar sized utility companies. Aquila currently includes only the base pay portion of that cost in the rates to its customers in Missouri. According to the Report, Missouri rates include a total of approximately $1.2 million for the top 5 executives. According to Hewitt Associates, the market for the top five executives in utilities with revenues approximating that of our electric business in Missouri would be over $3 million.

CHAPTER 5 - PENSION AND OTHER POST-EMPLOYEE BENEFITS ("OPEB") FUNDING CONTROLS

While the Report correctly points out that philosophical differences can and do exist in regards to the appropriate funding of and ratemaking for pension and OPEB programs, Aquila believes that this chapter is factual and agrees with the Staff's conclusion that "there appear to be no concerns regarding Aquila's funding of pensions and OPEB's at this time".

CHAPTER 6 – EMPLOYEE BONUS PAYMENTS

While we have not checked the figures reflected in Staff's summations of various bonus payments, we believe the data and description provided in this section of the report provide a fair and accurate reflection of Aquila's bonus practices and recent history. One point of clarity Aquila submits to the comments at the bottom of page 43 is that Norma Dunn and Robert Poehling left the company as the result of the company's restructuring. Their positions were eliminated, or duties consolidated, and therefore they were still eligible to receive the retention/performance award per the terms of the agreement if the final sale of property is closed.

CHAPTER 7 –ARIES GENERATION FACILITY

The Company believes the discussion on the Aries generating facility is generally accurate and provides a reasonable summary of the history surrounding the plant. It is important in reviewing Aquila's past interest in the plant, that one consider the nature of the industry at the time the plant was funded, built, and brought into service. During the late 1990s when planning for Aries was being undertaken, the utility industry was in the throes of restructuring. Many new generating companies such as Calpine and Dynegy were being formed to provide power in partnership with power "merchant" companies such as Aquila Merchant. This is acknowledged on page 56 of the Report where it states that "The industry climate across the nation was a shift to restructuring. Legislation had been proposed in Missouri."

As further evidence of the uncertainty facing the electric industry (particularly in regard to electric generation) at that time, Aquila notes the issuance of a May 1998 report of the Retail Electric Competition Task Force ("Task Force"). The Task Force was created and commissioned by the Missouri Public Service Commission in docket number EW-97-245 to study issues that the Commission might face under the assumption that electric restructuring would occur. Chapter 4 of the Task Force report was dedicated to a discussion of stranded cost issues such as extent of recovery, quantification, timing of recovery and mitigation. Ultimately the Task Force could take no position on the overall recoverability of stranded costs. Likewise, in June 1998, the Staff of the Missouri Commission presented a comprehensive plan to provide some general policy direction and proposals for implementation of retail competition. The Staff plan emphasized the importance of mitigating stranded costs. Their 1998 report suggested that divestiture of generation by utilities, as opposed to additions to the regulated asset base, would more quickly promote competition; that utilities would not desire to commit to new contracts that might result in stranded costs; and that much of any additional capacity would be met through short-term purchased power contracts. Similarly, in 2001 the "Final Report of the Missouri Energy Policy Task Force" presented to Governor Bob Holden reviewed, among other things, electric restructuring issues. That report provided no further guidance on the stranded cost issue but concluded that the PSC "should oversee the process of evaluating such claims of positive or negative 'stranded' costs or investments."

Clearly, the addition of a generating plant such as Aries at a cost of over $300 million dollars would have greatly increased the likelihood of stranded investment and financial uncertainty for Aquila and its customers. It has always been Aquila's objective to provide its customers with the lowest cost source of power. Given the uncertainty in regard to electric restructuring, potential for incurrence of stranded investment costs, and uncertainty of the effect on customer rates through regulatory treatment or mitigation of stranded costs, Aquila believed that it was in the customers' best interests to postpone permanent investment in generation and enter into cost effective purchased power agreements ("PPA") until the industry's path was more certain. For this reason in 1999, after a competitive RFP process, the Company elected to enter into the PPA contract with Aries and MEPPH. This contract was determined to be the low cost alternative over the near term and has proven to be in our customers' best interests to date.

With regard to the three areas where the Report indicates there have been differences of opinion regarding Aries, the Company responds as follows:

Use of Short-Term Purchase Power Agreements

Staff stated in its report that "The Staff opposed the short-term, five-year PPA that was executed in February 1999 for Aries power." However, a memo from the Staff's Chief Economist, Michael Proctor to the Commission dated April 5, 1999, recommended the approval of the proposed purchase power contract. Mr. Proctor also stated, "Based on the information presently available, the competitive bidding/negotiation process used by MPS appears to be consistent with obtaining needed power at least cost. Therefore, the staff is willing to state that the PSA between MPS and MEPPH is in the public interest, subject to the conditions and ratemaking standards discussed below and in the accompanying recommendation, which will permit a detailed review of the transaction in the context of a rate increase or earnings compliant case" (Page 8, Proctor Memo to MPSC, April 5, 1999).

Use of an Affiliate to Build Aries

The Report states that "it was staff's opinion that the Company believed it could earn higher profits by having a non-regulated affiliate construct a power plant and sell the power through a PPA than having the MPS Division of Aquila construct and operate the power plant." Aquila is and was fully aware that affiliate contracts are subject to close scrutiny and additional rules promulgated by the PSC. The MPS division of Aquila entered into the PPA with its affiliate because, as noted by the Staff memo dated April 5, 1999, it was the lowest cost option received in response to a request for proposal for the utility's capacity needs.

Sale of Aries to Calpine

Aquila agrees with the concept that the Aries combined cycle unit would be a valuable asset, but believes that is true only at an appropriate cost. The Report states only that Aquila decided to sell its ownership interest in Aries because it had experienced financial difficulties and was disposing of nonregulated generating assets. A more complete depiction is that Aquila had decided to exit the merchant business, while Calpine, our ownership partner in Aries, had made a strategic decision to remain in that business. The plant could not be efficiently or effectively operated as both a regulated generating unit and a merchant plant. Aquila and Calpine therefore began extensive contract discussions in 2003 because one or the other of the two partners had to take full operational control and ownership of the plant. By this time, the stranded cost uncertainties of regulated generation had abated and Aquila believed the plant could fill much of its existing capacity needs. However, Aquila could not agree that meeting Calpine's asking price, well in excess of the plant's original $310 million cost, was in the best interests of our customers and instead agreed to sell our ownership interest to Calpine. Ultimately, Calpine declared bankruptcy and Aquila recently entered into a contract to purchase the facility, subject to an auction conducted by the bankruptcy court seeking better bids, for a price of $158.5 million.

CHAPTER 8 – SOUTH HARPER GENERATING FACILITY

The Report in Chapter 8 recommends that Aquila "give adequate consideration to all available options when planning for future capacity requirements that will ensure the development of cost-effective decisions". Aquila believes that the processes it currently has in place have complied and continue to comply with this recommendation. Aquila utilizes the principles of least cost utility planning. Least cost utility planning is an economic analysis method with the lowest total system operating cost as the objective target. Least cost utility planning methods are applied to an Integrated Resource Plan (IRP). The IRP is the result of testing all available resource candidates under various scenarios and determining which of those candidates most economically meets the needs of the system.

While the Report quoted Staff testimony stating that the Company did not follow the least cost option in electing to use only three combustion turbines, instead of five, in constructing the present South Harper facility, it did not include Aquila's explanation for the variance from the least cost plan. In Case EA-2005-0248, Aquila witness Jerry Boehm filed direct testimony regarding this exact concern:

> Q. Was this solution the lowest cost plan?
> A. No. We call the 3-CT plan the "preferred plan". The lowest cost scenario results under base conditions was a plant with 5 CTs (5x105MW)
> Q. Why did you take your preferred plan over the least cost scenario?
> A. Aquila took into consideration the following issues:
> - Portfolio size: Ownership concerns over adding 525 MW from the same style of generator had a "too many eggs in one basket". Should the turbine design prove to be a problem Aquila would have a sizable portion of its capacity tied up. A practical approach would be to build a site for five or more units, gain experience and confidence in the turbine design over a few years and, if operating experience is favorable, add the remaining turbines.
> - Purchase Power Agreement ("PPA") Flexibility: Aquila's experience with midterm and short term purchases has suggested that cost effective purchase solutions still existed. The PPA's under consideration would complement a 3 CT plan by supplying energy at intermediate and baseload pricing By using intermediate energy at system participation (system average cost from the supplier) and baseload energy at fixed pricing contracts add significant value as a hedge against natural gas price increases associated with the 3 CT plan.
> - The value of diversity: The results of the modeling returned differences between a 3 CT and a 5 CT plan of $4 million on a 10-

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year basis. Aquila believed that the fuel, price and source diversity added by splitting the need into multiple sources (portfolio approach) easily justified the cost difference.

Second, the Report states "Heavy reliance on natural gas-fired generation facilities has subjected customers to rate increase requests due to significant increases in natural gas prices." Aquila agrees with that statement but hopes that it is not intended as a criticism of its resource planning practices. Only about 4 percent of Aquila's firm generated energy requirements are met by natural gas-fired resources, but that gas-fired energy has to be available when needed. Aquila's load profile, particularly on its MPS system, is comprised of a largely residential, substantially rural service territory. This results in a load profile that to be most cost effective requires more reliance on peaking facilities to meet the pronounced "needle peak" demands brought about by air conditioning use on hot summer days. The most efficient peaking facilities are typically gas fired. The Staff itself had recommended the construction of 5 combustion turbines, which would indicate its understanding that gas-fired peaking generation is needed to meet Aquila's load profile.

Many decisions regarding generation resources must be made years in advance of construction. An optimum supply mix may vary from year to year due to changing prices and other factors, and appears to have some cyclical nature. Gas-fired resources have lost much of their recent glamour due to escalating fuel prices. However, reliance on coal is beginning to be questioned as increased transportation costs, diminishing availability of suitable high Btu content coal, and rising environmental compliance costs are combining to make that resource less attractive. Nuclear fuel, which in recent years has been maligned, seems to be growing in favor with some long-term resource planners. Despite these substantial uncertainties, Aquila believes that its current and planned generation resources are reasonably balanced and reflect a near optimum supply mix for its existing load profile.

Third, the Report does not mention the plans by the Company to bolster its owned generation by purchasing the Aries plant from Calpine for intermediate load, if it can do so at a reasonable price, or by participating in the Iatan II plant with Kansas City Power & Light Company ("KCPL") and the Empire District Electric Company to increase its baseload generation by 2010, an undertaking authorized by the Commission in Case No. EO-2005-0293 when it approved Aquila's application for authority to enter into a secured financing arrangement.

Finally, as a matter of clarification in regard to the Chapter 8 Historical Summary, it should be noted that the statement that three Siemens Westinghouse Power Corporation turbines were to be installed at the Aries generation facility is not entirely correct. While these units were purchased by the Aquila Merchant subsidiary, their final installation location had not been determined. During the time in question, there was considerable demand for natural gas-fired turbines and extended lead times in their manufacture. Purchasers placed orders often before they knew where the turbines would be located; however, suppliers required a delivery point for their records (which could be changed through a contract modification). This was the case for the three turbines discussed in the Management Audit report. While Aquila Merchant designated them for delivery at the

Aries location, no decision had been made at that time as to where they would ultimately be installed.

In summary, the Company understands that two parties considering the same facts can reach different conclusions. However, given the information provided in this section about the environment facing Aquila at the time decisions were made, we must respectfully take issue with the Staff's conclusion that "Company management has not always given adequate consideration to all available options for accommodating its future electricity capacity requirements." Aquila maintains that it has always strived to maintain a proper and cost effective balance among its generating resources giving due consideration to the best information available at the time the decisions were made.

CHAPTER 9 – PROTECTIONS FOR REGULATED ACTIVITIES FROM PARTICIPATION IN UNREGULATED ACTIVITIES

On page 1 of the Executive Summary, Staff makes the following statements:

"The Staff concludes that Aquila has provided little if any service quality or rate making protections to its Missouri customers, but instead is of the opinion that the efforts of multiple state and federal regulatory bodies with various authorities have provided appropriate protection to date."

On page 5 of the Executive Summary, Staff discounts three specific actions that were taken by Aquila to protect regulated customers and states that "Staff has found little evidence that Aquila has made substantial efforts of its own to protect its regulated business." On page 66 of the main body of the report, Staff acknowledged that "items 2 and 3 of the company's response can and do provide protections to the company's regulated activities, these protections can, at least in part, be attributed to Missouri regulatory requirements and authority." The Staff cites two examples where it believes that Aquila pursued actions that were not in the best interest of Aquila's regulated business: the application to pledge its Missouri assets to support a utility working capital loan and the transfer value of the South Harper turbines.

Aquila concurs with Staff's conclusion that there are not "any present detriments to Aquila's Missouri consumers, either in rates paid or in present service quality concerns." However, Aquila does not believe that the Staff report has fully discussed the decisions made by management to protect regulated activities from unregulated activities. Aquila, as stated earlier, recognizes that this more detailed explanation was not provided in the data request response.

Aquila offers the following points of clarification to ensure that the record is complete:

1. Aquila acknowledges that its corporate structure limited the options available to provide a pure "ring-fencing" protection for its utilities from the unregulated businesses. However, a paper published by a NARUC subcommittee on the topic of ring-fencing concluded that "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" (emphasis added). Aquila maintains that its intent has always been clear – to protect its regulated customers from the activities of its other businesses to the greatest extent possible.

2. In 1986, as Aquila began the development of its utility growth strategy, it developed the "business unit capitalization procedures." One of the six stated objectives, which all dealt with a focus on addressing potential concerns with Aquila's (at that time UtiliCorp's) organizational structure, was "to insulate each business unit from the activities of other business units and from UtiliCorp operations" (emphasis added). Clearly, 20 years ago, Aquila recognized the importance of creating operational and financial insulation between business units. In 1996, Aquila undertook a review of this procedure and confirmed again the importance of maintaining the benefits of this financial ring-fencing technique. While the Missouri Staff has not accepted the business unit capital structure in ratemaking, most of Aquila's other state commissions have.

3. In March 2003, Aquila developed a "Debt Reduction and Restructuring Plan." In that plan, Aquila reconfirmed its focus on three key business principles:

   a. Protect utility customers from potential adverse financial impacts.
      - Maintain the Aquila capital allocation process that utilizes "hypothetical" capital structures and long-term debt assignment
      - Price new/replacement debt to utility divisions at comparable BBB credit rating

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

   c. Enhance regulatory transparency
      - Transition to a state-based organization
      - Create 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

This confirmation was another clear statement by Aquila that while the challenges of repositioning might be externally viewed as a potential distraction for management, the commitment to protect the regulated customers was the highest priority. Aquila further reinforced the importance of the utility focus by developing an internal web site that tracked and published the key customer service metrics on a monthly basis, and also management aligned the employee variable compensation program with the effective achievement of these metrics.

The testimonies of Mr. Empson and Mr. Vancas in Case No. ER-2007-0004 provide greater detail.

This concerted effort to heighten the importance of further enhancing customer service was symbolic of Aquila's commitment to protect its regulated customers from the activities related to the unregulated businesses.

4. Issuing secured debt is a common utility practice. While the Missouri Commission chose not to include the Missouri utility assets in the pool of assets to secure a utility working capital loan, both Colorado and Iowa Commissions did approve similar applications. While the secured utility working capital facility was issued in April 2003, it was restructured in September 2004 and the lien on utility assets removed. There was no negative impact to any utility customers as a result of the 17 month lien.

5. When Aquila identified the need to install three combustion turbines, we voluntarily initiated a third-party review to determine the value of turbines held by its merchant affiliate. Aquila Merchant's original book value of the turbines and other project costs was almost $82 million. The third party expert determined that the market value of the turbines and related equipment was $70,796,850. Aquila wrote down the original book value to reflect the market value and booked a loss of about $11 million in the fourth quarter of 2004. As part of a settlement with the Missouri Staff, Aquila agreed to further reduce the value by $3 million. Aquila does not agree that the offer to sell the combustion turbines to KCPL has any relevance because, among other things, the proposed early sale would have avoided significant expected storage costs of almost $9 million had the turbines been diverted to KCPL. When the turbines were delivered to Aquila Merchant, storage costs could not be avoided and the lower offer of sale to KCPL was withdrawn.

6. As detailed in Mr. Empson's testimony, page 21-25, Case No. ER-2007-0004, Aquila made an exhaustive effort to ensure to the greatest extent possible that only costs necessary to operate a safe and reliable electric utility were included in the rate case. Aquila retained at the corporate level $22.9 million of expenses and also made adjustments to such items as to eliminate retention bonuses paid to executive management, annual and long-term incentives to executive management, Board of Director costs, facility costs, the supplementary executive retirement plan, and certain costs associated with South Harper.

7. Aquila agrees that the regulatory process is designed to ensure that only the costs necessary to operate a safe, adequate, and reliable utility company are included in rates. Aquila also agrees that the Missouri Staff and Commission have been very diligent in ensuring that this protection occurs. However, Aquila does not believe that Staff, in this Report, has given recognition to the decisions made by Aquila's management to fulfill this obligation and to continue to improve its customers' service.

CHAPTER 10 – INVESTMENT IN UNREGULATED ACTIVITIES

Aquila believes that this Chapter properly reflects the nature of unregulated activities conducted by the Company in recent years. In regard to the concern that subsequent to a rate case Aquila could cut costs and thereby negatively impact service quality or reliability, Aquila reiterates its focus on and commitment to service quality. We earlier reflected in our response the high customer service metrics that have been maintained despite financial difficulties in recent years, and therefore will not restate those comments here.

CHAPTER 11 – ACTIVITES THAT WERE ILLEGAL, INAPPROPRIATE OR IMPROPER UNDER STATE OR FEDERAL STATUTES OR REGULATIONS

Aquila believes that this Chapter is factual and that the conclusion that past allegations have been without merit or resulted in settlements that had no rate implications for consumers is correct. Aquila further believes that ratemaking, along with Aquila's own commitment and efforts, have effectively served to insulate Missouri consumers from settlement payments and the Company's legal and investigation fees resulting from alleged improprieties.

CHAPTER 12 – INVESTIGATION OF ANONYMOUS SIX-POINT SUMMARY COMPLAINT

Aquila is in total agreement and is pleased with the Staff's conclusion, after thorough analysis and review, that the six points of allegation were either unfounded, or did not indicate any improper action or wrongdoing on the part of Aquila or its employees. Aquila is certainly dismayed by the fact that unidentified sources, perhaps with their own personal agenda or grievance, can make such unfounded allegations and that the resources of the Company and the Commission are wasted in meaningless investigations. However, we also understand that it is important for everyone to complete these detailed investigations so the rumors and allegations can finally be put to rest.

MANAGEMENT AUDIT OF AQUILA, INC.

CASE NO. EO-2006-0356

PREPARED BY

THE MISSOURI PUBLIC SERVICE COMMISSION

ENGINEERING AND MANAGEMENT SERVICES DEPARTMENT

October 31, 2006

****Denotes Highly Confidential Information**** **NP**

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TABLE OF CONTENTS

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Attachment 1-15

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Attachment 1-16

EXECUTIVE SUMMARY

The following provides a summary for each of the areas directed by the Commission for Staff's review in its June 13, 2006, Order, which established Case No. EO-2006-0356. The Staff has reached the general conclusion that while, without question, the attention of Aquila's management has been diverted to problematic concerns created by its pursuit of unregulated business activities, the Staff has not documented quantifiable detriment to Aquila's Missouri customers. The Staff concludes that Aquila has provided little if any service quality or rate making protections to its Missouri customers, but instead is of the opinion that the efforts of multiple state and federal regulatory bodies with various authorities have provided appropriate protections to date.

Incentive Compensation

Aquila employees have a wide variety of methods in which to earn additional compensation and awards which includes commissions, bonuses and discretionary awards. During Company rate cases, the Staff has consistently attempted to apply criteria as recommending only those incentive awards that can reasonably be determined to produce results beneficial to Missouri ratepayers and the quality of service they are receiving. The Staff has consistently recommended that goals that focus on the improvement of financial ratios, which benefit primarily shareholders, be excluded from rate recovery. Commission case history presented in the chapter generally demonstrates that ratepayers have been protected from funding what the Staff believes to have been incentive compensation awards that did not benefit the ratepayers. The Staff does encourage Aquila to take steps to verify that its incentive compensation programs actually do motivate employees to better perform. Staff made one recommendation to Company management that it:

> *Review present incentive compensation programs to determine that they are serving as a cost effective motivation to employees.*

Executive Compensation

Executive compensation has become an extremely complex area making it increasingly difficult to determine the actual amount of total compensation being paid. The Securities and Exchange Commission (SEC) is expected next year to require greater disclosure from companies including the worth of executive compensation packages. While the cornerstone of any executive compensation package is the element of base salary, many other forms of remuneration, such as pension benefits, may be developed as a percent of base salary.

Historically, the Commission Staff has applied specific criteria to determine whether to support an adjustment to incentive compensation program areas. The Staff has been unsuccessful in the past on presenting supportable cases on the issue of executive compensation. While the Staff performs thorough review and analysis of the allocation of executive costs, the actual amount of salary packages have not been successfully challenged.

Staff's review resulted in the following recommendations to Company management that it:

> *Review and utilize methodologies to fully determine, define and document the total amount of executive compensation.*
>
> *Re-examine the Company's staffing levels, staff responsibilities and attendant executive compensation levels to ensure such compensation is commensurate with executive responsibilities.*
>
> *Adjust executive compensation levels based upon the results of the examination.*

Pension and Other Post-Employee Benefits Funding Controls (OPEBs)

OPEBs were defined in the Commission's Order in Case No. ER-93-37 as benefits, other than pensions, such as health care, dental care and life insurance. The Commission's Order further indicated that OPEBs are legitimate and are historically approved costs of providing service, and absent evidence that they are excessive or imprudently incurred, they will continue to be recovered.

An examination of Aquila's books and records during Case No. ER-2005-0436, discovered that Aquila had not funded its Voluntary Employee Beneficiary Association (VEBA) Trust Fund from 2003 through 2005. The Office of Public Counsel filed a complaint case regarding the matter, which it subsequently requested be dismissed after Aquila contributed approximately $7 million toward its OPEB obligation. Rates paid by Missouri consumers are impacted to the extent pensions, base Supplemental Executive Retirement Plans (SERPs) and OPEBs are included in rates. Aquila's SERPs have been identified as excessive by Staff witnesses in recent Company rate cases, but those cases have all been stipulated, indicating that in the Staff's opinion, the Company's total revenue requirement received has been appropriate.

Employee Bonus Payments

The Company has not requested executive bonuses be included in customer rates for the past several years. Other bonuses have been allowed if the compensation criteria provided benefit to ratepayers. As indicated above, the most recent three rate cases filed by Aquila have been stipulated, indicating that the Staff has been satisfied with the total revenue requirements Aquila has received for the past several years. As previously indicated, the SEC is expected next year to require greater disclosure from companies including the worth of executive compensation packages.

Decisions Aquila Made Regarding The Aries Generation Facility

The Aries generating facility is located in Pleasant Hill, Missouri on property previously owned by Aquila. The Aries facility was built to supply Aquila's energy needs in Missouri and was initially owned equally by Calpine Corporation (Calpine) and Aquila Merchant, an unregulated affiliate of Aquila, Inc., through shares held by Merchant Energy Partners. A Power Supply Agreement was executed between Aquila and Merchant Energy Partners in February 1999. Due to financial difficulties, Aquila Merchant and Calpine went into default on financing for the Aries facility. Aquila Merchant subsequently sold its share of Aries to Calpine in September 2003. An investigation into the Aries facility was opened by the Commission which ultimately concluded that the Commission did not have jurisdiction over the sale of Aries.

While concerns have been raised regarding the Company's ownership and sale of Aries and potential detriment to Aquila's regulated customers, all Company rate cases subsequent to the building of Aries have resulted in stipulated settlements. These rate cases have carefully examined Aquila's costs to provide electricity to the Company's Missouri customers, and their settlements indicate that Staff has supported the revenue requirements Aquila has been able to recover from its Missouri customers.

Pertinent to the analysis of the Company's decisions that impact all of its actions regarding the supply of power to its Missouri customers, is the previous internal Company policy that prevented its regulated entities, including its Missouri Public Service operating division, from constructing generation facilities to meet future capacity needs. The Company's use of extensive short-term purchase power arrangements has placed Missouri customers at risk for high volatility in market prices.

<u>Decisions Aquila Made Regarding The South Harper Generating Facility</u>

In anticipation of a power shortage for its Missouri Public Service operating division, Aquila Merchant purchased three combustion turbines in September 2001. These new combustion turbines were the beginning steps of a planned Aries II project, but by July 2002, Aquila decided to cancel Aries II when the merchant energy market was collapsing. The Company ultimately decided to use the three purchased turbines at the present South Harper site. Aquila planned to supplement power generated from the three turbines with three to five-year purchase power agreements (PPAs), in spite of concerns expressed by the Commission Staff with such short-term agreements.

Subject to conditions, the Commission issued a Report and Order on May 23, 2006, that granted Certificates of Public Convenience and Necessity for the generating units and electric transmission substation. The site of the Company's generation at South Harper continues to be litigated between the Company and Cass County.

The Staff has, on previous occasions, expressed its concern regarding Aquila's reliance on short-term purchase power agreements to serve its Missouri customers. While the last several rate cases have resulted in settled revenue requirements that the Staff has supported and believes has provided appropriate rate protections for Aquila's Missouri customers, the Staff is of the opinion that Aquila management has not given adequate consideration to all available options for meeting its future electricity capacity requirements.

The Staff's chapter, which addresses decisions Aquila made regarding the South Harper Generating facility concluded with one recommendation:

> *<u>Give adequate consideration to all available options when planning for future capacity requirements that will ensure the development of cost-effective decisions.</u>*

<u>Decisions Aquila Made To Protect Its Regulated Activities From The Company's Involvement In Unregulated Activities</u>

While the Company points to three specific actions it has taken to protect its regulated activities from its non-regulated activities, it is the Staff's conclusion that these responses either do not protect Aquila's regulated properties or, provide protections because regulatory authorities require the protection. The Staff has found little evidence that Aquila has made substantial efforts of its own initiative to protect its regulated businesses. Harm to Missouri utility consumers that may have resulted from Company decisions to enter into short-term power supply and decisions to enter the energy trading business have been mitigated in spite of Company management decisions, primarily due to regulations regarding rate and service quality. The Staff's review resulted in one recommendation to Company management:

> *<u>Provide advance notice to the Commission prior to investing in future unregulated activities along with documentation of all known and potential impacts those activities may have on Aquila's Missouri utility customers. Include in the Company's notice to the Commission all plans the Company has to ensure that Aquila's Missouri customers will not be negatively impacted by investing in future unregulated activities.</u>*

<u>Decisions Aquila Made to Invest In Unregulated Activities</u>

Aquila pursued aggressive growth strategies between the periods of 1985 to 2002. Part of the Company's strategy was to be in the forefront of utility deregulation. With its failed merger attempt with KCPL in mid-1996, and its inability to grow itself domestically, Aquila focused on international growth opportunities.

The Company reorganized in 1994 and it had five business segments; four of the business segments were unregulated. During 2001, Aquila Merchant went public, Mr. Richard Green stepped down as CEO, Mr. Robert Green became CEO and the Company consisted of four business segments. Three of the four business segments were unregulated.

Its largest unregulated activity, the energy trading business, collapsed in 2002. Lower investor confidence significantly impacted Aquila's financial condition, subsequently forcing it to sell assets, cut costs and seek other means to raise cash. While the Staff cannot unequivocally state that Aquila's decisions to invest in unregulated activities have not resulted in any detriment to the Company's Missouri utility consumers, the Staff is not aware of any present detriments to Aquila's Missouri consumers.

<u>Decisions Aquila Made That Involve Activity That Was Illegal, Inappropriate Or Improper Under State Or Federal Guidelines</u>

As summarized in the body of the report, a number of allegations and charges have been raised against Aquila, alleging numerous activities that could be described as "illegal, inappropriate or improper." Activities by Aquila Merchant Services have fallen under particular scrutiny by the Commodities Futures Trading Commission (CFTC) and the Federal Energy Regulatory Commission (FERC). Resulting settlement payments were made by Aquila, none of which were recovered in customer rates. Additionally, executive misconduct was the subject of two recent Company investigations. The results of the investigations, which were prompted by a May 12, 2003, letter to the Company's Board of Directors and allegations made to the Staff of the Commission by an anonymous source, resulted in no material findings. Staff's review regarding the later allegation was incorporated by the Commission in its order which required the present Management Audit of Aquila, Case No. EO-2006-0356.

A summary of Aquila's current litigations are also presented in the report. As addressed previously, litigation continues regarding the siting of South Harper generating facility. Based upon the findings resulting from various investigations into Aquila and the ratemaking and service quality protections provided to the Company's customers, it is the Staff's conclusion at this time that allegations of illegal, inappropriate or improper activities have had minimal rate and service impacts on Aquila's Missouri consumers. What is more difficult to measure is the impact negative public perception has had on Aquila's customers.

CHAPTER 1 MANAGEMENT AUDIT OF AQUILA, INC. INTRODUCTION

Management Audit Overview

On March 16, 2006, the Office of the Public Counsel (OPC) filed a motion with the Missouri Public Service Commission (Commission) to open a new case to conduct a management audit of Aquila, Inc. (Aquila, Company). Specifically, OPC's motion indicated that the Commission had ordered management audits in the past of utilities under its jurisdiction when there have been indications of mismanagement. OPC's motion further indicated that "never had a major utility stray as close to the edge of bankruptcy as Aquila has."

In a March 20, 2006, filing, the Staff recommended that the Commission issue an Order indicating the areas and matters it wanted investigated. The Staff also requested the Commission schedule a technical conference for the purpose of the parties to address the scope specified by the Commission, timeframe, staffing, cost and cost recovery related to the investigation and/or audit desired by the Commission.

Aquila also filed a response to OPC's motion on March 20, 2006 and requested the Commission deny the motion based upon a number of factors. Included in Aquila's request that an audit not be ordered were statements that the Company's financial circumstances and management practices had not adversely impacted the Company's ability to provide safe and adequate utility service at just and reasonable rates to its Missouri customers. The Company also indicated that bonuses referred to by OPC were not sought to be recovered by Aquila's customers. The Company further indicated that there had been significant changes in its management team, that OPC allegations concerning Other Post-employment Benefits (OPEBs) obligations had been resolved and that building the South Harper Facility was appropriate, in the best interests of all of Aquila's customers and had the Staff's support.

On April 19, 2006, the Commission ordered a conference to discuss the need for a formal management audit, as well as the purpose and means for conducting such a review. The conference took place on May 15, 2006, and on May 30, 2006, the Staff, OPC and Aquila filed a report summarizing the conference. On June 13, 2006, the Commission issued its Order which required a management audit of Aquila, Inc. The Order directed the Staff to examine the impacts on Missouri consumers of Aquila's past decisions regarding: 1) incentive compensation;

2) executive compensation; 3) employee bonus payments; 4) pension and other post-employee benefits funding controls; 5) the South Harper generating facility; and 6) to complete its ongoing investigation of allegations that an individual has made regarding particular activities at Aquila. The Commission further directed the Staff to investigate several additional issues. These included: 7) decisions that Aquila has made to invest in unregulated activities; 8) decisions that Aquila has made related to efforts to protect its regulated activities from the Company's involvement in unregulated activities; 9) decisions that Aquila has made that involve activity that was illegal, inappropriate, or improper under State or Federal statutes or regulations; and 10) decisions that Aquila has made regarding the Aries facility.

Approach of the Review

The Staff began by assessing information within its possession including case testimonies, Stipulations and Agreements, Commission Reports and Orders, and Staff Audit Reports concerning the Company. These reports included the December 2002 Missouri Public Service Commission's Staff Report on Aquila, Inc. and the October 2005 Review of Aquila, Inc. Customer Service Processes and Operations report. Also reviewed was a paper, "The Kansas City Power and Light Merger – Western Resources or UtiliCorp!" authored by Karyl B. Leggio, Associate Professor of Finance at the University of Missouri – Kansas City and Marilyn L. Taylor, Gottlieb Missouri Chair of Strategic Management and Faculty Director, Academic Service-Learning, Students In the City – Center for the City.

The Staff also reviewed Federal Energy Regulatory Commission (FERC) and Securities and Exchange Commission (SEC) filings. Data requests were issued to the Company and the Staff conducted interviews with various Company personnel. Staff also reviewed minutes of Aquila's Board of Director's meetings and Board Committees' minutes. Aquila's shareholder reports were reviewed, as well as, numerous other Company documents. News articles were used as sources of information of the Company's operations. Commission rules, such as Affiliate Transactions, were also reviewed in conjunction with the development of this report.

CHAPTER 2 OVERVIEW OF AQUILA, INC.

As indicated in the Missouri Public Service Commission's Staff Report on Aquila, Inc., dated December 2002, Aquila was founded in 1917 as Green Light and Power Company. The Company provided electric, natural gas and water regulated services in Missouri and changed its name to the Missouri Public Service Company (MPS) in 1927, to UtiliCorp United, Inc. in 1985 and to Aquila in 2002. The Company maintains its headquarters at 20 West 9th Street, Kansas City, Missouri.

Between 1985 and 2002, Aquila grew from a medium-sized electric utility to one of the largest wholesalers of electricity and natural gas in North America. By 2002, Aquila owned and operated electrical and natural gas distribution networks in seven states within the United States as well as distribution networks in Canada, New Zealand and Australia. As of December 31, 2001, Aquila had total assets of $12 billion and annual sales of $40 billion.

At the time of this report, the Company has sold its foreign distribution networks and its Missouri natural gas operations. Presently, the Company has electric operations in Missouri and Colorado as well as natural gas operations in Iowa, Kansas, Nebraska and Colorado. Aquila's Missouri natural gas operations were recently sold to Empire District Electric Company. Aquila presently provides electric service to approximately 292,000 Missouri customers. The only remaining unregulated entity of Aquila's pre-2002 restructuring is Aquila's Merchant Services which is presently comprised of 14 gas contracts and a 340 megawatt peaking unit. Aquila, Inc. has 3,204 employees.

CHAPTER 3 INCENTIVE COMPENSATION

Historical Summary

The Commission's Order specifying the issues to be addressed within this docket stated that the evaluation was to "examine the impacts on Missouri consumers of Aquila's past decisions" regarding various issues, including incentive compensation and employee bonus payments. A historical review of the Company's programs for incentive compensation along with their filing for recovery within rates will be detailed in this chapter. If a Commission Report and Order was issued and addressed the issue of incentive compensation, it will also be noted. While there is some overlap between the subjects of incentive compensation and bonus payments, they will be addressed in separate chapters.

Incentive compensation is normally defined as any form of variable awards or compensation, paid in addition to base salary, that is based on performance for a period of 12 months or less. The terms "bonus" or "incentive compensation" are commonly used when referring to the types of awards that can be given in addition to base salary. In most cases, a bonus is an after-the-fact monetary award that is based on the overall success of the company. Participants generally do not know for certain what the amount of the bonus may be if the Company is successful.

In contrast, strict incentive compensation programs provide more specific motivation to the employee by defining, at the beginning of the year, detailed goals with the award opportunity. These award opportunities may take the form of dollars or other awards. Incentive compensation programs frequently have goals based upon individual achievement factors that assist the company in reaching its overall corporate goals. Corporate financial goals are normally reserved for the top executive management in setting incentive compensation goals.

However, while some generalizations can be made, companies can and do tailor these programs to their specific needs and such programs can be impacted by changes in the tax laws. Some type of incentive compensation program is used by most companies to provide additional motivation to employees.

Incentive Compensation at Aquila

The Compensation and Benefits Committee of the Board of Directors (Compensation Committee) is authorized to handle all matters related to CEO and non-CEO compensation. This Committee holds sole authority to retain the Company's outside compensation consultant and conduct annual reviews of all elements of executive compensation, including the annual and long term incentive plans. Recent SEC rulings have called for companies to provide greater disclosure of information relating to benefits. The Compensation Committee now also reviews all broad-based variable compensation plans.

The compensation philosophy utilized by Aquila provides that: 1) Aquila's compensation and benefits practices will target the market 50th percentile of domestic regulated utilities most similar to Aquila; 2) Aquila's compensation and benefits practices will be sufficient to attract and retain the talent necessary to run the business and execute Company strategies; and 3) Aquila's compensation and benefits practices will support and reinforce important organizational goals and objectives.

Historically, the Company has maintained incentive compensation plans for both non-union employees and executive management. These programs have changed over time to reflect the financial conditions of the Company as well as the market for labor. The Annual Incentive Plan (AIP) was in effect during 2001-2002 and then was replaced with the Annual Variable Compensation Plan (VCP) in 2003. The metrics and objectives for the VCP are established by management in operational departments and then reviewed by the Compensation Committee. In November of each year, the Committee reviews the status of outstanding award plans. Then, in February, the Committee reviews the actual performance against the metrics. From this analysis, payout levels are determined for the Annual Variable Compensation Plan and any long-term incentive plans. Incentives are then paid in March.

The Annual Variable Compensation Plan is available for participation by all non-union employees at Aquila. The executives at the Company have declined the opportunity to participate in the incentive compensation plans since 2001. The reason they have cited for not participating include their desire to maintain community and employee relations by avoiding potential negative media attention during a difficult financial time at the Company.

The specific structure and features of these incentive compensation plans, as well as their titles, have changed over time. These will be detailed more in the historical information presented.

The Staff attempted to obtain figures on costs of the incentive awards made to employees over the years. The following table represents a response to this request and reflects only payments made on the Annual Incentive Plan (2001-2003), the Variable Compensation Plan (which replaced it in 2004), and the Long Term Incentive Payments made in cash.

Chart Highly Confidential In Its Entirety

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The table illustrates the reduction in benefits paid to employees, beginning in the year 2003. The Long Term column represents programs only available to executives.

<u>Aquila's Past Decisions Regarding Incentive Compensation</u>

Case History of Staff and Company Filings and Commission Decisions on Incentive Compensation

Case No. ER-93-37 (then UtiliCorp United, Inc.)

In this case, the direct testimony of Staff witness Larry Cox addressed the Staff's concerns with the Company's incentive pay plan for its employees. The Staff took issue with utilizing net income as one of the criteria by which the size of the incentive awards were calculated. The Staff did not believe that incentive awards should be based on an element such as net income. The benefits of increasing net income accrue to the Company's shareholders, not its customers. Therefore, shareholders and not customers should pay for incentive programs designed to achieve this objective. In addition, increasing net income is influenced to a large extent by factors beyond the employee's control and is not a very good indicator of employee performance.

The Staff also found that the goals upon which these rewards were based were constantly being changed and many of them represented tasks that employees were required to do as part of normal job duties. Some of the goals were for activities that may not be deemed to be in the ratepayer's best interests. These included items like an incentive award to the Revenue Requirement Department for securing $10-$13 million in total rate relief for cases presently filed with the Commission. Another questionable item was to reward the Rates Department for shifting rate design to the residential class. In addition, some of the goals were for activities that are not typically allowable in the Company's cost of service, such as community service.

The Staff's review of these goals also did not find them to elicit exceptional performance beyond the usual performance expectations. Some of these goals were as simplistic as "avoiding personal injury and vehicular accidents". The Staff believes that an incentive pay program should reward employees for superior performance which can be measurably shown to benefit the ratepayer. Costs of incentive programs that are included in rates should not be based on criteria that an employee has limited ability to influence. The Staff did not pursue a disallowance of the costs of these incentives in this specific proceeding because of the overall revenue requirement in the case. However, the Staff noted it would examine this area in future rate proceedings, and propose adjustments if the Company's incentive compensation program is not restructured to better encourage superior performance in activities that may benefit ratepayers.

This Case was stipulated and there was no mention of the issue within the Stipulation and Agreement.

Case No. ER-97-394 (then UtiliCorp United, Inc.)

James R. Dittmer with Utilitech, Inc. was retained by the Staff to submit testimony on a number of issues in this case. Mr. Dittmer's direct testimony included a discussion regarding incentive compensation that was included within test year operating expenses. He did not propose an adjustment in this case due to a decision made by the Staff. At the time his testimony was being prepared, it was obvious that Staff would be recommending a significant rate reduction and the Company had requested a significant rate increase. Mr. Dittmer noted that the issue of ratepayer recovery of incentive compensation costs requires a professional yet subjective judgment. In the interest of conservatism in this case, a decision was made to not further pursue the issue of incentive compensation. However, Dittmer did make recommendations regarding what would be required and examined in future cases. These recommendations focused on the Company maintaining documentation, and utilizing comparisons within the industry in setting up these incentive programs.

Case No. ER-2001-672 (then UtiliCorp United, Inc.)

The direct testimony of Staff witness Graham Vesely addressed UtiliCorp United, Inc.'s, (UtiliCorp or UCU) incentive compensation and made a distinction between the different goals within the incentive compensation program. Historically, the Staff had recommended that ratepayers pay for progress made toward accomplishing goals of improving safety and /or controlling costs, and that goals intended to improve UtiliCorp's earnings/rate of return should be assigned to shareholders. He cited the Commission's Order in Case No. TC-89-14, Southwestern Bell Telephone Company (SWB), wherein the Commission stated:

> In the Commission's opinion the results of the parent corporation, unregulated subsidiaries, and non-Missouri portions of SWB, are only remotely related to the quality of service or the performance of SWB in the state of Missouri. Achieving the goals of SBC (the parent company) and unregulated subsidiaries is too remote to be a justifiable cost of service for Missouri ratepayers. Accordingly, the Staff's proposed disallowances in the senior management's long term and short term incentive plans...should be adopted.

The Commission also addressed this in Case No. TC-93-224, et. al., SWB, the Commission reiterated its position expressed in TC-89-14, and accepted the Staff's proposed disallowances of both short-term and long-term incentive costs. In particular, with regard to the long-term plan, the Commission stated:

> The structure of the plan provides an implicit incentive for participants to try to increase SBC's stock price. This in turn could encourage senior managers to spend a greater percentage of time on regulated companies and discourage time and effort spent on Missouri operations...The likelihood of SBC managers emphasizing whatever they perceive will cause the market to react favorably to SBC stock, including giving priority to unregulated subsidiaries, further convinces the Commission that Missouri ratepayers should not fund the long term incentives.

Staff witness Vesely described the Annual (short-term) Incentive Plan and an Executive Long-Term Incentive Plan in place at Aquila at that time. The Company responded to the Staff's request for the purpose of the Annual Incentive Plan by stating the following:

> The purpose of the UtiliCorp United (UCU or UtiliCorp) Annual Incentive Plan is to reward the accomplishment of business goals set by UCU and to motivate participants to accomplish significant business group and individual goals. Achievement of these goals will further enhance UCU's mission to create shareholder value by providing superior energy solutions for our customers.

The Annual Incentive Plan made payments based upon the achievement of three separate components:

1) UCU Financial Goals
2) Business Group/Department Goals
3) Team/Individual Goals

Both the UCU Financial Goals and the Business Group goals specify achieving a certain earnings per share or earnings level. The Company did include incentive payments for the achievement of these financial goals in their filed case.

The Staff believed that the financial goals of parent company earnings per share and earnings level closely met the Commission's reasons for disallowance cited in Case Nos. TC-89-14 and TC-93-224. UtiliCorp requested a total of $2,697,104 to cover annualized payments for the Annual Incentive Plan, which were to be paid in March 2000. Senior executives were included in this Plan. The Staff recommended an adjustment to reduce the annualized level of incentive compensation by all the payments made for UCU financial goals. The Staff did not recommend any disallowance of annual incentive payments made for team and/or personal goals of improving performance.

The other incentive plan utilized by the Company is the Long Term Executive Incentive Plan (LTIP). The purpose of this plan was provided to the Staff in a data request response and stated:

> The UtiliCorp United (UCU) Executive Long Tem Incentive Plan is designed to share and reward long term success of significant business goals set by UCU management and to motivate participants to achieve goals which lead to increased total return to shareholders.

This plan was limited to a select group of executive management and utilized a performance objective based upon total shareholder return. The Staff believed that this was a clear example of incentives to achieve goals that benefit shareholders and therefore did not meet Commission standards for rate recovery. The Staff did make an adjustment to remove all

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amounts associated with this plan. A Stipulation and Agreement was reached in the case and it was silent on the issue of incentive compensation.

Case Nos. ER-2004-0034 and HR-2004-0024

The direct testimony of Company witness Ronald A. Klote described the two-factor compensation system and how the incentive plan fits into the salary schedule. The incentive pay plan in 2003 was the Variable Compensation Plan and was tied to organizational objectives such as customer service, reliability, effective use of capital and safety. The Company sought recovery of $968,675 for the MPS Electric Division and $308,314 for the L&P Electric Division with payout to be made in March 2004.

In rebuttal testimony, Staff witness Dana Eaves noted that the Company did not make any awards to employees based upon the year 2002 plan. He included information from Aquila's 10K Report to the Securities and Exchange Commission (SEC) for the fiscal year ended December 31, 2002 filed with the SEC on April 15, 2003. The report stated the following:

> Our Long-Term Incentive Plan (LTIP) enables the company to reward key executives who have an ongoing company-wide impact. Eligible executives are awarded performance units based on a comparison of our total shareholder return over three years to a specific group of companies with operations similar to ours. Incentives have been paid in cash, restricted stock, restricted stock units or deferred compensation agreements funding stock option grants based on the executives' total shareholdings of the company common stock and their elections. Total compensation expense for the years ended December 31, 2001 and 2000, was $19.6 million and $8.5 million, respectively. Due to the Company's 2002 performance, no awards were earned for the year ended December 31, 2002, no new awards were granted in 2002, and potential for the year ended December 31, 2003 were suspended.

The Company did develop a new incentive compensation plan for 2003 and it was outlined in the direct testimony of Company witness Klote. Staff witness Eaves opposed the Company's adjustment for two reasons. 1) It did not meet the "known and measurable" standard, and 2) The measurement was based upon improper goals.

Staff witness Eaves indicated that the Company did not know with any certainty the actual date or level of payout to be given to employees. The Staff's position recognized the possibility that no awards will occur as happened with the Company's 2002 plan. The Staff recommended that no incentive compensation payments based on financial results of the corporate entity were to be charged to Missouri customers. This approach to the area of incentive compensation is long standing and reflects previous Commission decisions.

Company witness Jon Empson also addressed the issue of incentive compensation in his surrebuttal testimony. He provided information to clarify that the incentive plan expenses included by the Company in this rate case are for the annual incentive plan for employees and do not include any incentive payment for senior executives. The Long Term Incentive Plan (LTIP) was developed solely for key executives. This LTIP was suspended through December 31, 2003.

Company witness Empson also stated that the Staff had proposed recovery of all incentive payments made for team/personal goals of improving work performance in the past. He confirmed that Aquila would be making payments for achievement of the 2003 incentives in March 2004.

The case was settled through a Stipulation and Agreement which did not specifically address the issue of incentive compensation.

Case No. ER-2005-0436

Staff witness Lesley Preston submitted direct testimony addressing the issue of incentive compensation. She stated from a historical standpoint that the Staff had recommended that ratepayers pay for progress made towards accomplishing goals of improving safety, reliability and customer service, and that the costs associated with goals intended to improve the Company's earnings/rate of return be assigned to shareholders. The Company had two distinct incentive plans associated with salaries.

The Variable Compensation Plan (VCP) was designed to, "reward the accomplishment of operation business objectives and to motivate participants to accomplish significant business group and individual goals." Incentive payments are made based upon the achievement of established goals for the components of reliability, safety, customer service and effective use of capital. The Company requested $1,328,448 for the MPS-Electric division and $424,336 for the L&P Electric division. These payouts were to be made in March 2005 and were under the Variable Compensation Plan, which replaced the prior Annual Incentive Plan. The Staff did not recommend any disallowance of payments made under the VCP in this case because the goals were not directly related to the Company achieving a specific rate of return or financial earnings benchmark. Future recommendations made to support inclusion in rates for the VCP will be made on a case-by-case basis based on the information at the time.

The other plan is the Long Term Incentive Plan (LTIP) which was the plan developed for executive management. The Company did not seek recovery of LTIP plan in rates at this time. A nonunanimous Stipulation and Agreement was reached in this case.

Case No. ER-2007-0004

Company witness Jon Empson states in his direct testimony that executive management has chosen not to participate in either the annual or long-term incentive plans. On page 22 of his direct testimony, Mr. Empson relates the downsizing of the executive board from nine members in 2004 to five members today to reflect the smaller size of the Company. While some retention bonuses were paid to executives, these were not included in this case and were not intended to be recovered through rates. The Company is presently not paying annual or long-term incentives to the executive management.

As described in the direct testimony of Company witness Klote, the Company maintains a two-factor compensation system, which consists of a fixed and a variable portion. The fixed portion consists of base salaries and wages. The variable portion is an incentive pay component that is computed based on organization and personal objectives that have been set. The fixed and variable components are added together to obtain a salary level.

Employees are placed in one of five bands (from A-D and Executive) that represent increasing levels of responsibility. An employee can earn from 0 to 150% of the target percentage based on the achievement of corporate operational and financial goals. The present incentive pay plan is tied to the following objectives:

1) Customer service
2) Reliability
3) Effective use of capital
4) Safety
5) Reduce ongoing cost of service

Incentive pay plan rewards will be computed against the achievement of goals in these areas. The Company requested $2,206,553 in annualized incentive pay for the MPS-Electric division and $745,149 for the L&P-Electric division in this case. The Staff has not filed testimony in the case yet.

Impacts on Missouri Consumers

The Company has stated that since the year 2003, it has designed its variable compensation plans to reflect operational service metrics such as reliability, customer satisfaction, safety, and effective use of capitol. The Company believes that all of its variable compensation plans are designed to be cost effective motivational tools.

The Staff has consistently attempted to apply criteria to the evaluation of incentive compensation awards used by regulated utility companies. The guidelines were developed in order to distinguish between incentives that are beneficial to customers and affect the level and quality of service they are receiving. These goals include safety and reliability of service. The Staff has maintained and applied the concept that goals and their attendant rewards that focus on the improvement of financial ratios such as the rate of return accrue primarily to the shareholder, not the customer. The Staff has usually recommended that these types of awards be excluded from rate recovery. This has served to protect Aquila's customers from paying for what the Staff believes are inappropriate goals.

In some of the cases cited earlier, the Staff, Company and other parties reached a Stipulation and Agreement after a careful analysis of costs. While a specific adjustment was not made regarding incentive compensation, the Staff believed that the revenue requirement reached was in the interest of the Missouri customer.

The chapters on Executive Compensation and Employee Bonuses will address programs targeted to provide additional recognition to employees and executive management.

Findings and Recommendations

Aquila employees have a wide variety of methods in which to earn additional compensation and rewards. These include commissions, bonuses and discretionary awards. As these types of incentive programs become a greater portion of an employee's salary, the Company should determine the relationship between their incentive compensation programs and its ability to motivate its staff. As the Company continues to seek ways to provide motivation to it employees under periods of financial stress, there needs to be a clear connection between rewards and results. The Staff believes that it has communicated to the Company through past testimony and cost of service adjustments, the guidelines it uses to recommend rate recovery of incentive compensation. The Company may, of course, implement any programs it wishes while being aware of the Staff's guidelines for inclusion in rates. However, even without inclusion in rates, the Company has a responsibility to use incentive compensation in a responsible manner that provides effective results.

The EMSD Staff Recommends that Company Management:

> *Review present incentive compensation programs to determine that they are serving as a cost-effective motivation to employees.*

This review should include the types of programs available, the level of awards being paid to employees, and an indication of what the total potential maximum incentive programs actually cost the Company.

CHAPTER 4 EXECUTIVE COMPENSATION

Historical Summary

The Commission's Order in Case No. EO-2006-0356 directed the Staff to examine, among other things, the impacts on Missouri consumers of Aquila's past decisions regarding executive compensation. The term executive compensation can encompass many different elements from base salary to the inclusion of incentive compensation, stock options, supplemental benefits and perquisites. Executive compensation is most normally viewed as a package. One of the factors that often distinguishes executive compensation from other forms of employee compensation at a company is the level and variety of additional benefits, incentive and bonus programs available to the executive.

The cornerstone of any executive's compensation package is the element of base salary, however, many of the other forms of remuneration, such as pension benefits, may be developed as a percent of base salary. Utility companies also utilize these types of add on features to attract and retain individuals in key leadership positions.

Due to the complexity of these salary packages, it is sometimes difficult to determine a true cost and worth as well as potential future costs and worth associated with top executives at companies. Even some Boards of Directors at these companies have difficulty determining the total value of their executive compensation packages. Corporations appear to be leaning more toward pay-for-performance types of programs with a smaller percentage of the total package put into base salary. There is a call for these performance indicators to become more challenging, requiring that executives do more than just fog the mirror to earn additional rewards, whether they be stock options or cash. Perks such as country club memberships are being viewed in a new light as boards recognize that the executive earns enough money to pay these fees themselves. Questions are being asked by boards such as "Are such perks truly job related?" An additional issue involves exit payments for executives which can be astronomical and not fully considered within the salary package at the time they are negotiating to obtain a talented executive.

Retention Concerns

The Board of Directors of Aquila reviewed various options available for restructuring the Company after the decline of the Merchant business in Year 2002. Mr. Rick Green was reappointed as CEO and other senior managers were selected. The past methods employed by the Company had resulted in significant payouts to executives and employees during high profit years. It was determined that bonuses and awards of any type were to be cancelled during this time. The executives' base salary rates were maintained in an attempt to retain these individuals.

There was a concern in 2003 that the Company was facing a significant risk of losing employees and executives due to Company uncertainty and what it perceived as below market pay. Discounted incentive programs were reinstated for employees and a long term incentive plan was added back for lower level executives. The Long Term Incentive Plan for top executives was not restored.

In 2004, Aquila became concerned with the level of Company pay relative to the market. The Compensation Committee of the Board of Directors (Compensation Committee) approached its outside consultant Hewitt Associates (Hewitt) for a recommendation to adjust its compensation to realign itself closer to the market while also recognizing the current conditions of the business. Hewitt made several recommendations to the Company that were all declined for public relations and cost concerns. After several high-level management individuals left the Company in 2005, the Compensation Committee again became concerned about retaining its key leaders and insisted that at least a portion of Hewitt recommendations for addressing the competitive pay gap be adopted. The Performance/Retention Awards were adopted in response to this and became a bonus plan focused on anticipated asset sales. These were determined to be an incentive type of award but were classified by the Company as a bonus tied to the successful completion of the asset sales. This award will be discussed in more detail in the section on bonuses.

Aquila has stated that its current pay practices for senior executives do not really reflect its compensation philosophy. The Company's present financial position has caused it to discontinue the long-term incentive plans it had utilized in the past. It was stated that this has not allowed the Company to provide competitive pay to employees nor tie executive pay to important Company objectives.

The Company has stated that it realizes that it cannot expect to compete with large international companies for top talent now. Going forward, the Company has stated a simple objective of being able to communicate that Aquila pays fairly compared to similar jobs, in companies of similar size and scope, in the industry.

History of Aquila Executive Compensation

The Staff was unable to find an Aquila case in the last 15 years in which the topic of executive compensation was an issue on which testimony was submitted. While it appears that the Company has consistently received rate recovery of the executive salaries in its filings, the Staff has also consistently performed a thorough review of the methods used to allocate these salaries to assure that Missouri ratepayers were not charged excessive amounts of total salaries and other expenses.

** The following table illustrates the amount of executive compensation requested by the Company within rate cases for its MPS and L&P Divisions in the last five years. **

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In addition, the issue of incentive compensation (which previously was a part of the total executive compensation package) is reviewed by Staff within cases and is subject to the same criteria and guidelines that such programs for other Company employees have to meet. Executives have not participated in the incentive compensation program that was originally designed for them since 2002 due to the financial condition of the Company. However, Staff does not believe this means that executives have not been rewarded via other methods for what the Company may have considered good performance.

While Staff has not specifically recommended an adjustment to executive salary levels at Aquila, there were a few instances at other companies wherein Staff proposed adjustments.

Case History

In Case Nos. EC-87-114 and EC-87-115, the Staff complaint case against Union Electric Company, the Staff proposed an adjustment to management salaries. Staff recommended that management salary increases be limited to the same percentage as increases that were granted to union employees. The Commission's Report and Order noted that the Company's salary increases were based upon a study performed by an outside consultant and found these increases to be supported. The Commission determined that the Staff's adjustment to management salaries should be rejected.

Senior management base salaries were also reviewed in the Southwestern Bell Telephone Company (SWB) Case No. TC-89-14. In this case, the Staff proposed an adjustment to management salaries in the amount of $9,553,000. This amount was based upon the contention that SWB's goal of compensating employees at a 75th percentile level was unnecessary and unjustified. The Commission's opinion was that the Staff did not provide evidence on compensation that the levels were unreasonable and rejected the Staff's adjustment.

Present Philosophy of Aquila Regarding Executive Compensation

Aquila defines the primary components of executive compensation as base pay, annual incentive, long-term incentives and benefits. The Compensation Committee has overall responsibility for a wide range of practices with respect to the pay practices in effect at the Company and a number of important functions with respect to executive compensation. The Compensation Committee's responsibilities include the review and approval of corporate goals relevant to CEO compensation, evaluation of CEO performance and the final approval of this compensation based on this evaluation. The Compensation Committee produces a Compensation Committee report on executive compensation, as required by the SEC, for inclusion in the Company's proxy statement filed with the SEC. In addition, the Compensation Committee has the sole authority to retain and terminate any compensation consultant to assist in the evaluation of director, CEO or senior management compensation, including sole authority to approve such consultant's fees. The Compensation Committee has utilized an outside consultant, Hewitt Associates, since the Year 2001 for an annual review of pay practices.

The guiding principles the Company has developed for compensation require the Company to provide compensation that approximates the 50th percentile of the market of domestic regulated utilities selected as similar to Aquila. Practices for benefits and compensation are to be sufficient to attract and retain the talent necessary to support and execute Company strategies.

Recovery in Rates

A portion of the base pay of Aquila executives is recovered in rates paid by Missouri customers through the allocation process. The Company has not sought recovery of expenses associated with senior executive variable compensation, long term incentives and additional awards like the retention bonuses in the last three Missouri rate cases. These cases were Case Nos. ER-2001-672, ER-2004-0034, and ER-2005-0436. The Company stated that restrictions on recovery in rates have been a factor in the Company's decision to not provide these additional awards to executives.

Impacts On Missouri Consumers

In a review of Aquila's past rate cases, we have noted that the Staff did not challenge the overall level of executive compensation. The Staff has proposed rate recovery of base salary only and opposed rate recovery of bonus payments and other compensation that was related primarily to Aquila's nonregulated operations. In the past, the Staff did not determine that the overall executive payroll costs allocated to Aquila's MPS division of approximately 20 to 30% was unreasonable. The Staff did, however, reduce the amount of executive payroll charged to Missouri through its corporate allocation adjustments. The adjustments were made to ensure that Aquila corporate overhead costs, including executive salaries, were appropriately allocated to all of Aquila's business operations and that Aquila's Missouri operations did not receive an unfair share of these costs.

<u>**Findings and Recommendations**</u>

Executive compensation has become an extremely complex area making it increasingly difficult to determine the actual amount of total compensation being paid. This is complicated more by the wide use of additional forms of compensation beyond that of base salary.

The Commission Staff has historically applied specific criteria to determining whether to support an adjustment to incentive compensation program areas that are utilized in any level of the Company. These areas are addressed in the chapter on incentive compensation. However, the Staff has not been successful in the past on presenting a supportable case on the issue of reducing executive salaries. Most large companies utilize an outside professional specialist to develop a peer group for comparative purposes in which to determine their selected market level. While the Staff has made significant adjustments to the overall level of corporate overhead costs, including executive salaries, it has not made any specific adjustments to reduce individual executive compensation costs.

The Securities and Exchange Commission (SEC) is expected to require greater disclosure from companies about executive compensation starting next year. The final requirements for these reporting items are expected to be announced soon. Such disclosure would force businesses to provide a total compensation figure for top executives along with extensive details about their perks, projected retirement payments, severance and deferred compensation. A recent <u>Wall Street Journal</u> article (April 10, 2006) focused on a tool that some companies have begun to utilize to enhance transparency for their investors as to what they are actually paying for this top executive talent. These are called "tally sheets" and are used to project payouts under different scenarios. They enhance a full disclosure of possible pay and disclose the costs associated with a number of compensation practices. In anticipation of these changes, Aquila has begun to look at the changes in reporting requirements and realizes that it will need to calculate and report a significantly greater amount of information than was used in the past.

In light of increasing concerns over executive compensation and the availability of accurate complete information on it,

THE EMSD STAFF RECOMMENDS THAT COMPANY MANAGEMENT:

> *Review and utilize methodologies to fully determine, define and document the total amount of executive compensation.*

In addition, the Company has taken actions to reduce the size of its utility properties. In consideration of this, the Company should also:

> *Re-examine the Company's staffing levels, staff responsibilities and attendant executive compensation levels to ensure such compensation is commensurate with executive responsibilities.*

Should the examination of executive compensation levels conclude that those levels are inappropriate, the company should:

> *Adjust executive compensation levels based upon the results of the examination.*

This information should be shared with the Compensation Committee to assist it in making decisions, as well as the various state and federal regulatory agencies, including the Missouri Commission.

CHAPTER 5 PENSION AND OTHER POST-EMPLOYEE BENEFITS FUNDING CONTROLS

Historical Summary

The primary purpose of a pension plan is to provide income to employees at retirement. Pension plans also include a Supplemental Executive Retirement Plan (SERP). A SERP guarantees additional retirement payments to top executives. Other Post-Employee Benefits (OPEBs) plans generally provide health, dental and life insurance benefits to retirees. SERPs and OPEBs will be further defined and discussed in separate subsections within this Pension section.

Pension plans and OPEBs funding are governed by federal and state law. The Employee Retirement Income Security Act (ERISA), signed into law on September 2, 1974, is a "comprehensive 'reform' measure that imposes reporting and disclosure requirements and fiduciary standards on all types of employee benefit plans." (AMA Management Handbook, Second Edition, pp. 12-19). ERISA also grants legal rights to plan participants and their beneficiaries and establishes minimum standards for retirement plans, as well as termination insurance for pension plans.

ERISA requires reporting to government agencies. Companies must file Summary Plan Descriptions (SPD) with the United States Department of Labor, file an annual report with the Internal Revenue Service (IRS), and file certain forms with the Pension Benefit Guaranty Corporation for defined benefit pension plans. According to Aquila management, the Pension Benefit Guaranty Corporation insures pension plans.

ERISA requires that certain information must be included in a SPD. The SPD must be written so that an average plan participant can understand it and be accurate and comprehensive enough to explain to participants and beneficiaries their rights and obligations under the plan (AMA Management Handbook, Second Edition, pp. 12-19).

Staff witness Steve Traxler explains another aspect of ERISA at page 5 in his Direct Testimony in Case No. ER-2004-0034: "The Employee Retirement Income Security Act of 1974 (ERISA) is a Federal statute enacted to ensure that Defined Benefit Pension Plans in the United States are adequately funded." All companies with defined benefit pension plans are required under ERISA regulations to make contributions when necessary to adequately fund their pension plans (Case No. ER-93-37, Traxler Direct, p. 30). Future contributions to the pension plan are dependent upon investment performance of the pension assets and increases and decreases in the discount rate used to value liabilities. When pension plan assets exceed liabilities, Aquila does not need to make its contribution to the plan.

Mr. Traxler's Direct Testimony in Case No. ER-93-37, pp. 24-26, explains pension funding requirements:

> Q. Please explain the minimum contribution requirement under ERISA regulations.
>
> A. Funding requirements for defined benefit pension plans have been established by the federal government under the ERISA and subsequent revisions. The Internal Revenue Service (IRS) has responsibility for monitoring compliance with these federal regulations.
>
> In accordance with ERISA and IRS regulations, the actuary is required to compute a minimum and a maximum allowable contribution for a company. The minimum contribution requirement is designed to insure that an employer's contributions are sufficient to meet its obligations as defined by the pension plan.
>
> The maximum contribution determination is intended to insure that employers are not allowed a tax deduction for excessive contributions to a defined benefit plan.

Hewitt and Associates (Hewitt) serves as Aquila's current actuary. Hewitt reviews the performance of Aquila's pension plan and reports quarterly to Aquila's management committee and at least annually to the Compensation Committee of the Board. Hewitt submits an annual Actuarial Report to Aquila. As noted in the testimony mentioned above, the actuary must compute minimum and maximum contributions to the pension plan in order for the Company to meet its funding obligation. According to Company management, the Actuarial Report contains funding levels for various purposes: the IRS, financial accounting, the Pension Benefit Guarantee Corporation, and the full funding or plan termination limit. Aquila stated that the Pension Benefit Guarantee Corporation is the most stringent, as they use the lowest discount rate to value the plan's assets.

The IRS and the United States Department of Labor are charged with monitoring company pension plans. Companies are required by the IRS to have an annual financial audit.

KPMG performs this annual audit for Aquila. The annual audit report is attached to IRS Form 5500, completed internally by Aquila, and sent to the IRS in October of each year. Aquila management explained that Form 5500 is similar to an annual income tax, except that it is for benefit plans and, in addition to the pension plan, includes Aquila's 401(k) administered by J. P. Morgan, medical, life insurance and long-term disability plans. The completed Form 5500 is also placed on the Internet where it can be examined by the United States Department of Labor. Pension and benefit plans are also examined by Staff auditors during the course of rate case proceedings before the Commission. In addition, Aquila sends a Summary Annual Report (the SPD mentioned earlier) to pension plan participants, showing the financial viability of the plan.

Pension issues over the years have been related to the level of annual pension cost allowed in rates. Financial Accounting Standard 87 (FAS 87) is used by the accounting profession to account for pension cost for financial reporting. Pension cost, the amount listed on the financial statement as the cost of the pension plan, is determined by Aquila's actuary, Hewitt, in accordance with FAS 87. Issues in the pension area have included the method of calculating pension expense and whether FAS 87 or the ERISA minimum contribution should be used for ratemaking purposes.

Aquila makes a contribution to the pension plan when funding is required. Aquila's contribution to its pension fund is mentioned in a September 23, 2005, Statement of Unanimous Consent to Action Taken in Lieu of a Meeting of the Compensation and Benefits Committee of the Board of Directors of Aquila. In the Pension Plan Contribution section, a statement noted, "Mr. Morton advised the Committee that on September 30, 2005 Aquila contributed $8.0 million to the Company's pension trust to ensure pension plan assets exceeded the accumulated benefit obligation."

According to Staff auditors, Aquila has made the cash contributions to adequately fund its pension plan, as required under ERISA regulations. There appears to be no current problem with Aquila funding its pension plan. An OPEBs funding deficiency was discovered and solved during Case No. ER-2005-0436, and that will be discussed under OPEBs.

Although there appears to be no problem with Aquila funding its pension plan, some controversy has arisen over the years regarding the method of calculating pension expense for ratemaking purposes and whether Aquila's pension plan has been overfunded. Calculations of pension expense over the years have included the ERISA minimum cash contribution and

FAS 87, the accrual method. After 1994, Staff has consistently recommended use of FAS 87, an accrual accounting method for calculating pension costs, similar to the accrual method used in FAS 106 for calculating OPEBs. Following is case history regarding calculation of the pension expense and instances where Staff alleged Aquila's (also referred to as MoPub, MPS, and L&P) pension plan was overfunded.

Case No. ER-90-101

Company Witness Judith Samayoa recommended the contribution method of funding for the pension plan, while Staff witness Traxler recommended that the pension expense be calculated under FAS 87. Staff witness Traxler's Rebuttal Testimony at pages 3-4 discusses a funding policy:

> Q. From a ratemaking standpoint, why is it inappropriate to determine pension costs based upon a policy which sets contribution levels significantly above the minimum requirements under ERISA?
>
> A. ERISA requirements are intended to ensure that pension funds are adequate to meet the pension plan obligations. In the Staff's opinion a funding policy which sets contributions above ERISA minimum requirements is unnecessary and would result in overrecovery of pension costs if this policy were used for ratemaking purposes.
>
> . . . .
>
> Q. Please explain your previous assertion that the contribution method fails to recognize a situation where the returns earned on the pension fund assets exceed current pension costs.
>
> A. Under ERISA requirements, the minimum contribution cannot result in an amount which is less than zero. Therefore, when the returns earned on pension fund assets exceed the current costs the excess return could not be reflected for ratemaking purposes as a negative expense if a contribution method were used. From a ratemaking standpoint this result is not appropriate. The contribution approach would reflect any losses incurred resulting from investment performance or assumption changes, but would not reflect a situation in which pension fund gains exceed additional increases in pension costs. The ratepayer would be responsible for providing all pension cost increases and losses on investment, but would not receive the benefit of pension fund gains which exceed pension cost increases.

> Q. How does pension fund expense determination under Statement of Financial Accounting Standards No. 87 (FAS 87) treat pension fund gains which exceed additional pension costs?
>
> A. FAS 87 provides consistent treatment for gains and losses resulting from the difference between actual and expected results. Under FAS 87 both gains and losses are amortized and included in the pension cost calculation. The Staff is recommending that gains and losses be amortized over a five year period.

Staff witness Traxler stated at pages 20-21 in his Direct Testimony in Case No. ER-90-101 that MoPub's pension fund was overfunded. He claimed that as of December 31, 1989, MoPub's pension fund assets exceeded its current accumulated pension benefit liability by 79.7%. Traxler stated that according to the answer provided by MoPub in response to his Data Request No. 502, MoPub employees had no legal right to the pension fund assets that exceeded the accumulated benefit obligation. Traxler mentions problems that could occur with overfunding of the pension plan:

> . . . The excess funds in the pension fund belong to MoPub and could be used by MoPub if the plan were terminated. . . .
>
> Q. From a ratemaking standpoint, what is the problem with a pension fund which is overfunded?
>
> A. Pension costs are included in the cost of service and recovered through rates. An overfunded pension fund results when pension expense has been overstated. An overstatement of any expense overstates revenue requirement. (ER-90-101, Traxler Direct, pp. 20-21).

The Commission's Report and Order in Case No. ER-90-101 noted that the pension issue had been settled, but was silent as to how the issue had been settled. Staff Witness Charles Hyneman's Surrebuttal Testimony in Case No. ER-97-394, p. 16, referenced the earlier settlement:

> In the electric rate case prior to 1993, No. ER-90-101, the Company and Staff agreed that rates should reflect the recovery of pension expense based on the ERISA contribution method. Prior to Case No. ER-90-101, the Company's last litigated rate change predated the adoption of FAS 87. It is clear that MPS' electric rates have never reflected a FAS 87 negative

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Attachment 1-49

pension expense; therefore, its ratepayers have never benefited from a negative pension expense.

Case No. ER-93-37

Staff witness Traxler, at pages 25-26 in his Direct Testimony, discusses calculation of pension expense and states that MPS' pension plan is adequately funded.

> Q. Why is it appropriate to determine pension expense for ratemaking purposes based upon the ERISA minimum contribution?
>
> A. The ERISA was enacted to insure that employers (sic) pension obligations be adequately funded. By basing pension expense for ratemaking purposes on the ERISA minimum contribution, the Commission will be providing the utility with an adequate pension cost amount based upon safeguards included in the ERISA regulations.
>
> Q. Are the minimum required contributions under ERISA and the maximum IRS tax deductible calculated by MPS' actuary?
>
> A. Yes, both contribution amounts are calculated by MPS' actuary, William Mercer, Inc.
>
> . . . .
>
> Q. Your last answer reflects that MPS has not been required to make a pension plan contribution under ERISA regulations for the last 5 years. Does this give some indication of the funded status of MPS' pension plans?
>
> A. It certainly does. The fact that MPS has not been required to make a pension plan contribution under ERISA regulations is a clear indication that MPS' pension fund is adequately funded.

The Stipulation and Agreement in Case No. ER-93-37 says in part: "Signatories agree that Company's accounts shall reflect pension costs equal to contributions made to its established pension funds, discontinuing its previous practice under FAS 87 effective June 29, 1993." (Company Witness H. Davis Rooney, Surrebuttal Testimony, p. 2).

Case No. ER-97-394

Staff witness Charles R. Hyneman described the accrual method (FAS 87) for calculating pension expense:

> Under FAS 87, pension plans are accounted for on the accrual basis by charging net pension expense against income on the income statement. Any difference between FAS 87 pension expense recognized on the income statement and the ERISA amount funded to the pension plan is recorded as an accrued liability or prepaid asset. A liability is recognized if contributions are less than the expense. If contributions exceed pension expense, an asset (prepaid pension cost) is recognized. . . . (Case No. ER-97-394, Hyneman Surrebuttal, p. 14).

Staff witness Hyneman summarized the Staff's position on pension expense:

> The Company lacks consistency in its proposal not to recognize FAS 87 expense for pensions while recognizing FAS 106 expense for OPEBs. MPS' emphasis is on current cash flow and not on a consistent application of existing expense recognition standards. Since the law requiring the Commission to recognize FAS 106 expense in 1994, the Staff has consistently recommended the adoption of both FAS 87 and FAS 106 for ratemaking purposes. All major Missouri utility companies who sought the adoption of FAS 106 also sought the adoption of FAS 87 for ratemaking purposes. And, the Commission has consistently ordered the adoption of FAS 87 in conjunction with FAS 106 in rate proceedings. (Case No. ER-97-394, Hyneman Surrebuttal, pp. 16-17).

The Commission adopted FAS 87 for determining pension cost for MPS in its Report and Order effective March 18, 1998 (Report and Order, pp. 32-33). In this case, the Commission adopted the Staff's suggested five-year amortization period and stated that it found it preferable to recognize gains or losses in pension expense in current rates as closely as possible.

<u>Case No. ER-2001-672</u>

In Case No. ER-2001-672, Staff witness Janis Fischer discusses FAS 87 in her Direct Testimony at page 6:

> The FAS 87, <u>Employers' Accounting for Pensions</u> provides the accrual accounting method used in determining the annual expense and liability for providing pensions. This statement was also issued by the FASB and is considered GAAP for financial reporting purposes.

According to Staff witness Fischer in her Direct Testimony in Case No. ER-2001-672, the Commission is not required under generally accepted accounting principles (GAAP) or Missouri law to adopt FAS 87 for determining pension expense for ratemaking purposes, but using FAS 87 is similar to using the required FAS 106:

> However, since State law beginning in 1994 has required the adoption of FAS 106, the Staff has taken the position that consistent treatment of retirement costs requires the use of FAS 87 for determining pension expense for ratemaking purposes.

The Stipulation and Agreement filed in Case No. ER-2001-672 on February 5, 2002, and approved by the Commission on February 21, 2002, is silent as to the issue of accounting for pensions. Aquila had initially requested an overall increase in rates of $49,352,769 in this case. While preparing for trial in Case No. ER-2001-672, Staff filed a Complaint (Case No. EC-2002-265) alleging excess earnings by Aquila of $20 million annually. The two cases were consolidated. All parties agreed to a rate reduction of $4,250,000, exclusive of gross receipts and occupation taxes, to settle this case. Of the $4,250,000 decrease, it is not known if there was a decrease in the amount allocated to pensions.

Case No. ER-2004-0034

The Unanimous Stipulation and Agreement in Cases Nos. ER-2004-0034 and HR-2004-0024, at page 9 stated:

> . . . Company is authorized to reflect pension cost equal to this provision for the ERISA minimum and record the difference between the ERISA minimum and the annual provision for pension cost as a regulatory asset or liability. This regulatory asset and/or liability is intended to track the difference between the provision for the ERISA minimum contribution included in cost of service in this case, and the Company's actual ERISA minimum contributions made after the effective date of rates established in this case. This regulatory asset and/or liability will be included in rate base in the company's next rate case and amortized over a five (5) year period. . . .

The Order Approving Stipulation and Agreement in Case No. ER-2004-0034, at page 5, sets out the amounts for annual provision of pensions to be included in rates:

> The parties agree that the amounts to be included in rates for annual provision of pensions, prior to capitalization, shall be: $1,470,509 for MPS; $8,858 for L&P electric; and $261 for L&P steam. The parties agree that Aquila will record the difference between the ERISA minimum and the annual provision for pension cost as a regulatory assets (sic) or liability to be amortized over a five-year period and included in Aquila's next rate case.

> The parties further agree that MPS rates include a \$2,110,436 annual provision for MPS electric jurisdictional prepaid pension amortization, \$2,252,742 for L&P electric and \$98,687 for L&P steam. For MPS the amortization period will be 5½ years. For L&P the amortization will be 9¼ years.

Case No. ER-2005-0436

A Nonunanimous Stipulation and Agreement was filed in Case No. ER-2005-0436 granting similar treatment to pensions as in the prior rate case, Case No. ER-2004-0034. Specifically, the Nonunanimous Stipulation and Agreement stated at page 6:

> MPS rates include a \$1,492,540 annual provision, prior to capitalization, for MPS electric jurisdictional pension cost. L&P rates include a \$15,651 annual provision, prior to capitalization, for L&P electric pension cost. Company is authorized to reflect pension cost equal to this provision for the ERISA minimum and record the difference between the ERISA minimum and the annual provision for pension cost as a regulatory asset or liability. This regulatory asset and/or liability is intended to track the difference between the provision for the ERISA minimum contribution included in cost of service in this case, and the Company's actual ERISA minimum contributions made after the effective date of rates established in this case. This regulatory asset and/or liability will be included in rate base in the Company's next rate case and amortized over a five (5) year period. The Company is authorized to make such additional entries as are appropriate under FAS71 to reflect that rates do not include FAS87 in cost of service. Company is authorized to adjust its calculation of the MPS and L&P ERISA minimum. MPS rates include a \$2,110,436 annual provision, prior to capitalization, for an MPS electric jurisdictional prepaid pension amortization. This amortization will be in effect for a five and one-half (5½) year period beginning with the effective date of rates established in Case No. ER-2004-0034. L&P rates include a \$3,352,742 annual provision, prior to capitalization, for L&P electric prepaid pension amortization. This amortization will be in effect for a nine and one-quarter (9.25) year period beginning with the effective date of rates established in Case No. ER-2004-0034.
>
> MPS rates reflect a rate base offset for a (sic) electric jurisdictional regulatory liability of \$1,752,357. L&P rates reflect a rate base offset for a regulatory liability of \$10,556. Rates reflect a 5-year amortization of the regulatory liabilities, identified in this paragraph, prior to capitalization. This amortization will begin with the effective date of rates established in this case.

The Order Approving Stipulation and Agreement noted that "not all parties signed the stipulation and agreement. However, Commission Rule 4 CSR 240-2.115(2) provides that if no party objects to a nonunanimous stipulation and agreement within seven days of its filing, the Commission may treat that stipulation and agreement as unanimous." No party objected, so the stipulation was treated as unanimous.

Case No. ER-2007-0004

Company witness Ivan Vancas discussed Aquila's aging workforce at page 11 in his Direct Testimony, mentioning that the compensation team is working to ensure that Aquila's wages and benefits are competitive. Pensions were not specifically mentioned.

Supplemental Executive Retirement Plan (SERP)

SERPs serve as a type of restoration plan to restore incremental pension benefits to highly-compensated employees disallowed by tax law. Aquila's SERP can be found on Aquila's website at Aquila.com as an attachment to the Securities and Exchange Commission (SEC) Form 10-Q filed June 30, 2001. Results from a 2003 Hewitt survey showed that 80% of Standard and Poor's 500 companies have implemented supplemental retirement programs (Case No. ER-2007-0004, Beyer Direct, p. 2).

According to Company witness Philip M. Beyer in his Direct Testimony in Case No. ER-2007-0004, Aquila's SERP was implemented in 1986, amended in 1996 and restated in 2001. The IRS rules [Code Sec. 415(b)(1)(a) and 401(a)(17)] limit the amount of compensation that can be used in benefit formulas of 401(k) profit sharing and pension plans. Beyer states that limit is $220,000 in 2006. He gave the example that if an executive earns $250,000 in 2006, only $220,000 may be included in Aquila's qualified retirement plan formulas. The $30,000 difference between the $250,000 salary and the $220,000 IRS limit would be considered as "base SERP." Aquila's SERP contains three components, a base SERP, a bonus SERP, and a Supplemental SERP. In the latest rate case, Case No. ER-2007-0004, Aquila is requesting only the base SERP be included in rates.

Case No. ER-2001-672

According to Staff witness Fischer in her Surrebuttal Testimony in Case No. ER-2001-672, at pages 12-13, Staff's position on SERPs is as follows:

> The objectives of a SERP in the Staff's view are related to the protection of shareholders interests and, therefore, the costs of the SERP should be borne by the shareholders of UCU. SERPs are compensation packages that guarantee additional retirement payments to top executives and key employees above and beyond those provided to the majority of UCU employees. The Staff's position is that no recovery of these costs from ratepayers is warranted. These are costs that benefit only a very few employees. Of course, UCU has the right to compensate its executives however it sees fit, but the Staff's contention is that the shareholders should pay for these potentially excessive costs, not the ratepayers.

Case No. ER-2004-0034

Staff witness Hyneman discusses the purpose of Aquila's SERP in his Surrebuttal Testimony in Case No. ER-2004-0034, at page 2:

> Aquila's SERP was originally designed as a "restoration plan" to restore incremental pension benefits to highly-compensated employees disallowed by tax law, but has evolved into an additional compensation plan as well as an executive protection plan reserved only for selected highly-compensated employees.

Staff witness Hyneman claims that the Change in Control Provisions of Aquila's SERP are "golden parachutes designed to prevent a takeover of Aquila and serve as nothing more than an executive protection mechanism if a change in control of Aquila occurs." Hyneman believes these costs should not be borne by Aquila's ratepayers. In Hyneman's Direct Testimony, Case No. ER-2004-0034, at pages 25-26, he explains Staff's opposition to cost of service recovery for MPS's share of Aquila's SERP:

> A. . . . First, Aquila's SERP includes a "Change in Control" provision. This provision requires a funding of the plan in the event of a change in ownership as defined in the "Change in Control" provision of the plan. This provision acts as a deterrence for another company to acquire Aquila and thus acts as employment security protection for Aquila's top executives and highly compensated employees. These employees are the employees who are at a high risk of not being retained by a company that successfully merges with or acquires Aquila. While this protection may be beneficial to Aquila's executives and highly compensated employees, it is not a cost that could reasonably be considered necessary to operate a utility company.
>
> Second, Aquila's SERP was significantly modified on January 1, 2001 to add additional SERP benefits. The modifications increase the benefits to SERP participants by adding a Bonus SERP Benefit (designed to provide executives an additional retirement benefit based on the executives'

> annual bonus pay) as well as a Supplemental SERP Benefit (designed to provide executives an additional market-based retirement benefit). Given Aquila's current financial difficulties, the Staff does not believe it is an appropriate time to reward Aquila's top executives by providing them with additional retirement benefits. While it is up to Aquila's Board of Directors whether or not to rescind this increase in retirement benefits for Aquila's senior executives, it is up to this Commission whether or not to allow the costs of Aquila's SERP in rates. The Staff recommends that the Commission not include the costs of Aquila's SERP in rates in this case.
>
> Third, the individuals in Aquila's SERP are or have been participants in all of Aquila's other benefit plans, including Aquila's regular pension plan and 401(k) plan. In the Staff's view, these plans provide sufficient retirement benefits for all of Aquila's employees and the addition of another retirement plan is excessive.
>
> Finally, Aquila's SERP has in the past been accounted for on a cash, or pay-as-you-go basis. Aquila recently decided to change to an accrual method of accounting for the SERP, which significantly increased the current costs of the plan. In the Staff's view, the accounting for the SERP on a cash basis, which Aquila did for many years, was appropriate. Aquila was not required by any accounting regulatory body to change the method of accounting for the SERP, but it decided to do so on its own.

Hyneman's recommendations regarding future allowances for recovery of Aquila SERP costs are:

> (1) accounted for on a pay-as-you-go basis,
> (2) the costs are reasonable considering Aquila's SERP expenses in previous years,
> (3) the terms and conditions of the SERP allow for the calculation of the SERP benefit only at the amount that is limited by tax law compensation limits, and
> (4) the SERP does not include Change in Control provisions which act in the manner of a "poison pill" or executive "golden parachutes."
> (Case No. ER-2004-0034, Hyneman Surrebuttal, p. 13).

The Unanimous Stipulation and Agreement in Case No. ER-2004-0034 did not specifically mention including or excluding Aquila's SERP in rates, but did include an annual provision for MPS electric, L&P electric, and L&P steam jurisdictional prepaid pension amortizations.

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Case No. ER-2005-0436

Staff witness Hyneman proposed to remove all of Aquila's SERP costs for similar reasons as in the prior rate case, Case No. ER-2004-0034, i.e., change in control provisions, adding Bonus and Supplemental SERPs, and that the individuals in Aquila's SERP have been participants in Aquila's other benefit plans such as the regular pension plan and the 401(k) plan, the same as all other employees (Case No. ER-2005-0436, Hyneman Direct, pp. 33-34).

Hyneman's Surrebuttal Testimony in Case No. ER-2005-0436 at page 20 sheds light on prior recovery of SERP expenses:

> . . . In past rate cases the Staff has allowed recovery of SERP expenses that were reasonable in amount, based solely to restore regular pension benefits and were actually paid to retired executives.

Case No. ER-2007-0004

Company witness Jon Empson stated in his Direct Testimony at page 3 that Aquila has not requested that bonus and incentive components used to calculate SERP be included in this filing:

> . . . 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. . . .

Company witness Beyer states in his Direct Testimony on page 5 that base SERP benefits for Aquila senior leaders and former executives should be included in rates "since the expenses are directly attributed to the restoration of benefits lost due to IRS limits on base pay." The base SERP expenses are excluded for Robert Green and former Merchants employees. This is a current case, and Staff has not yet filed testimony regarding its position.

Other Post-Employee Benefits (OPEBs)

OPEBs are defined in the Commission's Report and Order (page 6) in Case No. ER-93-37 as benefits, other than pensions, such as health care, dental care and life insurance. The Report and Order further states on page 10:

> OPEBs are legitimate and are historically approved costs of providing service, and, absent evidence that they are excessive or imprudently incurred, they will continue to be recovered by MoPub. . .

Prior to 1994, the pay-as-you-go method, which reflected the actual annual cash outlay for benefits, was used for ratemaking. According to the Report and Order on Rehearing (page 13) in Case No. ER-93-37, the Financial Accounting Standards Board in 1990 issued FAS 106, which required companies to use an accrual method of accounting for OPEBs after December 15, 1992. The Commission continued to require utilities to recognize OPEBs on a cash basis for ratemaking purposes because the benefits were paid out to former employees, rather than on an accrual basis.

House Bill 1405 (Section 386.315 RSMo) was passed by the Missouri Legislature in 1994. Section 386.315, RSMo requires the Missouri Commission to adopt FAS 106 for ratemaking purposes. It also requires the utility to fund the FAS 106 cost collected in rates. The Commission is required by Section 386.315 RSMo, to allow the recovery in rates of OPEB expense, as calculated under FAS 106:

> . . . Additionally, the commission shall not disallow or refuse to recognize the actual level of expenses the utility is required by Financial Accounting Standard 106 to record for postretirement employee benefits for all the utility's employees, including retirees, if the assumptions and estimates used by a public utility in determining the Financial Accounting Standard 106 expenses have been reviewed and approved by the commission, and such review and approval shall be based on sound actuarial principles.

<u>Case No. ER-2001-672</u>

Staff witness Fischer states in her Direct Testimony in Case No. ER-2001-672 that Section 386.315 requires the adoption of FAS 106 for setting rates for OPEBs costs:

> The Commission must adopt the FAS 106 method for ratemaking purposes as long as the assumptions used by the utility are considered reasonable, and the amounts collected in rates are externally funded by the utility. (Fischer, Direct, p. 6).

Company management stated that Aquila self-funds its medical benefits plan. The annual FAS 106 costs are determined by Aquila's actuary. This amount is recognized as an expense on the books, and Aquila must make a cash contribution to a fund set up specifically for funding the FAS 106 obligation in that same amount.

Aquila had established a Voluntary Employee Beneficiary Association (VEBA) trust as the independent external funding mechanism required by Section 386.315.2:

> A public utility which uses Financial Accounting Standard 106 shall be required to use an independent external funding mechanism that restricts disbursements only for qualified retiree benefits. In no event shall any funds remaining in such funding mechanism revert to the utility after all qualified benefits have been paid; rather, the funding mechanism shall include terms which require all funds to be used for employee or retiree benefits. . .

Case No. ER-2004-0034

Staff witness Traxler stated in his Direct Testimony in this case at page 5 that after House Bill 1405 became law, "the Staff began recommending the use of accrual accounting method for pension costs, FAS 87, in order to use a similar accrual accounting method for all post-retirement employee benefit costs." Before House Bill 1405 became law, rates were set on a "pay as you go" or "cash" basis for both pension and OPEB costs.

Case No. ER-2005-0436

Staff witness Traxler describes FAS 106 in his Direct Testimony in this case at page 5:

> FAS 106 is the Financial Accounting Standards Board (FASB) approved accrual accounting method used for financial statement recognition of annual Other Post-Retirement Employee Benefit (OPEB) costs over the service life of employees.

When examining Aquila's books and records during this rate request, it was discovered that Aquila had not funded its VEBA trust FAS 106 costs during a three-year period from 2003 through 2005. Aquila maintained that at no time did retirees ever suffer a lapse of retirement benefits. Subsequent to the finding, the OPC filed a Complaint, Case No. EC-2006-0171, alleging that Aquila violated Section 386.315 and Commission Orders in Case Nos. ER-97-394 and EM-2000-292 by failing to fund OPEB obligations in 2003, 2004, and 2005.

Aquila's decision to discontinue funding its FAS 106 obligation was addressed in the settlement in Case No. ER-2005-0436, wherein Aquila agreed to make at least one payment per year equal to the current year FAS 106 calculation (ER-2005-0436, Nonunanimous Stipulation and Agreement, p. 7). On March 24, 2006, the OPC requested dismissal of its Complaint in Case No. EC-2006-0171 after Aquila contributed $7,017,530 toward its OPEB obligations. The Complaint was dismissed and Case No. EC-2006-0171 was closed on March 28, 2006. Due to the timing of this decision, FAS 106 cost was not impacted in a prior rate case. Rates in Aquila's recent case were not impacted because FAS 106 was recomputed assuming all prior funding had been done and the funding deficiency was eliminated by deposits to the VEBA trust as a requirement for settling the issue. Aquila stipulated to fund its annual FAS 106 cost on a going forward basis. In Case No. ER-2005-0436, the Order Approving Stipulation and Agreement, page 2 states:

> The stipulation and agreement also provides that if Aquila funds its VEBA trust in the amount of $1.4 million, as it has agreed to do in the stipulation and agreement, Public Counsel will dismiss, with prejudice, its complaint against Aquila, now pending before the Commission in Case No. EC-2006-0171.

The Nonunanimous Stipulation And Agreement noted on page 7 that, "For purposes of this paragraph, 'dismissal with prejudice' means that Public Counsel will not file another complaint based upon the allegations in its complaint in Case No. EC-2006-0171 unless Aquila fails to fund the additional $1.4 million as provided herein."

<u>Case No. ER-2007-0004</u>

Company witness Ronald A. Klote explains the components of the FAS 106 OPEB expense adjustment in his Direct Testimony in this case at pages 15-17:

> A. The annual OPEB expense under the SFAS 106 calculation is provided by our actuary Hewitt. The calculation of post retirement benefit cost includes the following components:
>
> - Service cost
> - Interest cost
> - Expected return on assets
> - Prior service cost amortization
> - Transition obligation amortization
> - Gain/loss amortization
> - Regulatory adjustment
>
> These components are defined as follows: The employee service costs are defined as the estimated costs of benefits paid in the future, discounted to the present year. The interest cost is the increase in the projected benefit obligation due to the passage of time. The expected return on assets represents the increase in funds from interest, dividends, and realized and unrealized changes in the fair market value of the plan in the year. The prior service cost component results from amendments to the pension plan. The transition obligation is the under funded and unrecognized accumulated post-employment benefit obligation for all plan

participants at the date SFAS 106 is adopted. Differences between the actuarial assumptions and actual experience, the gains/losses, are amortized over five years. Regulatory adjustment includes an adjustment to the Missouri jurisdictions for the prescribed method for recognizing actuarial gains and losses.

. . . .

Q. Has Aquila met its obligation concerning OPEB contributions as defined in the Stipulation and Agreement from Case No. ER-2005-0436?

A. Yes. Per the Stipulation and Agreement from Case No. ER-2005-0436 at page 7: "Aquila agrees to make at least one payment per year equal to the current year FAS-106 calculation."

In December 2005, Aquila funded its prior year obligations amounting to $7,017,529 reflecting the catch-up of 2003 and 2004 FAS-106 contributions and $1,975,884 for 2005. Going forward, Aquila will generally fund the FAS-106 contributions at the end of the second or third quarters.

Impacts on Missouri Consumers

Missouri consumers are impacted to the extent pensions, base SERPs, and OPEBs are included in rates. The dollar amounts are calculated by an actuary and submitted in an Actuarial Report. As long as pensions and OPEBs are reasonable, the Commission is required by federal law (ERISA), and state law (Section 386.315 RSMo), to allow Aquila to recover these expenses in rates. As noted earlier, pension funds are monitored by the IRS and the U.S. Department of Labor. According to Staff auditor Traxler, Aquila has funded the pension plan in accordance with ERISA requirements. In Staff's opinion, there appear to be no concerns regarding Aquila's funding of pensions and OPEBs at this time.

Additional Findings and Conclusions

The Staff has no recommendations at this time.

CHAPTER 6 EMPLOYEE BONUS PAYMENTS

Historical Summary

Aquila, Inc. (Aquila or Company) defines "bonus" as "any pay above base pay designed to motivate or recognize past or future performance of the individual, company, or business unit." (Data Request (DR) MPSC-0010 Response). According to Aquila management, all bonus plans are established to focus employees on important Company objectives. Bonuses are generally given for one-time events or special projects and are tied to customer satisfaction, reliability, safety, effective use of capital, and reducing ongoing cost of service.

Aquila responses to Staff data requests on bonuses included information on the Variable Compensation Plan and the Long Term Incentive Plan (LTIP), as well as cash awards, options, restricted stock, discretionary award programs, and a variety of spot recognition programs. Staff discusses the Variable Compensation Plan and the LTIP in the Incentive Compensation section.

The Board of Directors Compensation and Benefits Committee (Compensation Committee) is authorized to handle all matters related to Chief Executive Officer (CEO) and non-CEO compensation that require Board attention, including conducting annual reviews of all elements of executive compensation. The Compensation Committee has the authority to retain and terminate a compensation consultant, whose function in part, is to provide relevant market compensation data to the Board. Hewitt and Associates (Hewitt) currently serves as Aquila's compensation consultant. The Compensation Committee "approves Aquila's Annual Variable Compensation Plans, the long term incentive plans and any equity awards provided" (DR MPSC-0012 Response). While all non-union employees participate in the Annual Variable Compensation Plan, there is no broad-based bonus plan for union employees – only what may be negotiated in their union contracts.

Aquila noted that during 2001 a special, one-time profit sharing bonus was provided to all employees due to the Company's record profitability, primarily due to its nonregulated trading activities. According to Aquila, in 2002 and 2004, non-executive employees participated in two all employee stock option grants, in part "to make up for the loss of bonus opportunities and lower than normal base pay increases" (DR MPSC-0010 Response).

Employees participate in spot award programs and discretionary award programs. Spot recognition programs are usually under $250 and approved by the budget owner. Spot recognition programs over the years include:

Award Name	Years Provided
Cash Awards	2003-2004
Rewards Program	2001-2006
Non-Cash Awards	2001-2006
Suggest One Awards (for great ideas)	2001-2002

(DR MPSC-0011 Response and Aquila Management Interview)

Spot award programs and discretionary bonuses are generally for one-time events and come from money that has been set aside for supervisors to award employees for specific projects. As part of the "Recognition Express" award program, beginning January 1, 2005, Aquila replaced their "Exclusively Yours" card with a "Reward Card." Reward cards enable managers to award employees in any amount between $5 and $500. Awards are charged to the budget of the department identified through the award nomination and approval process.

Larger discretionary bonuses up to $2,500 are approved by the budget owner and are intended to recognize significant contributions. Awards in excess of $2,500 require senior management approval, while discretionary bonuses for senior executives are approved by the Board of Directors. Other bonuses include long-term incentive payments made in cash, safety awards given primarily to union employees, and commission payments to a few small select groups for limited programs. Restructuring/retention awards were provided from 2002 to 2004 to some individuals brought over from Aquila Merchant to work Aquila out of its remaining merchant contracts.

Form DEF 14A, page 16, filed April 15, 2003, with the Securities and Exchange Commission, shows bonuses received by Aquila's top executives in 2000 and 2001. These bonuses are as follows:

Executive	2000	2001	2002
Richard C. Green, Jr. Chairman and CEO	$2,000,000.00	$3,000,000.00	
Keith Stamm Chief Operating Officer	$2,339,066.00	$4,310,000.00	
Leo E. Morton Chief Administrative Officer	$ 959,219.00	$ 804,750.00	
Leslie J. Parrett, Jr. Senior Vice President and General Counsel	$ 855,188.00	$ 816,250.00	$300,000.00 To retain services.
C.E. Payne, Jr. Chief Risk Officer	$ 448,665.00	$ 695,500.00	
Robert K. Green Former CEO and President	$2,000,000.00	$3,000,000.00	
Edward K. Mills Former President and COO, Aquila Merchant Services	$3,377,056.00	$4,310,000.00	
Dan J. Streek Former Chief Financial Officer	$ 444,844.00	$1,524,000.00	

According to Staff auditors assigned to Case No. ER-2001-0672, to the best of their knowledge, none of these executive bonus payments were included in rates.

Bonuses were awarded in October 2005 to Aquila's top executives for performance/ retention and focus on the successful sale of four of Aquila's utility assets (Kansas electric, and Michigan, Minnesota, and Missouri gas utilities). Aquila management stated the award was primarily for retention, but also to keep senior leadership focused on the restructuring objective.

A September 28, 2005, article in the Kansas City Star entitled, "Aquila execs would double pay" reported that top executives at Aquila stood to double their paychecks under agreements to sell four utilities in an attempt to reduce the Company's burdensome debt. Bonuses approved by the Compensation Committee were reported to total $3.338 million. Nine executives were to collect one-fourth of the money immediately and the remainder once the sales were completed. Bonuses were to equal each executive's 2005 salary. The immediate portion of the bonus was to acknowledge completion of the first step to reducing Company debt. The larger deferred portion provides "an incentive to complete each of the four announced transactions." The news article noted that executives have to remain at Aquila until the sales are completed to receive the second part of the bonus. Bonus amounts in the article were reported as follows:

Richard C. Green	$1,028,077
Keith G. Stamm	$ 467,308
Rick J. Dobson	$ 309,616
Leo R. Morton	$ 344,770

The remaining $1,200,000 is to be shared among five employees:

Jon R. Empson
Robert L. Poehling
Brock Shealy
Christopher M. Reitz
Norma F. Dunn

A Jefferson City News Tribune article published shortly after June 13, 2006, "PSC orders audit of Aquila executives pay" stated, "The company denies that customers have paid for executives' bonuses." Subsequently, a June 30, 2006, article in the Kansas City Star entitled "Aquila to seek a rate increase" reported, "The company has argued that bonus money came from what would have been shareholder profits, rather than from ratepayers."

Form DEF 14A that Aquila filed with the Securities and Exchange Commission on March 24, 2006, and viewed from Aquila's home page website noted on page 14:

> In order to recognize the accomplishments and to retain our executive officers through a critical juncture in our organization's history, our executive officers were granted a one-time, cash-based special performance/retention award in 2005. Twenty-five percent of the award was paid in cash in October 2005 upon execution of definitive agreements to sell certain of our utility assets, and the remaining 75% will be paid upon the successful closing of the utility asset sales. The award sizes were set for each executive at a multiple of one times his or her base salary. The Committee believes these awards were appropriate in order to align the interests of these executives with the achievement of our long-term business strategy, as the utility sales are critical to the long-term financial viability of the Company.

Page 15 of Form DEF 14A under the heading "Chief Executive Officer CEO Compensation" stated:

> . . . Mr. Green received $247,500, Mr. Stamm received $112,500, Mr. Dobson received $75,000, Mr. Empson received $75,000 and Mr. Morton received $83,000.19.

Bonuses were mentioned in a number of Board of Directors Compensation Committee Minutes as noted below:

The Compensation Committee of the Board of Director Minutes noted from its special meeting on August 6, 2002: ". . . 2002 bonuses based on performance units are forecasted to be $0 based on the Company's performance".

Minutes of a Meeting of the Compensation and Benefits Committee of the Board of Directors on May 3, 2005 stated:

> Mr. Morton next addressed the Company's plan to provide retention awards to employees who remained through the transition period. He noted that the retention awards (i) cover approximately 140 employees, (ii) range from 15 to 75% of base pay, (iii) amount to approximately $5 million in the aggregate, and (iv) do not include Mr. Green or his direct reports.

Minutes of a Meeting of the Compensation and Benefits Committee of the Board of Directors on August 2, 2005 discussed Hewitt's recommendations regarding bonuses:

> As the first order of business, the Chairman invited Mr. Nichols to present a proposal concerning an executive plan. Mr. Nichols began by reminding the Committee that in recent years, Hewitt has made several

recommendations for executive incentive compensation but that the Committee had declined to make any awards since 2001 due to a variety of reasons, including the Company's financial condition and the request of the Chief Executive Officer that none by (sic) made. Mr. Nichols further noted that in light of recent turnover of key executives, and given the desire to ensure that executives are appropriately aligned with the strategy of the Company, Hewitt was again recommending a performance-based compensation program. Mr. Nichols then reviewed with the Committee an executive incentive plan that consisted of (i) a restricted stock award, the vesting of which was partially time based and the balance of which vested upon the achievement of certain credit metrics, and (ii) a cash restructuring bonus payable in part on the Company's execution of agreements to sell certain utility properties and the balance of which was payable upon the closing of those transactions. The Committee then discussed the details of the plan with Hewitt, Mr. Green and Mr. Morton and proposed modifications to the plan in light of those discussions. Following the discussion, the Committee unanimously agreed to review the proposed executive compensation program with the full Board.

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Attachment 1-66

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Prior case history has touched on bonus issues. Those issues will be discussed below.

<u>Case No. ER-97-394</u>

In Case No. ER-97-394, the Staff recommended adjustments to disallow discretionary bonuses and the costs of awarding certain merchandise displaying the "EnergyOne" brand to employees, while UtiliCorp claimed the bonuses would help them to retain employees. The Commission's Report and Order issued March 6, 1998, agreed with Staff's proposed adjustment, stating on page 51:

> The Staff witness states that the employee bonuses in question are not predicated on any achievement of goals or targets and seem to be an after-the-fact reward. The witness continues that in his experience such after-the-fact rewards are not common in the utility industry. Further, the Staff witness states that he finds it difficult to believe that ratepayers benefit from the employee bonuses.
>
> The Staff continues that UtiliCorp awarded certain merchandise displaying the "EnergyOne" brand to its employees during the test year. The cost of the merchandise was included as an operating expense in certain ESFs. The Staff takes the position that all costs of promoting the EnergyOne brand name should be borne by the UtiliCorp shareholders.
>
> UtiliCorp states that both the merchandise and bonus plans are part of a UtiliCorp program to retain its employees. . . . The bonuses are intended to recognize and reward exceptional performance. In addition, UtiliCorp maintains that the program is, in effect, "self-funding" because the expense to replace experienced employees is greater than the expenditures of salary and benefits combined.
>
> The Commission finds the discretionary bonus plan to be as the Staff describes it, an after-the-fact reward plan not predicated on any achievements or goals. The Commission typically does not award costs to the ratepayers for programs of this nature without a substantial showing of direct ratepayer benefit. The Commission finds the Staff proposed adjustment to be just and reasonable.

The Commission adopted the Staff's proposed adjustment in this instance.

Case No. ER-2004-0034

In Case No. ER-2004-0034, Staff witness Charles Hyneman's Surrebuttal Testimony stated at page 32: ". . . Aquila paid $800,000 in retention bonuses to Aquila's legal staff to retain their services through its current financial restructuring." Mr. Hyneman also stated at pages 26-27 of his Surrebuttal Testimony that, "Aquila witness Beverlee Agut removed $800,000 retention bonuses for General Counsel Department from Aquila's corporate cost allocation pool." Thus, these specific bonuses were not included in rates in this case. The Unanimous Stipulation and Agreement and the Order Approving Stipulation and Agreement were both silent as to treatment of bonuses in this case.

Case No. ER-2005-0436

In Case No. ER-2005-0436, Staff witness Lesley R. Preston stated in her Direct Testimony at pages 14-15 that Aquila had not paid any executive bonuses in 2004, but did mention the bonuses for sale of utility properties in 2005:

> Q. Has Aquila paid any executive bonuses in 2004?
>
> A. No. However, Aquila announced the sale of four of its utility properties on September 21, 2005. The Compensation and Benefits Committee of the Board of Directors determined that the chief executive officer and eight other top executives will receive a cash bonus of 25% of their current salary. Upon the consummation of the sales transactions, the executives are eligible for an additional 75% cash bonus of their current salary.
>
> Q. Has the Staff reflected the announced executive bonuses in its direct filing?
>
> A. No.
>
> Q. Will the executive bonuses be reflected in the true-up?
>
> A. No.
>
> Q. Why will these bonuses not be reflected?
>
> A. These bonuses are associated with the corporate restructuring activities and should not be recovered in rates. . . .

While describing the progress Aquila has made in its restructuring activities, Staff witness Charles Hyneman noted in his direct testimony that Aquila announced on September 21, 2005, that it planned to sell four utility businesses for a total of $896.7 million, and expected it would take approximately 12 months to receive regulatory approvals for the transactions. Mr. Hyneman also addressed executive compensation during Aquila's restructuring operations:

> Q. Did several of Aquila's top executives receive significant compensation for the work done on the utility asset sales portion of Aquila's overall restructuring operations?
>
> A. Yes. In its Form 8-K filed with the Securities and Exchange Commission on September 21, 2005, Aquila described the bonus it was paying to its corporate executive team for the work done on the utility asset sales:
>
> > On September 22, 2005, the Compensation and Benefits Committee of the Company's Board of Directors adopted an executive cash bonus plan. The objective of the plan is to acknowledge the successful execution of the initial phase of the Company's strategy to reduce debt through the sale of the utility properties described above as well as to provide an incentive to complete each of the four announced transactions. Under the bonus plan, executive officers of the Company will immediately receive a cash bonus of 25% of base salary and, if all of the transactions are consummated, will receive a further cash bonus of 75% of base salary. (Hyneman Direct, p. 23).

The Nonunanimous Stipulation and Agreement and the Order Approving Stipulation and Agreement were both silent as to treatment of bonuses in this case.

<u>Case No. ER-2007-0004</u>

In Aquila's latest rate case, Company witness Jon Empson stated in his Direct Testimony at page 3 that Aquila has not requested executive bonuses be included in this filing:

> . . . Aquila has <u>not</u> 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. . . .

More specifically, on pages 22-23 of his Direct Testimony, Company witness Empson addresses executive bonuses:

> 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.

In this same case, Company witness Ronald A. Klote's Direct Testimony at page 24 spoke of excluding bonuses:

> Bonus: This adjustment excludes 2005 corporate employee bonus costs of $691,004 that were allocated to MPS and L&P. MPS and L&P direct employee bonus amounts have been excluded from 2005 payroll costs in the CS-83 Miscellaneous Test Year Adjustments.

The following charts show the number and dollar amounts of bonus payments that Aquila's Missouri employees have received from 2001 through 2006.

CHART IS HIGHLY CONFIDENTIAL IN ITS ENTIRETY

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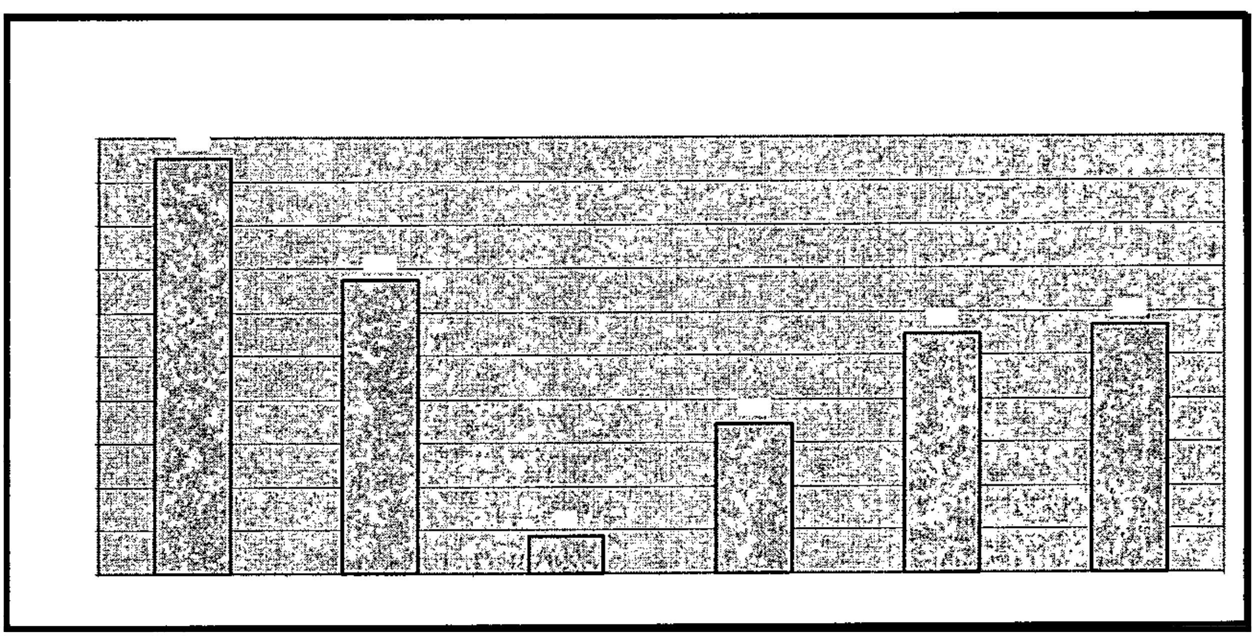

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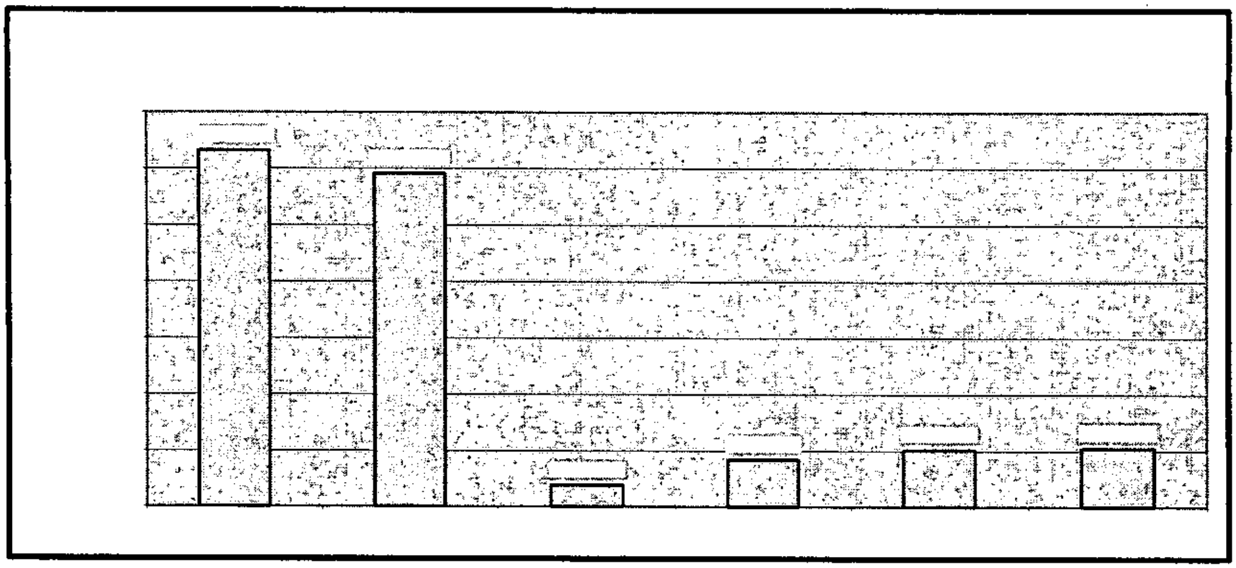

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The numbers on the charts are for all Missouri bonuses, as defined by the Company, including those from the Variable Compensation Plan, profit sharing awards, spot recognition programs, discretionary bonuses, long term incentive payments, retention/restructuring awards, safety awards and commission payments. According to the Company, the amounts also include executive awards allotted to Missouri operations. The charts indicate that the number and amount of bonuses dropped significantly after 2002.

More specifically, bonus amounts and totals awarded for Missouri operations in each category for the years 2001 to the present in 2006 are noted in the following tabNP:

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Attachment 1-71

TABLE IS HIGHLY CONFIDENTIAL IN ITS ENTIRETY

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Impacts on Missouri Consumers

Executive bonuses have not impacted consumers in recent years because these costs have been borne by the shareholders. Staff auditors have noted that Aquila has neither requested nor been allowed to recover executive bonuses in rates for at least the last several years. As noted in the discussion above, testimony in Case Nos. ER-2005-0436 and ER-2007-0004 states that executive bonuses related to the recent sale of utility assets have been excluded from rates.

NP

Consumers are impacted to the extent bonuses are included in customer rates. Company management stated that employee bonuses are generally requested to be included in rates; however, the amounts to be included in rates in each case are negotiated. As mentioned earlier, Aquila has developed five metrics that are most important to employees receiving bonuses: customer satisfaction, reliability, safety, effective use of capital, and reducing ongoing cost of service. Aquila management explained that bonuses are generally disallowed for the "effective use of capital" component. Staff auditors stated that in some instances, bonuses may be allowed if the compensation criteria provide a benefit to ratepayers.

Aquila's response to DR MPSC-0010 noted that the "Spot Recognition" bonuses have been usually excluded from past rate cases. Aquila stated in its response to DR MPSC-0011 that profit sharing, discretionary awards up to $2,500, long-term incentive payments, retention/restructuring awards, and travel incentives had all been eliminated from both past and current rate cases.

According to supplemental information provided by Aquila regarding its response to DR MPSC-0011, all of Aquila's rate proceedings for MPS and SJLP have been settled since 2000, so it is impossible to say how much of the bonuses have been included in rates. Specifically, Case Nos. ER-2001-672, ER-2004-0034, and ER-2005-0436 have been settled. Aquila noted that, "one could argue all of the bonuses, as well as none of the bonuses, have been included in rates since the components of those settlements are not disclosed."

Additional Findings and Conclusions

The Staff has no recommendations at this time.

CHAPTER 7 DECISIONS AQUILA MADE REGARDING THE ARIES GENERATION FACILITY

Historical Summary

This discussion on the history of the Aries generation facility begins in 1998 while Aquila, Inc. (Company, Aquila) was named UtiliCorp United, Inc. UtiliCorp United, Inc. became Aquila, Inc. in March 2002. Aquila, Inc. provides electric service in Missouri within the two regulated operating divisions of Aquila Networks – MPS (MPS) and Aquila Networks – L&P (L&P). Aquila Networks – MPS operates in the electric service territory covered by Missouri Public Service Company before its name was changed to UtiliCorp United, Inc. in 1985. Aquila Networks – L&P includes the service territory of St. Joseph Light and Power Company before it was acquired by Aquila in December 2000. The Company implemented a growth and diversification plan in 1984 that involved the acquisitions of utility and utility-related businesses outside of Missouri.

Company personnel state that the process to acquire new supply-side resources, which were ultimately provided by Aries, was begun in the Spring of 1998, well before Aquila acquired the St. Joseph area it now serves as L&P. This process was begun in the same time frame that agreements related to planning for supply-side resources were reached in Case No. EO-98-316. The final order in this case was effective on July 7, 1998, and included three main elements: 1) The Company would provide the Commission staff (Staff) and the Office of Public Counsel (OPC) with periodic reports and briefings on its supply-side resource planning, 2) the Staff and OPC would be given the opportunity to comment on any Request for Proposal (RFP) that the Company would issue to acquire additional supply-side resources, and 3) the Company would provide the Staff and OPC the results of its evaluation of the proposals received in response to RFPs.

The Company sent a letter to the Staff and OPC in April 1998 that outlined the capacity needs for 2000 and 2001 and provided a draft RFP for supply-side resources designed to accommodate those needs. The draft RFP did not contain an option for the Company to construct a rate-base generating plant, but it did include a section reserving the right of the Company to submit a "self-build" proposal in the form of an unregulated Exempt Wholesale Generator (EWG). An EWG is defined as a non-regulated affiliate of a regulated electric utility that is exclusively in the business of owning and/or operating all or part of an eligible facility and selling electricity at wholesale. The Electric Policy Act of 1992 authorizes the existence of EWGs as long as certain determinations are made by the appropriate state regulatory commission. Aquila filed Case No. EO-99-369 to obtain the necessary determinations from this Commission. The Commission made the required determinations in its April 22, 1999, order, but reserved all ratemaking determinations concerning any EWG until a future rate case. A final RFP without the section allowing for an EWG was ultimately issued on May 22, 1998, with proposals due on July 3, 1998. Aquila decided to provide an estimate of the cost to provide power from an EWG because it was of the opinion that this would be a low cost alternative.

In September 1998, the Company formed Merchant Energy Partners (MEP) within Aquila Merchant, a non-regulated division of Aquila, to develop and own all EWG facilities of the Company. Aries was originally owned 100% by Aquila Merchant. While it was being built, Aquila Merchant entered into a 50/50 partnership with Calpine Corporation (Calpine) through shares held by MEP. Aquila solicited purchase power agreement (PPA) bids and Aquila Merchant subsequently submitted its proposal on November 30, 1998, to supply Aquila's MPS capacity needs. Aquila completed its evaluation of the proposals it had received in January 1999, and a power supply agreement (PSA) between MPS and MEP was executed on February 22, 1999. The agreement reserved most of the power that would be produced from the Aries generating facility for Aquila's Missouri service area from 2001 until the expiration of the contract in May 2005.

Aries is located in Pleasant Hill, Missouri, on property that had been owned by MPS until 1992 and was adjacent to a Company substation that has operated for many years. The Aries generating facility was designed as a combined cycle plant with a total generating capacity of 585 MW. It consists of two 160 MW natural gas-fired combustion turbines and a 265 MW heat recovery steam generator (HRSG) that operates as part of the combined cycle unit. When the two 160 MW combustion turbines operate in the combined cycle mode, the heat generated by the two combustion turbine generating units that would otherwise be wasted is used to run the 265 MW HRSG.

When the Aries plant is operated in the combined cycle mode, the unit is considered an intermediate generating facility. Although the two combustion turbine-generators can be run in what is referred to as "simple cycle" or "independent mode," the most productive and efficient mode of operation is when the two 160 MW combustion turbine-generators run in tandem and the heat recovery system captures the exhaust heat and converts it to steam in order to run the 265 MW HRSG and generate a total of 585 MW.

The February 22, 1999, PSA between Aquila and Aquila Merchant provided that Aries would supply 320 MW of power during the simple cycle phase of operation from June to September 2001. When the combined cycle unit would become operational in early 2002, the agreement provided for a maximum of 500 MW over the peak periods from April to September in the remaining years, 2002 through May 2005. A maximum of 200 MW would be available during the non-peak periods from October to March of each year through March 2005.

The Aries generating facility began its test phase of operation in the Spring of 2001 when the two combustion turbines were operated in simple cycle mode. Actual operations with the two combustion turbines began in June 2001 and continued through the Summer of 2001. During the Fall and Winter of 2001, construction on the combined cycle unit was completed and the test phase of production was begun. The combined cycle unit began full production in late February 2002.

The Aries PSA between MPS and MEP is an example of a "tolling" agreement. Tolling agreements are usually capacity agreements between the owners of generating plants that sell the power and the buyers of the power such as Aquila. Under a tolling agreement, the utility agrees to purchase power through a firm capacity agreement, paying the seller for this capacity and generally an operation and maintenance expense based on a cost per MW. The utility tolling aspect of the agreement is that the buyer supplies the natural gas to power the generating unit. When the generating unit is under contract, the payments made by the buyer are designed to cover financing costs. In the case of Aries, the entire capacity of the plant was not under contract to Aquila. Consequently, the lenders insisted that the owners of the plant have a toll for the capacity of the unit that was not committed to Aquila. The tolling arrangement ensures that any unused capacity of the plant will be supported by sufficient revenues to cover the lenders' financing costs. As one of the owners, Aquila Merchant was responsible for 50% of the toll for the unit. The Aries owners were responsible for toll associated with the construction loan, regardless of the power that would be sold to generate revenues. In addition, even though the capacity agreement with Aquila was only through May 31, 2005, as one of the owners of the plant, Aquila Merchant was responsible for half of the toll obligation for any unused capacity beyond that date.

The financing of Aries was scheduled to be converted from construction financing to permanent financing in the Summer of 2003. Due to the financial difficulties experienced by Aquila and Calpine, the lenders demanded changes in the terms of the permanent financing. Aquila Merchant and Calpine refused to meet these new terms and went into default on the Aries financing on June 26, 2003. Aquila Merchant, subsequently, entered into negotiations with Calpine throughout the Summer and Fall of 2003 and reached an agreement to sell its ownership share of Aries to Calpine in September 2003.

On November 14, 2003, the Staff requested the Commission to open an investigation into the sale of the Aries unit in Case No. EO-2004-0224. The Staff was of the opinion that Aries was a valuable asset that the regulated operations should own to meet the capacity needs of Missouri's customers. The Commission stated in its Report and Order, effective March 4, 2004, that it did not have jurisdiction over the proposed transaction; however, it shared the Staff's concerns about adequate resource planning and was neither sanctioning or approving the sale.

Aquila issued an RFP for generation capacity in 2001, in anticipation of the capacity shortfall that would occur at the conclusion of the Aries PSA in May 2005. Although responses were received in late 2001, no immediate action was taken. No contract was signed in response to the 2001 RFP because the market was changing and prices were dropping. Discussions were held at Aquila's resource planning meetings and Staff agreed with Aquila that Aquila should reissue the RFP. Over the next several years from 2001 to 2005, Aquila issued several RFPs and received numerous bids to supply power generation to meet Aquila's MPS power needs. MPS submitted the "build" option in each of the many responses to the RFPs. The Aries partners submitted one of the bids to continue supplying power with another short-term contract through 2010 in response to the 2001 RFP. The Aries partners submitted a proposal to supply generation power to MPS from Aries or a combination of Aries and Aries II, which was to be built at the Aries site as three simple-cycle combustion turbines. Aquila management decided not to renew the contract for Aries power. These combustion turbines were later constructed at Aquila's South Harper facility. Further discussion on the South Harper generating facility is included in the following chapter.

Although the contract for power supplied by Aries expired in May 2005, there have been recent discussions regarding its ownership and operation. ** ______________________

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Many Company management decisions relate to the planning, construction, operation and sale of the Aries generating facility. Although there was universal agreement on the need for Aquila to accommodate the future power needs of its Missouri customers, many of the decisions related to fulfilling this requirement were disputed by the Staff. Varying opinions have been expressed in a variety of communications, most extensively in the testimony filed in several cases that included Aries issues. The following discussion summarizes three key issues where there have been differences of opinion.

Use of Short-Term Purchase Power Agreements

The Staff opposed the short-term, five-year PPA that was executed in February 1999 for the Aries power. Staff was of the opinion that Missouri customers were exposed to greater risks associated with future market-based pricing of power. Aquila management stated that a short-term PPA represented the lowest cost option that was available. Aquila was of the opinion that the Commission had encouraged shorter planning horizons in its Report and Order from Case No. EO-98-316 that would result in meeting new supply-side resource needs through a competitive bidding process and short-term purchase power contracts.

Use of an Affiliate to Build Aries

The Staff favored the option of Aquila constructing and operating a regulated generating unit to meet its power needs in the 2001-2005 period. The Staff thought this was a lower cost option for meeting Aquila's capacity needs than entering into short-term contracts for power. The Staff noted that the Company's preferred strategy stated in its 1995 planning document was to construct a combined cycle unit as part of its regulated operations. This strategy had changed by 1998 when Aquila eventually decided to form Merchant Energy Partners within its affiliate, Aquila Merchant, to own and operate all EWG and independent power producer facilities of the Company. The industry climate across the nation was a shift to restructuring. Legislation had been proposed in Missouri. Aquila was assuming that Missouri would also restructure and thereby decouple generation from its other operations. It was Staff's opinion that the Company believed it could earn higher profits by having a non-regulated affiliate construct a power plant and sell the power through a PPA than having the MPS Division of Aquila construct and operate the power plant.

Sale of Aries to Calpine

The Staff considered the Aries combined cycle unit to be a valuable asset that the regulated operations of Aquila should own to meet Missouri's customers' needs. As justification, the Staff noted that the facility was directly interconnected to the MPS transmission and distribution system, it was in a growth area of the Company, and its generating capacity was needed. In addition, the land used for Aries was sized for additional generating units that could be built to meet future capacity needs. Having experienced financial difficulties, the Company decided to sell its ownership interest in Aries to Calpine because it was exiting the trading markets and, therefore, was disposing of nonregulated generating assets like Aries.

Impacts on Missouri Consumers

There is no doubt that Company decisions associated with the planning, construction, and operation of the Aries generating facility have impacted Missouri consumers. Extensive Staff testimony has been filed in cases associated with Aries that has expressed concerns over the risk associated with short-term purchase power contracts and the potential for abuse with affiliate transactions. The adjustments made as a result of this testimony should have helped to reduce any negative impact on rates. Differences of opinion have also been expressed over the sale of

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Aries to Calpine. While it is not possible to quantify all of the negative impacts, it is obvious that open discussion of decisions and careful review by all parties will help to minimize any harmful effects.

Additional Findings and Conclusions

The Staff has no recommendations at this time.

CHAPTER 8 DECISIONS AQUILA MADE REGARDING THE SOUTH HARPER GENERATING FACILTY

Historical Summary

Aquila, Inc. (Aquila, Company) provides electric service in Missouri within the two operating divisions of Aquila Networks – MPS (MPS) and Aquila Networks – L&P (L&P). The following discussion regarding the history of the Company's South Harper generation facility begins in 2001. Aquila issued a Request for Proposal (RFP) in 2001, in anticipation of the capacity shortfall that would occur at the conclusion of the Aries Power Supply Agreement (PSA) on May 31, 2005. This contract for power from Aries between MPS and Merchant Energy Partners (MEP) provided MPS with 200 MW from October to March and 500 MW from April to September. Merchant Energy Partners is comprised of Aquila Merchant and Calpine Corporation (Calpine). Aquila Merchant is a wholly-owned, non-regulated affiliate of Aquila. Aquila Merchant decided to plan an Aries II project based on the prospect of getting a purchase power agreement with MPS. Three Siemens Westinghouse Power Corporation turbines were purchased by Aquila Merchant in September 2001.

MPS received a number of proposals in response to a 2001 RFP for power, but decided to postpone its decision. By July 2002, Aquila Merchant decided to cancel the Aries II project when the merchant energy market was collapsing. The three Siemens turbines were never delivered to the Aries site although Aquila Merchant started taking delivery of the equipment in August 2002 and the last of the turbine equipment was delivered in late 2002. The Siemens turbines and generators were stored at the MPS Ralph Green generating facility in the Kansas City area and the remainder of the equipment was placed in two airplane hangers at Richards-Gebauer Air Force Base.

In January 2004, MPS decided to use the three turbine units for the construction of a new generating facility (Camp Branch) near Higginsville, Missouri. When local opposition to Camp Branch began to develop, in late summer 2004, the Company, at the invitation of the City of Peculiar, decided to move the project to a location near Peculiar, Missouri, the present South Harper site.

The Commission Staff (Staff) became aware at a January 27, 2004, meeting that, even though the least cost option for meeting its 2005 capacity needs was to build five combustion turbines, the Company planned to fulfill its short-term capacity requirements with a generating facility that would be constructed using the three stored combustion turbines and three- to five-year purchase power agreements resulting from responses to a 2003 RFP. Staff responded with a letter on January 30, 2004, expressing concern over this strategy and stating its opinion that MPS should consider base-load generation and not become overly dependent upon purchase power agreements.

At the semi-annual resource planning meetings between MPS and the Staff on February 9, 2004, and July 9, 2004, the Company stated that its preferred plan was to build a generating facility with three combustion turbines and obtain the remainder of the power with purchase power arrangements. However, the resource plan presented at both meetings continued to show that the construction of a generating facility with five combustion turbines was still the least cost alternative. A Staff witness position on Aquila's resource planning was expressed in direct testimony offered in Aquila's Case No. ER-2005-0436.

> The Staff believes that prudently building and owning generation, whether it is baseload, intermediate or peaking, provides stability for Missouri consumers. PPAs are useful tools, but in the current environment they should not be relied upon as long-term solutions to capacity needs in the planning process without a firm long-term contract in hand.

Staff testimony also pointed out a common perception that building capacity places the Company in a stronger negotiating position when it is contemplating purchasing capacity.

Despite the City of Peculiar's invitation to Aquila to build, the Company's decision to locate and build a generation facility near Peculiar, Missouri, in Cass County, did not go unopposed. The residents of Peculiar declined to annex the South Harper site. Then a citizens-based group and the County of Cass filed a lawsuit seeking to stop construction of the South Harper facility. Litigation continues as of the Summer of 2006 related to whether Aquila will be able to continue operating the plant or whether it must be dismantled. A brief summary of some of this litigation is included later in this discussion about South Harper.

South Harper is the first generating facility constructed by MPS since MPS participated with Westar Energy in the Jeffrey Energy Center coal-fired generating units in 1983. MPS began land clearance and site preparation for South Harper in October 2004 on 38 acres of a 74 acre tract of land near Peculiar, Missouri. MPS also began land clearance activities for a related electrical transmission substation on approximately 10 acres of a 55 acre tract of land about two miles northwest of Peculiar. Construction continued through the end of 2004 and the first half of 2005. MPS had planned on having the units operational by the time its purchase power agreement for up to 500 MW of capacity from the Aries combined cycle unit ended on May 31, 2005. South Harper Unit 3 actually met system load requirements and was dispatched on June 30, 2005, Unit 2 on July 1, 2005, and Unit 1 began its commercial operation on July 11, 2005. The generating station is comprised of three natural gas fired Siemens Westinghouse combustion turbines. Each turbine is capable of generating 105 MW of electricity resulting in a total station capacity of 315 MW. The remaining capacity requirements have been met through purchase power agreements with other companies.

Aquila filed a rate case on May 24, 2005, wherein it sought to include in rate base the investment in South Harper. Company witnesses stated in testimony in Case No. ER-2005-0436 that the primary drivers of the rate request were higher fuel costs and significant investments in plant related to new generation facilities at South Harper. Staff witnesses proposed an adjustment in the case allowing for an investment in five combustion turbines, even though only three were installed. Several Staff witness offered opinions that the Company had made a mistake in only installing three turbines and relying on purchase power agreements to fill the remaining need. Staff witnesses thought the installation of two additional turbines would have been a lower cost alternative in the long run than using purchase power agreements. In an order with an effective date of March 1, 2006, the Commission approved a Stipulation and Agreement in the case which established an amount that Aquila would be allowed to carry on its books as an expense for the construction of the plant, but it did not authorize Aquila to place South Harper in rate base to recover any construction costs. The Company has sought to include the costs associated with South Harper in Case No. ER-2007-0004, filed on July 3, 2006,

As previously stated, shortly after site preparation activities began in October 2004, a citizens-based group and the County of Cass filed a lawsuit in the Circuit Court of Cass County seeking to stop construction of the South Harper facility. For purposes of this discussion, the South Harper facility is defined to include the generation facilities and the related substation. The following listing identifies the dates and some of the major actions related to this litigation.

Critical Dates Related to South Harper Litigation

January 11, 2005

The Cass County Circuit Court issued an injunction preventing Aquila from constructing and operating the South Harper facility. The Company was ordered to remove all improvements and equipment inconsistent with Cass County's agricultural zoning classification. The judgment also provided for the injunction to be suspended pending the posting of a $350,000 cash or surety bond during the appeal.

January 11, 2005

Aquila posted a surety bond, which was accepted on January 11, 2005, by the Circuit Court, and continued construction of the South Harper facility.

January 12, 2005

Aquila filed a Notice of Appeal of the Judgment in the Missouri Court of Appeals, Western District.

January 28, 2005

The Company filed an application with the Commission in Case No. EA-2005-0248 for confirmation of the Commission's permission, approval and authority or, alternatively, to grant a certificate of public convenience and necessity specifically for the South Harper facility.

April 7, 2005

The Commission confirmed that Aquila's existing certificates provided the necessary authorization. On May 4, 2005, Cass County, StopAquila and other individuals sought review of the decision in the Circuit Court of Cass County alleging the Commission acted illegally.

December 20, 2005

The Missouri Court of Appeals, Western District, found that Aquila's existing certificates of public convenience and necessity did not provide specific Commission authority for the Company to construct and operate the South Harper facility. However the court's decision did permit Aquila to seek the necessary authority from either Cass County or the Commission.

January 20, 2006

Aquila attempted to file special use permits for South Harper with Cass County, but the filing was not accepted.

January 25, 2006

Aquila filed an application with the Commission in Case No. EA-2006-0309 requesting the Commission to approve certificates of public convenience and necessity specifically for the South Harper facility.

January 27, 2006

Judge Dandurand of the Circuit Court of Cass County extended the stay of the injunction of his Final Judgment until May 31, 2006.

May 23, 2006

The Commission issued a Report and Order in Case No. EA-2006-0309 that granted Certificates of Public Convenience and Necessity for the generating units and electric transmission substation, subject to several specific conditions.

June 2, 2006

Judge Dandurand of the Circuit Court of Cass County ordered that the Judgment requiring the dismantling of the South Harper generating facility be stayed pending appeal and further order.

June 2, 2006

Cass County and individuals sought the Cass County Circuit Court review of the Commission's Case No. EA-2006-0309 Report and Order, charging it is unlawful.

<u>Impacts on Missouri Consumers</u>

There are many decisions associated with the South Harper generating facility that affect consumers. Certainly the outcome of the litigation involving the continued operation of the South Harper generating facility will impact customers. It is not known what that impact will be. Decisions to rely heavily on purchase power contracts and natural gas-fired generation have some of the greatest potential for negative effects. Company management's attention to this concern as it plans to provide for future electricity needs is critical.

Additional Findings and Conclusions

Company management has not always given adequate consideration to all available options for accommodating its future electricity capacity requirements. Company management has not constructed any base-load generation since 1983. A policy decision in the late 1990s precluded its regulated entities from building generation facilities to meet future capacity needs. Extensive use of short-term purchase power arrangements has placed customers at risk for high volatility in market prices. Heavy reliance on natural gas-fired generation facilities has subjected customers to rate increase requests substantially due to significant increases in natural gas prices. Although Company management participated in semi-annual resource planning meetings with the Staff, Company management pursued its own preferred option of negotiating PPAs instead of building adequate capacity in the short-term.

The best decisions are always made when genuine consideration is given to all legitimate options. Good decisions about capacity planning help to ensure greater stability in rates and an adequate source of reliable power.

THE EMSD STAFF RECOMMENDS THAT COMPANY MANAGEMENT:

> *Give adequate consideration to all available options when planning for future capacity requirements that will ensure the development of cost-effective decisions.*

Aquila will be required to meet the requirements of 4 CSR 22, the Commission's Electric Resource Planning rules, on February 5, 2007. In response, Staff and any intervenors will review Aquila's resource planning process and the implementation of Aquila's preferred plan. Specific deficiencies will be identified. If remedies cannot be agreed upon by the parties, the Commission will have the opportunity to determine an appropriate remedy.

CHAPTER 9 DECISIONS AQUILA MADE TO PROTECT ITS REGULATED ACTIVITIES FROM THE COMPANY'S INVOLVEMENT IN UNREGULATED ACTIVITIES

Historical Summary

The Staff requested the Company to describe all efforts it had made to protect its regulated activities from the Company's unregulated activities since the mid-1980's. The Company indicated it had instituted three initiatives to protect its regulated operations from non-regulated activities during that time period (Data Request No. 2, Exhibit 1).

Specifically, the Company identified: 1) the development of a capital assignment process shortly after its formation that was designed to insulate each of its utility divisions from other operations of the Company. The Company further indicated that Aquila's regulated utility operating units receive capital based upon costs at investment grade levels and percentages comparable to what peer utility companies receive. The Company also indicated that: 2) it was committed to the proper identification of allocated costs and to the creation of a more transparent structure to facilitate review of its operations. For costs that are allocated, Aquila pointed to its Cost Allocation Manual, which is revised annually or more frequently if a material change takes place. In addition, the Company pointed to detailed affiliate transaction reporting, procedures and monitoring. Finally, the Company indicated that: 3) its non-regulated and certain other corporate costs are identified and coded by accounting. The Company stated that these costs will not be charged to the regulated operations and will be absorbed by the corporate retained departments.

While the Company first pointed to its divisional capital structure as protection for its Missouri regulated properties, the divisional capital structure has been argued in the past by Missouri Staff rate of return witnesses to be inaccurate and not having direct relation to the capital mix that Aquila's Missouri properties have available for investments. Because debt and equity are generated from the parent Company, the Staff's opinion has been that Aquila's Missouri regulated operation relies upon Aquila to finance their investment in its Missouri properties. (See Case No. ER-2005-0436, Murray Direct.) The staff's position on capital structure was supported by Commission Orders in Case Nos. ER-90-101 and ER-97-394.

Specifically, the Commission's order in Case No. ER-90-101 on page 50 stated:

In ratemaking, establishing the correct capital structure is part of the process of setting the rate of return on the Company's facilities. The goal of selecting a rate of return is to attract sufficient capital for the Company's needs in financing its facilities. It is important that the rate of return established realistically reflect the assessment of prospective investors in that Company. The Commission finds that it is more reasonable to use the consolidated capital structure for MPS than it is to assign a hypothetical capital structure to MPS. As noted by Staff/Public Counsel, MPS has no capital structure of its own and its stock is not traded on the stock market. Investors cannot invest in MPS but can invest in UtiliCorp. It is the capital structure of UtiliCorp that prospective investors will examine when contemplating an investment. It is UtiliCorp which must attract capital for the use of its divisions and subsidiaries including MPS.

In addition, the Missouri Public Service Commission's Report and Order in Case No. ER-97-394, page 6 included the following:

> Based on substantial evidence of record, the Commission finds that the consolidated capital structure as proposed by the Staff accurately reflects the correct capital structure of UtiliCorp itself, and therefore MPS, during the actual test year.

Aquila also indicated in its response to Data Request No. 2 that it is committed to the proper identification of costs and maintains a detailed Cost Allocation Manual (CAM). The Company stated that its CAM is revised annually or more frequently if a material change takes place. The proper identification of costs and maintaining a CAM is required by Commission rules found in Chapters 20 and 40 of 4 CSR – 240. In addition, the Company indicated it "maintains detailed affiliate transaction reporting, procedures and monitoring." Affiliate transaction reporting is also required by Commission rules in 4 CSR -240, Chapters 20 and 40. Finally, the Company indicated that non-regulated and certain corporate costs are identified and coded to ensure costs are not charged to the regulated operations of the Company.

The very purpose of the Commission's Affiliate Transactions rules, as addressed in 4 CSR 240-20.015 and 4 CSR 240-40.015 are:

> … intended to prevent regulated utilities from subsidizing their non-regulated operations. In order to accomplish this objective, the rule sets forth financial standards, evidentiary standards and record keeping requirements applicable to any Missouri Public Service Commission regulated (electrical and gas) corporation whenever such corporation participates in transactions with any affiliated entity. The rule and its effective enforcement will provide the public the assurance that their rates are not adversely impacted by the utilities' nonregulated activities.

While items 2 and 3 of the Company's response can and do provide protections to the Company's regulated activities, these protections can, at least in part, be attributed to Missouri regulatory requirements and authority. The Company submits an annual CAM as a result of Commission rule requirements and this document is reviewed by Missouri Commission staff auditors. The appropriate coding and assignment of costs is also required by Commission rules and is reviewed by Missouri Commission staff auditors during rate cases.

Although the Company identified the actions above as those it has taken to protect its regulated activities from its non-regulated activities, Aquila has pursued actions that the Commission and the Staff have previously concluded were not in the best interests of Aquila's regulated business. Aquila's April 30, 2003, *Application for Authority to Assign, Transfer, Mortgage or Encumber its Franchise, Works or System*, Case No. EF-2003-0465 is one such example. In this case, Aquila requested permission from the Commission to pledge its Missouri regulated assets to support a $430 million, three-year Term Loan, and a $100 million, 364-day Term Loan. Aquila's request, which was not supported by either the Office of the Public Counsel or by the Missouri Commission staff, was denied by the Commission in its March 5, 2004, Report and Order and determined to be detrimental to the public interest.

Specifically the Commission's order stated on page 7:

> The unreasonable risk of harm includes the possibility that Missouri's regulated assets alone would support Aquila's $430 million loan. That loan includes money for Aquila's non-regulated businesses. Aquila's Missouri ratepayers alone might shoulder the burden of Aquila's financial difficulty, including a potential default on the note, or even bankruptcy. That burden could include a loss of service, since the loan agreement arguably allows the creditor to bypass the Commission, and immediately foreclose upon and sell the assets.

Because Aquila, Inc. was not permitted by the Commission to pledge its Missouri's regulated assets, there was no negative impact on Aquila's Missouri customers.

Another example where the Staff concluded Aquila had pursued actions that were not in the best interests of its regulated activities is the Company's filed Application in Case No. EO-2005-0156. In its application, Aquila sought Commission approval to sell and lease back three natural gas fired combustion turbines to the City of Peculiar in order to gain tax advantages, as permitted by sections 100.010 through 100.200 of the Revised Statutes of

Missouri. Aquila estimated the tax abatement to be in the range of $14 to $17 million over the expected 30 year life of the project.

At issue became the transfer value of the turbines by the Aquila affiliate, Aquila Equipment, LLC (AE) to its Missouri regulated utility, Aquila Networks - MPS. Aquila's application requested that the fair market value of the turbines be established at $70,796,850, which ultimately could have been paid for by Aquila's Missouri regulated customers had the Commission accepted that value of the turbines for future ratemaking purposes.

Aquila pursued the valuation amount even though it had previously offered to sell the same units to Kansas City Power and Light for approximately $4 million less, or $66,760,000. The difference between the two values of $4,036,850 would have benefited Aquila's affiliate, AE. The Company entered into a stipulation and agreement with the Staff and the Office of Public Counsel that valued the units at $66,760,000. The Commission's December 19, 2005 Order denied the portion of the Application which asked that a value be assigned to the turbines.

The Staff has also presented past service quality concerns during Aquila's 2003 rate case (See Case No. ER-2004-0034, Kremer Direct). Staff addressed service quality concerns which in its opinion, were at least partly, if not entirely, the result of Aquila attempting to reduce the costs of its call center. In 2001, the Company began to rely more heavily upon the use of temporary, outsourced services to perform a significant amount of work of its call center. During 2003, the Company had also reduced the number of management personnel of its call centers. While outsourcing may provide effective solutions to specific workforce needs, the Company has admitted that high call center turnover of temporary employees contributed to a decline in call center performance to the detriment of Missouri customers.

The Staff has analyzed Commission complaints and inquiries received from Aquila's Missouri operations and the volume increased from 2004 to 2005. Aquila's frequent requests for rate increases as well as negative press articles about the Company may be contributing to these increases. Complaints and inquiries can provide indication of service deficiencies and rule violations and the Staff will continue to monitor Aquila's complaint data. Commission complaints and inquiries have been trending upward. Numbers of Aquila's Missouri Public Service Commission complaints and inquiries are presented below:

Aquila PSC Customer Complaints / Inquiries					
Year	Total number of customers	Number of Complaints	Number of Inquiries	Total Number of Complaints & Inquiries	Complaints/ Inquiries per Thousand Customers
2002*	332,321	183	69	252	0.76
2003	338,227	242	56	298	0.88
2004	340,895	254	46	300	0.88
2005	345,463	324	67	391	1.13
2006*		*189	*48	*237	Unknown
2002* Includes Complaints/ Inquiries from UtiliCorp, Missouri Public Service and St. Joseph Light and Power					
2006* Complaints/ Inquiries included up to 09-05-2006					

Customer rates are developed to include and support the provision of safe and reliable service. Utility cost-cutting activities that result in service declines that are detrimental to Missouri customers should not be acceptable. In the instance described above, Aquila's actions indicated it was willing to sacrifice service quality in order to save costs that had been previously built into customer rates at its customers' expense. The Company has since ceased using temporary services to staff its call center, has begun reporting its performance on a monthly basis to the Missouri Commission Staff and its call center performance has improved.

In examining the Company's response to Data Request No. 2, past case records, and interviews with Company personnel regarding efforts Aquila made to protect its regulated activities from the Company's involvement in unregulated activities, the Staff has found little evidence that the Company has made substantial efforts on its own initiative. Protections provided to Aquila's Missouri customers from Aquila's unregulated activities are more the result of regulatory requirements to which Aquila's Missouri electric service is subjected. Aquila sold its Missouri gas properties in 2006 to Empire District Electric Company. Although Aquila management may have pursued and permitted activities that the Staff believes have not sufficiently protected the Company's customers, the Staff concludes that to date, federal and state regulations have sought and to a great extent have provided service and rate protections to Aquila's Missouri utility customers.

Two of the three protections identified by the Company in its data request response are required by Missouri Public Service Commission rules and are thoroughly examined in Company rate cases. The capital assignment process Aquila points to has been argued by the

Missouri Public Service Commission Staff as to not provide protection to Missouri consumers. The Missouri state utility ratemaking process results in careful analysis and review of all costs flowing back to Aquila's Missouri ratepayers, including corporate allocated costs to ensure Missouri customers do not pay more than an appropriate amount for costs that benefit Aquila's multiple jurisdictions and business interests. In interviews held with Company executives Mr. Rick Green, Mr. Keith Stamm and Mr. Jon Empson on August 30, 2006, there was general agreement from these key management personnel that utility regulation had provided both rate and service protections to Missouri consumers.

During 2002 when the Company's debt ratings were downgraded below investment-grade status, the Missouri Public Service Commission directed its Staff to review and report on the evolving financial situation at Aquila and the implications that situation had on Aquila's regulated operations in Missouri. The Staff initiated a process to identify, evaluate and document potential negative implications from the deterioration of Aquila's financial condition. Page 17 of the report, Missouri Public Service Commission's Staff Report On Aquila, Inc. presented three specific concerns that the Staff identified as possible negative impacts of Aquila's declining financial position on rates charged and the quality of service provided to Aquila's Missouri electric and gas consumers. The three specific areas identified in its report and the Staff's continued response to address these concerns include:

1) Higher capital, interest and restructuring costs will lead to higher utility rates. While Aquila's recent rate cases have resulted in stipulations that determine a 'black box' settlement and prescribe no specific amounts for cost of capital allowed in rates, the Staff approaches rate case settlements with parameters on all costs in total, which has included protections for Aquila's Missouri consumers from paying higher debt costs.

2) Reduced access to funds will reduce the quality of service. To address this concern, the Staff has been monitoring certain quality of service indicators on a monthly basis, including call center performance and reliability indicators from Aquila. The Staff also performed a comprehensive customer service review of the utility in 2005. This review

resulted in 52 recommendations to Company management for improvements.

3) Employee reductions will produce service and safety concerns. In addition to performance declines, the Staff identified staffing concerns in the Company's 2004 rate case. The Company discontinued outsourcing its call center hiring and returned to in-house staffing. Increased service quality monitoring provides some assurance that staffing will remain sufficient to appropriately serve customers.

Impacts on Missouri Consumers

While the Staff cannot unequivocally state that Aquila's protections or lack of protections to its Missouri regulated properties have not resulted in any detriment to the Company's Missouri utility consumers, the Staff is not aware of any present detriments to Aquila's Missouri consumers, either in rates paid or in present service quality concerns. Staff has addressed past service quality deficiencies with the Company and will continue to carefully monitor the service provided by Aquila to its Missouri customers.

Without question, a future sale of Aquila's Missouri electric property or bankruptcy could have rate and service implications to the Company's Missouri consumers. In addition, Aquila, Inc., as any regulated utility, may agree to a revenue requirement amount during rate case settlements or be ordered a specific revenue and subsequently strive to cut costs after rates go into effect in order to use customer revenue for purposes other than what Staff or other parties believe they are intended. Should some future determination be made that Aquila's actions resulted in detrimental impacts to the service quality it provides to its customers, the Staff will recommend what it believes are appropriate actions and remedies to the Commission.

Findings and Recommendations

Due to the potential negative impact Aquila's past unregulated activities could have had on its Missouri customers, it is the Staff's opinion that the Commission should be made aware of any future unregulated activities in which Aquila chooses to pursue. In addition, Aquila should be required to evaluate, document and provide to the Commission all known and potential impacts on its regulated customers.

The EMSD Staff recommends that Company Management:

> *Provide advance notice to the Commission prior to investing in future unregulated activities along with documentation of all known and potential impacts those activities may have on Aquila's Missouri utility customers. Include in the Company's notice to the Commission all plans the Company has to ensure that Aquila's Missouri customers will not be negatively impacted by investing in future unregulated activities.*

CHAPTER 10 DECISIONS AQUILA MADE TO INVEST IN UNREGULATED ACTIVITIES

Historical Summary

The decisions Aquila made to invest in unregulated activities was an additional issue Staff was directed to investigate by the Commission in its June 13, 2006 Order. The EMSD staff reviewed numerous documents, submitted data requests and interviewed Mr. Richard Green, Mr. Keith Stamm and Mr. Jon Empson in preparation of this report.

Following UtiliCorp's reorganization in 1994, its business segments included: 1) Energy Delivery, 2) UtiliCorp Energy Group, 3) Aquila Energy, 4) Energy Solutions and 5) International Opportunities.

1) Energy Delivery

This business segment was the Company's original core business that it called its "wires and pipes." It was the transmission segment of the Company and was under governmental regulation. It served electric and natural gas customers in the United States.

2) UtiliCorp Energy Group

This business segment included two subgroups – Generation Facilities and Wholesale Energy Marketing. Generation Facilities provided wholesale energy to the Energy Delivery group and other affiliated wholesalers. Revenues from Energy Delivery were based on an internal transfer-pricing model between the two groups. Generation Facilities operated electric generating plants and owned interest in 17 independent power projects in 1996.

3) Aquila Energy

This business segment had its own trading floors for the purchase and sale of gas and electricity contracts in the deregulated wholesale market. This segment was started in 1986 and by 1996, it had grown to become one of the top ten marketers of energy to industrial and large commercial customers across the United States and in Canada.

4) Energy Solutions

This business segment's primary operation was gas marketing to small commercial and industrial customers. The services were primarily designed to provide non-regulated services to retail customers who already purchased electricity or natural gas from the Company. Some of the services provided included appliance repair, home security, warranties and others. These services were bundled into a single monthly bill to the customer.

5) <u>International Opportunities</u>

This business segment was the Company's three domestic focal points: distribution networks, wholesale energy marketing and retail marketing. International operations steadily gained a larger share of the Company's consolidated operations. The Company recognized that utility industries in other countries were changing faster than in the United States due to privatization and deregulation. The Company spent more than $2 billion on growing opportunities in New Zealand, Australia, Canada and the United Kingdom from 1985 to mid-1986. The Company gained knowledge of operations in a deregulated environment by purchasing regulated and non-regulated operations in other countries. This international diversification also assisted in stabilizing the Company's earnings by compensating for business cycle fluctuations throughout the world. ("The Kansas City Power & Light Merger – Western Resources or Utilicorp?" with Marilyn Taylor, 2006, *Case Research Journal, 25:3, pp. 15-16.)*

The Company was committed to a significant two-year growth plan in 1995. The firm invested $634.9 million in 1995 into developing strengths in marketing and information systems. In May 1995 the Company used EnergyOne as a marketing tool, but the Company's name was not changed to EnergyOne. EnergyOne was the first national branding effort for energy services in the utilities industry. The Company knew that deregulation would eventually lead to consumers' right to choose between power providers and the Company wanted to establish a familiar brand name before its competitors did. ("The Kansas City Power & Light Merger – Western Resources or Utilicorp?" with Marilyn Taylor, 2006, *Case Research Journal, 25:3, p. 16.)*

During 2001, Aquila Merchant went public, Mr. Richard Green stepped down as CEO and Mr. Robert Green became CEO. Following these occurrences, the business segments of Aquila in 2001 included 1) Energy Merchant, 2) U.S. Networks, 3) International Networks, and 4) Services. The U.S. Networks segment and the International Networks segments were combined into the Global Networks business segment in November 2001. (Missouri Public Service Commission's Staff Report on Aquila, Inc., December 2002, p. 5.)

1) Energy Merchant

The foundation for the Company's Energy Merchant business began during 1992. The Company purchased Peoples Natural Gas (PNG) of Council Bluffs, Iowa, from Enron on August 16, 1986. At that time, PNG had two employees performing trading operations. The Company renamed its gas marketing subsidiary Aquila.

Aquila's Energy Merchant business segment provided risk management products and services, traded energy-related and other commodities, and marketed natural gas and electricity to industrial and wholesale customers in the United States and Canada. It also marketed energy in Europe through its offices in the United Kingdom, Germany and Norway.

These trading operations were performing well; in fact, the operations were growing. The Company moved the trading operations to Omaha, Nebraska, and eventually to Kansas City, Missouri. During 1995, Aquila Energy's revenues were $1,121,000,000, while its other four business segments' revenues totaled $3,865,000,000. In 2001, Aquila's Merchant Services business had $37.7 billion in sales, which accounted for 94% of Aquila's total sales, and contributed 65% of Aquila's earnings before interest and taxes (EBIT). At December 31, 2001, Merchant Services had $6.2 billion in assets, or 52% of Aquila's total assets. The energy-trading component of Merchant Services alone accounted for 90% of total company revenue, which made it one of the top trading companies in the United States. (Missouri Public Service Commission's Staff Report on Aquila, Inc., December 2002, p. 5.) Mr. Stamm informed the Board of Directors at its November 2, 2005, meeting that "Aquila is a 'Major League Franchise Player' along with Enron, Duke, Reliant, PG&E and Dynegy. Aquila is looking at 25% earnings growth over the next several years." (Aquila, Inc., Minutes of the Regular Meeting of the Board of Directors, November 2, 2005, p. 3).

After the collapse of Enron, the Company began dissolving Aquila Merchant and exiting the energy trading business. The Company stopped wholesale energy trading during the third quarter of 2002. It is estimated that between 1600 and 1800 employees lost employment when Aquila Merchant collapsed.

Aquila Merchant remains an Aquila subsidiary. The Company has attempted to sell this segment, but due to its size, there is little interest. It currently consists of a peaking plant in Crossroads, Mississippi (Crossroads Energy Center) and its wholesale energy trading business.

Although the Company stopped wholesale energy trading in 2002, it still has fourteen contracts because it has been unable to liquidate or terminate them economically.

On January 28, 2004, a $26.5 million settlement offer was made by Aquila Merchant to the Commodity Futures Trading Commission (CFTC). In Docket No. 04-08, the Company offered a settlement without admitting or denying the allegations of its violations to Sections 6(c), 6(d) and 9(a) of the Act, 7 U.S.C. §§ 9, 13b, 13(a)(2) and 15 (2001). The Company was accused of reporting false information, including price and volume information concerning natural gas cash transactions, to certain reporting firms. In August 2006, three former Aquila Merchant Services traders plead guilty to felonies.

2) U.S. Networks

The U.S. Networks business segment operated divisions serving electric distribution customers in Missouri, Kansas and Colorado as well as natural gas distribution customers in Missouri, Kansas, Colorado, Nebraska, Iowa, Michigan and Minnesota. Its seven domestic utility divisions are Aquila Networks-MPS, Aquila Networks-L&P, Kansas Public Service, Peoples Natural Gas, WestPlains Energy, Northern Minnesota Utilities and Michigan Gas Utilities.

In 2001, U.S. Networks had approximately $2.3 billion in sales, which accounted for 5.6% of total company sales and contributed 16.7% of total company EBIT. At end of year 2001, U.S. Networks had $3.5 billion in assets, or 29.4% of total company assets. (Missouri Public Service Commission's Staff Report on Aquila, Inc., December 2002, p. 6.) Aquila currently serves gas distribution customers in Colorado, Kansas, Nebraska and Iowa and electric customers in Missouri, Colorado and Kansas.

3) International Networks

This business segment operated electric and gas utility networks in Australia, New Zealand and Canada. Aquila managed and was 34% owner of United Energy in Australia. United Energy's four business units included Distribution, Energy Merchant, Utili-Mode and UeComm. The Distribution unit served 1.1 million electric and gas customers in Melbourne, Australia and the Mornington Peninsula. The Energy Merchant business bought and sold electricity in the wholesale market, traded related commodities and sold risk management products. Utili-Mode offered energy-related "back office" services including call center, billing, metering and account collection functions. UeComm was a telecommunications business that developed networks in Sydney, Melbourne and Brisbane, Australia.

Aquila and United Energy jointly owned 45% of AlintaGas Limited, a natural gas distributor in Western Australia with more than 430,000 customers. Aquila owned 55% of UnitedNetworks Limited (UnitedNetworks) a company that served approximately 600,000 customers. UnitedNetworks, one of New Zealand's largest network infrastructure companies, distributes energy to about 30% of the electricity consumers and more than 50% of the country's natural gas consumers. In addition, it owned and managed a telecommunications network business. UnitedNetworks was created in 1998 when Aquila combined the electrical distribution operations it acquired from three different New Zealand utilities and later a natural gas network. Aquila announced the sale of UnitedNetworks on October 11, 2002, with its share of the proceeds estimated to be approximately $362 million.

Aquila acquired West Kootenay Power in 1987 and TransAlta Corporation's distribution and retail operations in February 2000. This business operates as Aquila Networks Canada, Ltd.

During 2001, the International Networks business segment had approximately $354 million in sales, which accounted for less than 1% of Aquila's total sales, and contributed 17% of Aquila's EBIT. (Missouri Public Service Commission's Staff Report on Aquila, Inc., December 2002, pp. 6-7.)

Aquila sold its investments in Australia in the second and third quarters of 2003 and its investments in the United Kingdom in January 2004. Aquila sold its electric utility operations in Canada in May 2004.

4) **Services**

This business segment consisted primarily of Aquila Communications Services and Quanta Services. Aquila Communications Services was formed in early 2000 and provided a range of broadband services including local and long-distance voice, high-speed Internet access and digital television. During 2001, Aquila decided to limit its fiber-optic networks to the Kansas City market. As a result, it wrote off $16.5 million related to network design, long-term leases and other development costs related to markets outside of Kansas City that it does not intend to develop.

Quanta Services is a Houston-based firm that builds and maintains networks carrying energy and telecommunications. During 2001, Aquila held a 38.5% interest in Quanta Services and in 2001 and during the beginning of 2002, spent considerable time and resources trying unsuccessfully to achieve control over Quanta's operations. (Missouri Public Service Commission's Staff Report on Aquila, Inc., December 2002, p. 8.) Aquila presently does not own an interest in Quanta, but does contract with the company for some of its labor services.

Aquila Invests in Unregulated Activities

In the UtiliCorp United 1993 10-K, the Company stated that its "strategy is to balance its services by business segment, region, climate and regulatory jurisdiction, and to be in the forefront of utility deregulation". (UtiliCorp United, 1993 Form 10-K, p. I-1.) "In pursuit of these goals, the company actively seeks expansion opportunities in both the regulated and non-regulated segments of the industry." (UtiliCorp United, 1994 Form 10-K, p. 2.)

After Aquila's failed attempt to merge with KCPL in mid-1996, and its inability to grow itself domestically, it began to focus on international growth opportunities. Company executives were aware that the investment community viewed its balance sheet with some concern. There was expectation that the Company's merger with KCPL would improve some of those concerns. ("The Kansas City Power & Light Merger – Western Resources or Utilicorp?" with Marilyn Taylor, 2006, *Case Research Journal, 25:3, p.16).*

In addition, FERC Order 436, which was issued in 1985, affected Aquila's decision to enter the unregulated industry. This order encouraged the unbundling of natural gas sales and transportation by authorizing blanket certificates for interstate pipeline companies if those companies offered open access transportation on a first-come, first-served basis. As the market changed, and there was the potential pattern for states to provide choice, the Company saw the free markets as an opportunity. The Company's drive was to capitalize on a deregulated market. The Company stated during an interview held August 30, 2006, that it was the combination of these items that led the Company to invest in unregulated activities.

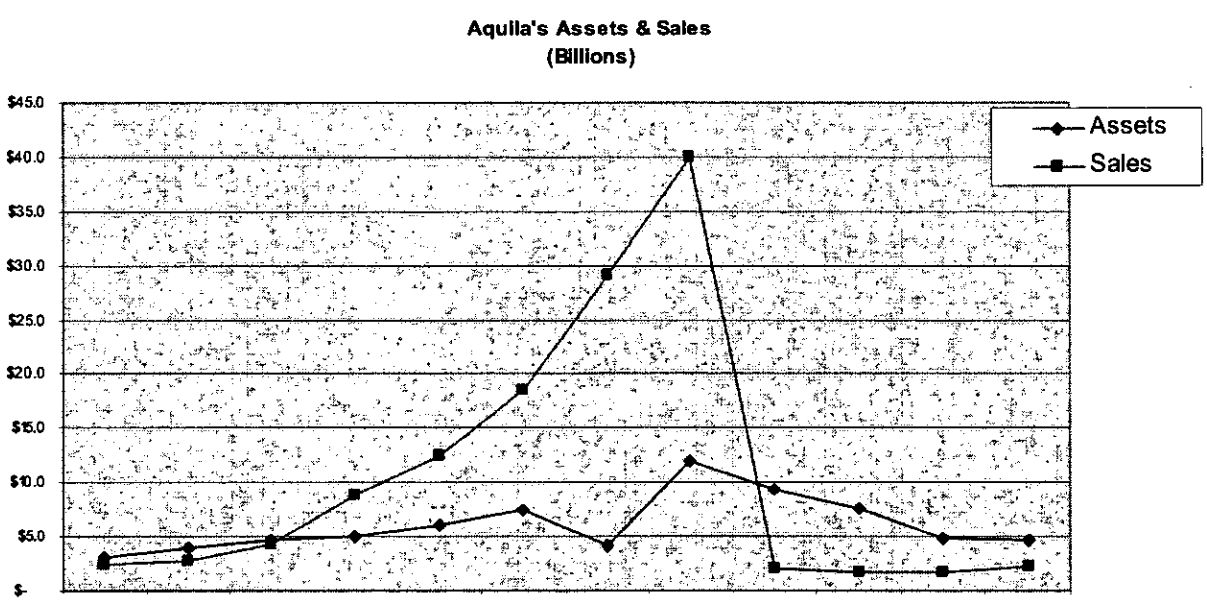
Aquila joined other companies in this business strategy. During the 1990s, utility companies were attempting to diversify their operations through mergers. Utility companies were enlarging their customer base, seeking economies of scale and attempting to acquire benefits of expanding their business internationally. As of December 31, 1997, the Company had $907.9 million invested internationally. (UtiliCorp United Form 10-K, 1997.)

In a reaction to the Enron collapse, Aquila's plan was to step in and grow its business following the fall of this number one player. At the same time, Aquila did not realize the reaction of the rating businesses to the Enron collapse.

Aquila's growth in assets and sales from 1994 through 2005 are shown below:

	Assets (Billions)	Sales (Billions)
1994	$3.1	$2.4
1995	$3.9	2.8
1996	$4.7	$4.3
1997	$5.1	$8.9
1998	$6.1	$12.5
1999	$7.5	$18.6
2000	$14.1	$29.0
2001	$12.0	$40.0
2002	$9.3	$2.0
2003	$7.7	$1.7
2004	$4.8	$1.7
2005	$4.6	$2.2

The graph below demonstrates the dramatic increase of Aquila's assets and sales from 1994 to 2005 and the decline following its decision to exit from the unregulated activities.



Recovery from the Unregulated Activities

On August 6, 2002, Aquila announced that it was totally eliminating all wholesale energy marketing and trading. (Missouri Public Service Commission's Staff Report on Aquila, Inc., December 2002, p. 11.) The Company stopped wholesale energy trading during the third quarter of 2002. (2005 Aquila Annual Report, p. 18.) In Staff's 2002 Annual Report, the Company stated:

> 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. (2002 Aquila Annual Report, p. i).

Mr. Richard Green became CEO of the Company in 1985, the year its name changed to UtiliCorp United, Inc. He stepped down as CEO in 2001, when Mr. Robert Green became the CEO. In October 2002, the Board appointed Mr. Richard Green as Chief Executive Officer and President of Aquila, in order to start the recovery program and rebuild the Company. The Company indicated that Mr. Robert Green has served in no capacity with the Company since early 2002.

Assisting in the recovery program and rebuilding of the Company has been the core group and the Company's Leadership Team. The core group consists of Green, Stamm and Empson and the Leadership Team consists of Mr. Green and his nine direct reports. The recovery program consisted of two components: 1) Determine how the Company would get out of debt, and 2) Determine how the Company would conduct itself within the utility business.

The Leadership Team meets weekly to share information from their various divisions. The EMSD staff requested minutes of the Company's Leadership Team meetings and was informed that there are no minutes taken of these meetings. This team devises strategy plans, although ultimately, Mr. Richard Green determines the strategy of the Company. Strategy information is provided to the Board of Directors at their quarterly meetings or, if necessary, on an as-needed basis. The Company's Business Process Improvements Committee, whose purpose is to oversee, monitor, evaluate and make recommendations regarding the formation, development and operation of the Company's business process improvement program, implemented Six Sigma, a process improvement program, to strengthen its customer service and operational efficiency, as a part of its repositioning program.

The Company stated in 2002 that although the year had been a difficult one, it had exited the merchant energy business, completed $1.3 billion in asset sales, reduced expenses and secured new funding. (2002 Aquila Annual Report, p. iii.) During the August 30, 2006 interview, the Company stated that it had completed its repositioning plan and that it has no intentions of entering the unregulated utility industry. Aquila's current business segments include: 1) Electric Utilities, 2) Gas Utilities, and 3) Merchant Services.

Impacts on Missouri Consumers

While the Staff cannot unequivocally state that Aquila's decisions to invest in unregulated activities have not resulted in any detriment to the Company's Missouri utility consumers, the Staff is not aware of any present detriments to Aquila's Missouri consumers due to its decisions.

Without question, a future sale of Aquila's Missouri electric property or bankruptcy could have rate and service implications to the Company's Missouri consumers. In addition, Aquila, Inc., as any regulated utility, may agree to a revenue requirement amount during rate case settlements or a revenue requirement may be determined by the Commission and the Company, subsequently, may strive to cut costs after rates go into effect in order to use customer revenue for other purposes than what Staff, the Commission or other parties believe they are intended.

It is critical that the quality of service provided by the Company continue to be monitored. In addition, auditing function in conjunction with filed cases should be alert to any cost cutting measures and their potential effects.

Additional Findings and Conclusions

The Staff has no recommendations at this time.

CHAPTER 11 DECISIONS AQUILA MADE THAT INVOLVE ACTIVITY THAT WAS ILLEGAL, INAPPROPRIATE, OR IMPROPER UNDER STATE OR FEDERAL STATUTES OR REGULATIONS

Historical Summary

The Staff requested that the Company identify all formal or informal allegations that it had participated in any activity that was illegal, inappropriate or improper under state or federal statutes or regulations since 1985, the period when Aquila initiated its growth strategy. A portion of the Company's response to this request is attached as Exhibit 2 and includes a confidential listing of all litigation involving Aquila. The Company also referenced a 2004 settlement with the Commodities Futures Trading Commission (CFTC Docket No. 04-08) and the Federal Energy Regulatory Commission (FERC Docket Nos. EL03-138-000 and EL03-181-000) regarding activities by Aquila Merchant. Both of these cases resulted in the payment by Aquila of settlements which permitted the Company to neither admit to nor deny the findings contained within the dockets.

To summarize, the CFTC docket alleged that Aquila Merchant Services (AMS):

> … through several of its trading desks, reported false information, including price and volume information concerning natural gas transactions, to certain reporting firms. Price and volume information is used by reporting firms in calculating published indexes of natural gas prices for various pipeline hubs throughout the United States.

During the period in question, from at least January 1999 through May 2002, the CFTC docket indicated that "AMS trading desks knowingly reported trades that did not occur and reported certain trades at false prices and/or volumes in an attempt to skew the indexes to benefit AMS trading positions." Aquila agreed to pay a total civil monetary penalty of $26,500,000. Missouri PSC Staff auditors have confirmed that none of this settlement payment was included in Aquila's Missouri customer rates.

On June 25, 2003, the Federal Energy Regulatory Commission opened Docket Nos. EL03-138-000 and EL03-181-000 also to address alleged activities by Aquila Merchant Services. These dockets indicate that a FERC "Gaming Order" determined that Aquila Merchant Services may have engaged in three Enron-type strategies in violation of the California Independent System Operator Corporation's (ISO) and California Power Exchange (PX) tariffs during the period of January 1, 2000 to June 20, 2001. These strategies included "False

Importing, Cutting Non-Firm and Circular Scheduling" and resulted in the establishment of Docket No. EL03-138-000. The FERC also, through its "Partnership Order", determined that AMS may have engaged in the False Import Strategy in a partnership with Public Service Company of New Mexico ("PSNM") and established Docket No. EL03-181-000. Aquila, Inc. agreed to pay the amount of $75,975.42 in settlement and did not:

> ... admit that the allegations set forth in the Gaming and Partnership Orders have any merit, or that ... AMS's trading activities violated any governing tariff, regulation, or statute, or adversely affected the price formation process. Payment of the Settlement Amount does not constitute the payment of any refund, penalty, or fine.

Missouri Staff auditors assigned to Aquila's rate cases indicate that none of this settlement payment was included in Aquila's Missouri customer rates.

The Company also indicated that in approximately 2003, two informal inquiries were made by The Office of the New York Attorney General and the California Attorney General's office. The New York Attorney General's Office raised questions regarding Aquila Merchant Services, Inc.'s accounting for prepaid gas contracts and the California Attorney General's office made an informal inquiry into allegations of improper trading by AMS. Aquila indicated that neither of these investigations resulted in any formal allegations being brought against the Company.

Two instances have occurred during the past three years where executive misconduct was alleged. The first instance occurred in May 2003 and is detailed in Aquila's March 8, 2004, Form 8-K filing with the United States Securities and Exchange Commission (SEC). A letter containing the allegations (Exhibit 3) was presented to Aquila's Board of Directors, signed by "Aquila Employees Who Believe in the Code and are Fed Up with Greed and Dishonesty." Copies were sent to the Federal Bureau of Investigation (FBI), the SEC, the Kansas City Star and the Kansas City Business Journal. To the Staff's knowledge, no cost of the investigations have been requested by Aquila or included in customer rates, but Staff does have a pending data request in to the Company to verify (Exhibit 4).

The Company's Form 8-K filing summarizes the allegations of the letter in the following way:

> The May 12 letter alleges that (1) the Company's 2000 and 2001 financial results were manipulated in order to increase executive bonuses, (2) certain executives and employees of the Company and three Australian

corporations in which Aquila previously held an indirect minority stock interest engaged in improper related-party or self-dealing transactions in Australia; (3) certain executives of the Company engaged in unlawful efforts to influence foreign government officials and provided false financial information to banks, investors and the Aquila Board in connection with the purchase of government-owned natural gas distribution assets in the Melbourne area; and (4) the Company engaged in undisclosed related-party real estate transactions with Company executives.

The Board referred the letter to the Company's Audit Committee for an independent investigation. A copy was also sent to the Securities and Exchange Commission which opened up an inquiry and asked the Company to retain documents relevant to the allegations made in the letter. The Audit Committee retained Latham & Watkins, LLP to provide legal assistance, Navigant Consulting, Inc. to provide forensic accounting services and Kroll Zolfo Cooper LLC to provide information technology consulting services. The Committee also retained counsel from the Australian law firm of Abbott, Stillman and Wilson to advise it with regard to certain issues of Australian law. Page 2 of Form 8-K concludes that the allegations of the May 12th letter were without merit.

In October 2005, an anonymous source contacted the Staff of the Missouri Public Service Commission and made six allegations regarding inappropriate behavior on the part of current and former Aquila employees and its Board of Directors. Staff completed a comprehensive investigation into these allegations, which the Commission ordered the Staff to report on as item number 6 in its "Order Requiring A Management Audit of Aquila, Inc. And Specifying the Issues To Be Addressed," Case No. EO-2006-0356. The Staff's report is included as the final chapter of this Management Audit Report. The separate report is entitled "Missouri Public Service Commission Staff Report On The Investigation of Aquila, Inc. Regarding Allegations Relating To Matters Of Aquila's Management And Board of Directors."

Impacts On Missouri Consumers

Based upon the findings resulting from various investigations into Aquila and the ratemaking and service quality protections provided to the Company's customers, it is the Staff's conclusion that allegations of illegal, inappropriate or improper activities have had minimal tangible impact to Aquila's Missouri consumers. While the Staff cannot unequivocally state that there has been no impact to Missouri consumers regarding any alleged illegal, inappropriate or improper activities, ratemaking has provided insulation to Missouri consumers from settlement payments made to federal regulatory bodies and the Company's legal and investigation fees resulting from alleged activities.

Further, oversight and regulatory responsibilities of the SEC, CFTC, FERC and the MoPSC have provided investigations into alleged illegal, inappropriate or improper activities. These investigations have concluded with determinations that either past allegations were without merit or monetary settlements were reached that had no rate implications for Aquila's Missouri customers.

What is more difficult to measure is the impact negative public perception has had on Aquila's customers. A shadow of doubt and question continues over Aquila even as it reports a program of recovery to restore its financial health.

The Missouri Public Service Commission Staff will continue to carefully monitor the Company and recommend what it believes are appropriate actions and remedies to the Commission in the event future illegal, inappropriate or improper activities are raised.

Additional Findings and Conclusions

The staff has no recommendations at this time.

AQUILA, INC.
AQUILA NETWORKS-MPS
MISSOURI MANAGEMENT AUDIT
CASE NO. EO-2006-0356
MISSOURI PUBLIC SERVICE COMMISSION
DATA REQUEST NO. MPSC-0002

DATE OF REQUEST: July 4, 2006

DATE RECEIVED: July 4, 2006

DATE DUE: July 24, 2006

REQUESTOR: Lisa Kremer

QUESTION:

With reference to page 2, item 8) of the MPSC's order in EO-2006-0356, please specifically describe all efforts Aquila has made to protect its regulated activities from the Company's involvement in unregulated activities since 1985.

RESPONSE: The Company has instituted several major initiatives to shield its regulated operations from non-regulated business since the mid 1980's as discussed below:

1.) Aquila instituted a capital assignment process shortly after its formation in the mid-1980's that was specifically designed to insulate each of its utility divisions from other operations of the company. Aquila's regulated utility operating units receive capital based upon costs at investment grade levels and percentages comparable to what peer utility companies receive. We have presented this process to state commissions in every rate case since 1988.
2.) Aquila has committed to the proper identification of allocated costs and to the creation of a more transparent structure to facilitate review of our operations. For the costs that are allocated, Aquila maintains a detailed Cost Allocation Manual that is revised annually or more frequently if a material change takes place. In addition, the Company maintains detailed affiliate transaction reporting, procedures and monitoring in compliance with Commission rules.
3.) Non-regulated and certain other corporate costs are identified and coded by accounting. These costs will not be charged to the regulated operations and will be absorbed by the corporate retained departments.

ATTACHMENT(S): NA

ANSWERED BY: Mark Reed

DATE ANSWERED: 7/21/06

NP

Exhibit 1
Attachment 1-108

EXHIBIT 2

IS DEEMED

HIGHLY CONFIDENTIAL

IN ITS ENTIRETY

May 12, 2003

Aquila Board of Directors:

A recent quote from Rick Green in a communication to all Aquila employees: "Aquila established a set of values and requires employees to be trained on its Code of Business. It also should be apparent that we depend on everyone to be aware of what is happening around us and to speak up when we believe that our values or our code is being violated."

The code has been repeatedly violated and we are speaking up. Please fully investigate these improper activities by Aquila (NYSE: ILA) executives and take appropriate action:

Rick Green (Aquila CEO), Bob Green (former Aquila CEO), Keith Stamm (Aquila COO) and Dan Streek (former Aquila CFO) falsified 2000 and 2001 reported earnings to increase executive bonuses. The four collectively received bonuses of more than $30 million for 2001 performance. Financial results were falsified through manipulation of mark-to-market and mark-to-model earnings, fabrication of transactions with trading counter parties, and creative purchase accounting adjustments. These same individuals certified and signed the 2000 and 2001 financial statements. These inflated earnings were largely reversed or restated in 2002, however no change has been made to reverse past executive bonus payments.

In an effort to increase executive compensation and Fortune 500 ranking, reported revenues were changed from a method that recognized only net margins on large energy sales transactions torecognition of gross sales amounts. This caused an increase in reported revenues from approximately$2 billion to $40 billion without any substantive change in underlying business activity or profitability. As a result in the change in revenue reporting, Aquila moved from not being ranked in the Fortune 500 to a #33 ranking. Compensation surveys and benchmarks typically utilize Fortune 500 rankings to determine appropriate executive salary levels. This change served to significantly increase executive compensation without any real improvement in business fundamentals. The true reason for the change in revenue reporting was never disclosed to Aquila shareholders. Rick Green and Leo Morton (Aquila Chief Administrative Officer) discussed the reasons for the reporting change internally and highlighted the beneficial impact on executive compensation.

Keith Stamm (while CEO of United Energy, an Aquila subsidiary located in Melbourne, Australia) participated in several illegal schemes to divert company funds for his personal benefit and the benefit of other executives:

- Peter Dean, former Manager of United Energy Information Technology, hired his brother to perform system development services for the company and directed several million dollars in improper payments to him. These payments were then distributed to Mr. Dean, Mr. Stamm and other United Energy employees.

- Keith Ondarchie, former CEO of the UEComm subsidiary, improperly directed payments to be made to vendor companies owned or controlled by Mr. Ondarchie for his personal benefit and the benefit of other United Energy and UEComm employees. Mr. Stamm supported and participated in these illegal activities. Additionally, Mr. Ondarchie was paid over $3 million by Mr. Stamm when he left the organization to remain silent.

- Wes Ferguson, former CEO of the UtiliMode subsidiary, improperly directed payments (several hundred thousand dollars) to related party vendors for the personal benefit of Mr. Ferguson, Mr. Stamm and other United Energy employees.

Keith Stamm and Paul Perkins (former head of Aquila Corporate Development) directed an effort to bribe foreign government officials and to submit false information to banks, investors, and the Aquila Board, regarding the purchase of MultiNet in Melbourne, Australia. Numbers were falsified to improve financial forecasts to convince financial institutions and investors to fund the project. Payments to government officials were made in the form of "gifts," promises of future employment, and cash – and were made directly and through Deutsche Bank Investment Banking personnel.

Real estate transactions have been structured through Zimmer Real Estate that allowed property to be acquired and then resold or leased to Aquila at a profit for the benefit of Rick and Bob Green. Leo Morton secretly arranged these deals for the personal enrichment of the Greens, Mr. Morton, and others. These related party deals were not properly disclosed and approved by the Aquila board, shareholders or regulatory agencies.

These facts are verifiable through the company or from current and former employees.

Signed,

Aquila Employees Who Believe in the Code and are Fed Up with Greed and Dishonesty.

cc: Federal Bureau of Investigation (FBI)
Securities and Exchange Commission (SEC)
Kansas City Star
Kansas City Business Journal

Missouri Public Service Commission

Data Request

Data Request No.	0139
Company Name	Aquila Networks-Investor(Electric)
Case/Tracking No.	ER-2007-0004
Date Requested	9/5/2006
Issue	General Information and Miscellaneous - Company Information
Requested From	Gary L Clemens
Requested By	Chuck Hyneman
Brief Description	Payments for fines, penalties, investigations
Description	1. Did Aquila seek rate recovery of any costs of any of the investigations it has undergone in the last ten years, including investigations ordered by its Board of Directors as a result of charges of illegal or unethical conduct on the part of Aquila management? If so, please describe. 2. Did Aquila seek rate recovery of any penalties, fines or settlements it paid to any regulatory body (such as the CFTC, FERC, SEC, etc.) in the last ten years? If so, please describe. 3. Is Aquila aware if any of the types of payments described in Nos. 1 and 2 above were previously or are currently included in its Missouri jurisdictional utility rates?
Due Date	9/25/2006

The attached information provided to Missouri Public Service Commission Staff in response to the above data information request is accurate and complete, and contains no material misrepresentations or omissions, based upon present facts of which the undersigned has knowledge, information or belief. The undersigned agrees to immediately inform the Missouri Public Service Commission Staff if, during the pendency of Case No. ER-2007-0004 before the Commission, any matters are discovered which would materially affect the accuracy or completeness of the attached information.

If these data are voluminous, please (1) identify the relevant documents and their location (2) make arrangements with requestor to have documents available for inspection in the Aquila Networks-Investor(Electric) office, or other location mutually agreeable. Where identification of a document is requested, briefly describe the document (e.g. book, letter, memorandum, report) and state the following information as applicable for the particular document: name, title number, author, date of publication and publisher, addresses, date written, and the name and address of the person(s) having possession of the document. As used in this data request the term "document(s)" includes publication of any format, workpapers, letters, memoranda, notes, reports,analyses, computer analyses, test results, studies or data, recordings, transcriptions and printed, typed or written materials of every kind in your possession, custody or control or within your knowledge. The pronoun "you" or "your" refers to Aquila Networks-Investor(Electric) and its employees, contractors, agents or others employed by or acting in its behalf.

Security	Public
Rationale	NA

Exhibit 4

NP

MISSOURI PUBLIC SEVICE COMMISSION

STAFF REPORT ON THE INVESTIGATION

OF AQUILA, INC. REGARDING

ALLEGATIONS RELATING TO MATTERS

OF AQUILA'S MANAGEMENT

AND BOARD OF DIRECTORS

August 21, 2006

THE FOLLOWING REPORT IS HIGHLY CONFIDENTIAL IN ITS ENTIRETY

NP