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April 30, 2003

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
P.O. Box 360
Jefferson City, Missouri 65102

FILED³

APR 30 2003

Re: Aquila, Inc.

**Missouri Public
Service Commission**

Dear Mr. Roberts:

On behalf of Aquila, Inc., I deliver herewith for filing with the Missouri Public Service Commission an original and eight (8) copies of the following:

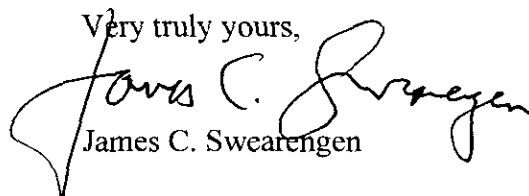
- An Application of Aquila, Inc. for Authority to Assign, Transfer, Mortgage or Encumber its Franchise, Works or System;
- Direct Testimony of Jon R. Empson;
- Direct Testimony and NP Schedules of Rick Dobson; and,
- A Motion for Protective Order.

When the Commission issues the requested Protective Order, the Highly Confidential Schedules of Rick Dobson will be filed.

A copy of the application, testimonies and motion will be served on the Commission's General Counsel and the Office of the Public Counsel.

Would you please bring this filing to the immediate attention of the appropriate Commission personnel. Thank you very much for your assistance and cooperation.

Very truly yours,


James C. Swearingen

Enclosures

cc: Dan Joyce
John Coffman

Exhibit No.:

Issue:

Witness:

Sponsoring Party:

Type of Exhibit:

Case No.:

Date Testimony Prepared: April 30, 2003

Encumbrance of Missouri
Assets

Jon R. Empson

Aquila, Inc.

Direct Testimony

MISSOURI PUBLIC SERVICE COMMISSION

DIRECT TESTIMONY

OF

JON R. EMPSON

ON BEHALF OF

AQUILA, INC.

FILED³

APR 30 2003

**Missouri Public
Service Commission**

April 30, 2003

1 **BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION**
2 **OF THE STATE OF MISSOURI**
3 **DIRECT TESTIMONY OF JON EMPSON**
4 **ON BEHALF OF AQUILA, INC.**
5

6 Q. What is your name and current position with Aquila, Inc. ("Aquila" or "Company")?

7 A. My name is Jon Empson, and I currently hold the position of Senior Vice President,
8 Regulatory, Legislative, and Gas Supply Services for the Aquila Networks business
9 unit.

10 Q. Mr. Empson, please provide the Missouri Public Service Commission ("Commission")
11 with a brief description of your educational background and business experience.

12 A. I hold a BA in Economics from Carleton College in Northfield, Minnesota and an MBA
13 from the University of Nebraska at Omaha. I have been with the Company since 1986
14 holding various officer positions both within the operating divisions and at Corporate.
15 Prior to my employment with the Company, I spent seven years (1979 – 1986) at
16 Enron (formerly Northern Natural Gas) as Manager of Public Affairs for Northern
17 Natural Gas, Vice President of Administration for Northern Plains/Northern Border and
18 Vice President of Administration for Northern Liquid Fuels. From 1972 – 1979, I held
19 various positions at the Omaha Chamber of Commerce including Manager of Research
20 for the Omaha Economic Development Council, Executive Director for Downtown
21 Omaha Inc., and Executive Director for the Omaha Economic Development Council.

22 Q. What is the purpose of your testimony?

23 A. As mentioned by Aquila witness Rick Dobson in his testimony, Aquila has been and will
24 continue to be focused on providing excellent service to its utility customers. Aquila
25 has also designed its financial plan, which is Schedule RD-1 in Mr. Dobson's
26 testimony, to avoid having an adverse impact on its customers.

27 Q. Has Aquila formally stated this commitment to protect the utility customers?

1 A. Yes. On pages 2 – 3 of the financial plan, Aquila states the following:

2 “During both Phase I and Phase II of its financial restructuring plan, Aquila has
3 maintained and will continue to maintain its focus on three key business principles:

4 **1. Protect utility customers from potential adverse financial impacts.**

- 5 ▪ Maintain the Aquila capital allocation process that utilizes “hypothetical”
6 capital structures and long-term debt assignments.
- 7 ▪ Price new/replacement debt to utility divisions at comparable BBB
8 credit rating.

9 **2. Maintain quality customer service.**

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

13 **3. Enhance regulatory transparency**

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

19 Q. Please discuss these three key business principles. First, regarding how Aquila
20 protects utility customers from potential adverse financial impacts, can you provide
21 more detail about Aquila’s capital allocation process?

22 A. Yes. Aquila has maintained a capital allocation process since 1988 that was
23 specifically designed to insulate and separate each of its utility divisions from the other
24 activities of Aquila. Aquila has not changed, and does not intend to change, this
25 practice. Aquila’s regulated utility operating units receive capital based upon what a
26 comparable utility would receive, and this process has been presented to the

1 Commission in every rate case since 1988. The intent has always been to financially
2 "ring-fence" the utility operations from Aquila's non-utility business.

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

4 A. Each business unit was internally financed with the proper mix of capital reflecting
5 economic activities, profiles, and market based comparative capital structures. For
6 electric distribution, the assigned, or hypothetical capital structure was 47.5%
7 equity/52.5% long-term debt and for gas distribution, 50% equity/50% debt. UtiliCorp
8 and later Aquila assigned, based upon need, specific debt issuances to those business
9 units receiving the proceeds of the issuance and that assignment is not changed until
10 corporate retires the series.

11 Q. Has the divisional or hypothetical capital structure approach been acknowledged by
12 any of the state regulatory commissions in which Aquila has operations as an effective
13 mechanism to help shelter utility operations from non-utility operations?

14 A. Yes, in recent investigations completed by the staffs of the Kansas Corporation and
15 Missouri Commissions' respectively, the following statements were made:

16 Kansas Docket No. 02-UTCG-701-GIG: Staff Report, page 14, paragraph 43:

17 *"How are Aquila's utility customers protected from the risks associated with UCU's*
18 *investments in or relationships with unregulated activities, whether such protections are*
19 *adequate and, if not, what protections should be instituted?"*

20 43. Hypothetical Capital Structures and Rate of Return in Rate Cases

21 *The purpose of using hypothetical capital structures is twofold; a) establishes*
22 *capital costs that are not influenced by the risks of non-regulated businesses, and b)*
23 *determines a rate of return that is adequate to provide sufficient and efficient utility*
24 *services."*

25 Missouri Public Service Commission's Staff Report on Aquila, Inc., pages 21; 27:

1 *"To prevent or mitigate Aquila's higher cost of capital from being charged to Missouri's*
2 *ratepayers, the Commission can order the use of a hypothetical capital structure for*
3 *rate making purposes to determine the mix of debt and equity that is appropriate for*
4 *MPS and/or L&P. The capital structure would not be dependent on the capital structure*
5 *currently in effect for Aquila."*

6 *"Instead of using Aquila's actual cost of debt and equity, the Commission could impute*
7 *debt and equity rates that it considers reasonable for Aquila's Missouri utilities."*

8 *"Specific examples of mechanisms that can be used to help prevent increased capital*
9 *costs being passed onto the MPS and SJLP ratepayers are: use of a hypothetical*
10 *capital structure, adjustments to embedded costs of debt and preferred stock,*
11 *adjustments to cost of equity estimates, use of comparable companies (to more closely*
12 *reflect the cost of capital for a regulated utility versus a diversified energy company)."*

13 Q. Do you agree with the comments contained in both the Kansas and Missouri reports?

14 A. Yes. The statements made are consistent with the capital allocation process Aquila
15 has been using for the past 15 years. The reports are also consistent with how Aquila
16 plans to continue to operate in the future. In fact, Aquila restated its commitment to
17 protect its utility customers in a letter sent to the Minnesota Public Utilities Commission
18 on August 26, 2002 stating: "Aquila acknowledges that (a) Minnesota ratepayers
19 should pay no more for debt costs than would be incurred by an investment grade
20 utility, and (b) the Commission has the authority during the ratemaking process to use a
21 hypothetical debt structure to address debt costs higher than those of an investment
22 grade company, if such a case arises."

23 Q. Does Aquila plan to maintain this assigned capital structure process during this period
24 of transition?

25 A. Yes. Aquila will maintain the comparable company debt/equity ratios and its current
26 long-term debt assignment process. Aquila has never intended, and does not intend,

1 to ever allocate more debt to its utility operations than what can be supported by its
2 comparable utilities analysis.

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

5 A. First, consistent with past practices, it is Aquila's intent to maintain a capital allocation
6 and cost process that reflects comparable utilities. It is Aquila's position that its
7 customers should continue to be charged debt costs that reflect representative costs
8 for comparable utilities with a BBB investment grade credit rating. As Mr. Dobson
9 explains in his testimony, Aquila has made this same commitment for the use and
10 pricing of the working capital that will be drawn, by the utility divisions, from the 3-year
11 term loan.

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

14 A. Aquila remains committed to continue delivering quality services to its customers.
15 Towards this goal, Aquila has developed internal service quality metrics. These
16 metrics include such functions as meter reading accuracy, emergency response time,
17 safety, SAIDI, SAIFI, CAIDI, generation availability, heat rates, and call center
18 performance. Aquila is also committed to work with (StateCommission) to modify its
19 current internal service quality metrics to reflect areas of specific concern. Every state
20 Operating Vice-President provides written status reports on a monthly basis and
21 detailed reviews of service quality performance for the state are conducted with
22 Aquila's Chief Operating Officer on a quarterly basis.

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

25 A. In the mid 1990s Aquila made the decision to centralize its utility operations in order to
26 gain economies from transitioning to common accounting and billing systems,

1 standardized operational practices, and common executive management. Having
2 achieved these economies, Aquila has now implemented a state-based utility
3 organization that is focused on taking advantage of the common platforms and on
4 providing excellent service to its customers. By reducing allocated costs and creating
5 an operational focus in the state, Aquila is trying to achieve a more transparent utility
6 structure, which should ultimately facilitate the Commission's understanding and review
7 of our operations.

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

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

15 Q. What about Aquila's affiliate transaction practices?

16 A. Aquila initiated detailed affiliate transaction procedures, monitoring, and reporting in
17 2000 in response to a new regulation in Missouri. However, Aquila made the decision
18 to apply the affiliate transaction process across all state jurisdictions in order to instill a
19 transactional discipline that we felt was important for demonstrating our commitment to
20 properly price the provision of services or sale of assets between utility and nonutility
21 affiliates. As Aquila executes its financial plan and reaches its "end-state" as basically
22 a seven-state domestic utility, Aquila will continue to maintain and update its current
23 affiliate transaction policy and procedures process to assure compliance with state law.

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

25 A. Aquila has developed a Code of Business Conduct ("Code") to provide employees
26 essential guidelines to help understand behavioral responsibilities. Employees acting

1 ethically and with integrity help Aquila become a good place to work for employees, a
2 good provider of products and services for our customers, a good investment for our
3 shareholders, and a good citizen in our communities. The Code is on the Company's
4 intranet so that all employees can access this information. In order to emphasize key
5 elements of the Code, Aquila also initiated, in 2001, required on-line, computer-aided
6 training. Ten training modules have been implemented and all current and new
7 employees are required to complete the modules.

8 Q. Do you have some concluding comments?

9 A. Clearly, Aquila understands and appreciates the sensitivity the Commission might have
10 about this request to use utility assets to secure utility debt. However, while Aquila
11 accepts full responsibility for its past strategy, Aquila is also taking full responsibility for
12 restoring financial stability without adversely impacting the customer. Aquila believes
13 that the guiding principles we outlined in the financial plan and presented in my
14 testimony today provide the required protection. By enabling Aquila to maintain
15 adequate working capital by approving this application, the Commission is providing
16 Aquila with the necessary support to execute its financial plan.

17 Q. Does that conclude your testimony?

18 A. Yes it does.

VERIFICATION

STATE OF MISSOURI)
) ss.
COUNTY OF Jackson)

I, Jon R. Empson, having been duly sworn upon my oath, state that I am the Senior Vice President, Regulatory, Legislative and Gas Applied Services, of Aquila, Inc.; that I am authorized to make this affidavit on behalf of Aquila, Inc., and that the matters and things stated in the foregoing testimony and schedules thereto are true and correct to the best of my information, knowledge and belief.

Jon R. Empson

Signed and sworn to before me, the undersigned notary public, on this 29 day of April, 2003.

Teresa A. Keefe
Notary Public

My Commission Expires: October 31, 2005

