

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

In the Matter of a Management Audit of                   )  
Aquila, Inc. d/b/a Aquila Networks-MPS                   )  
and Aquila Networks-L&P   )

Case No. EO-2006-0356

**STAFF’S RESPONSE TO PUBLIC COUNSEL’S RESPONSE TO COMMISSION  
ORDER DIRECTING PUBLIC COUNSEL TO CLARIFY ITS REQUEST  
FOR A MANAGEMENT AUDIT OF AQUILA, INC.**

Comes now the Staff of the Missouri Public Service Commission (Staff) in response to the Office of the Public Counsel’s (Public Counsel) response to a Commission Order directing Public Counsel to clarify its Motion to open a new case to conduct a management audit of Aquila, Inc. Based upon Public Counsel’s March 28, 2006 response providing clarification, the Staff sees no need to alter anything that it stated in its March 20, 2006 filing. Given the brevity of the Public Counsel’s response, the Staff will attempt to not repeat the content of its prior filing and suggests that Staff’s prior filing should be reviewed for Staff’s complete response to Public Counsel’s Motion. The Staff continues to believe that what the Public Counsel is requesting that the Commission direct the Management Services Department to perform is not a “management audit” as that term has been generally used at the Commission respecting the activity of the Management Services Department and the other departments at the Commission. Rather than suggesting that the Commission order a prehearing conference as previously proposed, the Staff suggests that the Commission issue an Order indicating the areas and matters it wants investigated and/or audited and the timeframe, if otherwise than in the manner indicated and suggested generally in Paragraphs 11 and 13 below. In support thereof, the Staff states as follows:

1. The Staff is not trying to minimize its workload or slight the matters addressed by Public Counsel. The Staff is attempting to prioritize its work when an unprecedented number of rate cases and other significant cases have been filed, are about to be filed, or will be filed in the near future. In addition to a variety of other projects, Management Services personnel are presently engaged in a comprehensive customer service audit of one of the large energy utilities regulated by the Commission. Such audits frequently result in a number of Management Services Department recommendations for improvement in operations with respect to billing, credit and collections, meter reading, payment remittance, call center, work order and service disconnection and reconnection activities. The Staff is well aware of the limited resources of the Office of the Public Counsel, but Public Counsel is attempting to impose its agenda on the Commission and has not offered to provide any resources itself. Public Counsel has recently filed in the KCPL rate increase case, Case No. ER-2006-0314, signed nondisclosure agreements of the members of a consulting firm that Public Counsel evidently is using in that case. The Public Counsel has given no indication of a commitment of any resources in the “management audit” docket that it requests that the Commission pursue against Aquila.

2. Just because the Staff is comprised of more individuals than the Office of the Public Counsel does not mean that surely there are Commission employees available to engage in a management audit of Aquila. Although others might not agree with the following statement, the Staff too operates with limited resources. Not every item brought to the Commission by a utility, Public Counsel, some other external entity or person, or a Commissioner or Commissioners can have the same priority. In fact, by statute the processing of rate cases is the Commission’s number one priority: Section 393.150.2 RSMo states, in relevant part, that the

Commission shall give to the hearing and decision of a rate proposed to be increased “preference over all other questions pending before it and decide the same as speedily as possible.”

3. The Commission attempted to obtain detail from the Public Counsel respecting Public Counsel’s March 16, 2006 Motion to commence a management audit of Aquila, and the Commission received a one and one quarter (1 ¼) page response. There are no Commission auditors sitting around waiting for the Public Counsel to request, and the Commission to order, a management audit of Aquila in order for them to have assignments and work to perform. Pursuant to Section 393.140(9), the Commission has the power to require “specific answers to questions upon which the commission may need information.” As Public Counsel indicated in its March 16, 2006 Motion, it is anticipated that Aquila will file its next rate case in early July 2006. Thus, although the Commission as a result of Public Counsel’s Motion, or on its own motion, certainly can direct the Staff to conduct an investigation regarding certain matters, the Commission can also, or instead, direct Aquila to address certain matters as part of the general rate increase filing that it is anticipated Aquila will make in the near future.

4. The answer filed by Public Counsel on March 28, 2006 is incredibly brief. From the Staff’s perspective, the brevity of Public Counsel’s response is not because (a) anyone with any familiarity with state utility regulation knows what a “management audit” is, and, therefore, there is no need for Public Counsel to provide detail as to what it is requesting, or (b) it is obvious that the Aquila actions cited by Public Counsel in its initial filing warrant what Public Counsel calls a “management audit.” Public Counsel in its short response has confirmed for the Staff that what Public Counsel is requesting is not a “management audit” as that term is generally used by the Staff, and is not a management audit as that term has been generally used by the Commission. Management audits have been forward looking, i.e., they have not been

investigations of discrete prior utility acts, but have generally involved comprehensive reviews of management processes with the purpose of making recommendations so as to improve future performance.

5. The Staff agrees with Public Counsel's characterization of the Commission's Management Services Department as "a group of trained professionals whose purpose is to investigate the management practices of Missouri's regulated utilities," but what Public Counsel appears to be requesting would not be left solely to be staffed by the Commission's Management Services Department. Other Commission departments including Staff accountants, engineers, economists and financial analysts would need to be involved and the audit would not take merely "approximately eight months." (Of course, if the Commission directed the Staff to spend no more than eight (8) months on the project, the Staff would complete the project within eight (8) months.)

6. For example, the Staff would view a comprehensive management audit of an electric utility as the management audit that was performed regarding Union Electric Company (UE) in Case No. EO-84-73, after the case cited by Public Counsel in its initial pleading, Case No. ER-83-163, not the management audit of Raytown Water Company, Case No. WO-93-194, also cited by Public Counsel in its initial filing. The Commission ordered a management audit of Raytown Water Company stating in its September 8, 1992 Report And Order in *Re Raytown Water Co.*, Case No. WR-92-85, 1 Mo.P.S.C.3d 367, 387 (1992): "The Commission determines that enough questions have been raised during the course of these proceedings to justify the Commission Staff conducting a management audit of the Company." On January 6, 1993 the Commission issued an Order Authorizing Management Audit of Raytown Water Company in Case No. WO-93-194, and approximately fourteen (14) months later, on March 1, 1994, the Staff

filed its Management Audit Report. Although the Commission commented in its Raytown Water Company Report And Order that “[i]t bears repeating that that this Company is basically ‘family’ owned and operated,” what occurred respecting Raytown Water Company and what Public Counsel is requesting regarding Aquila do not appear to be similar, and the utilities are not similar. 1 Mo.P.S.C.3d at 380. The Staff’s report filed in Case No. WO-93-194 notes at page 4 that Raytown Water Company had 6,700 customers at the time of the Staff’s management audit. As of December 31, 2004, Aquila had approximately 295,000 electric customers being served by Aquila Networks – MPS and Aquila Networks – L&P.

7. The Arthur Young Management Audit of UE in Case No. EO-84-73 is what the Staff would refer to as a comprehensive management audit of a large electric utility. The Staff believes that it would be beneficial for it to provide more detail about that management audit of UE. The Commission Report And Order cited by Public Counsel directing a management audit of UE was issued on October 21, 1983. The resulting Arthur Young Management Audit Report was filed with the Commission on July 3, 1986. The Arthur Young Management Audit Report shows a chart entitled as, and containing the information, indicated below:

UNION ELECTRIC COMPANY MANAGEMENT AUDIT  
Percent Level of Effort Expended by Functional Area

<u>Functional Area</u>	<u>Level of Effort Percent</u>
1. Project Initiation	1.1%
2. Organization	1.9%
3. Corporate and Operations Planning	6.6%
4. Engineering and Construction	8.5%
5. Fuels	6.5%
6. Power Operations	8.2%
7. Nuclear Operations	11.0%
8. Transmission and Distribution	9.2%
9. Customer Services	9.3%
10. Financial Systems	6.0%
11. Rates	1.6%

12. Financial (productivity)	4.7%
13. Computer Services	5.6%
14. Employee Relations	2.1%
15. Industrial Relations	0.4%
16. Public Relations	0.5%
17. General Counsel	0.3%
18. Purchasing	3.0%
19. Stores	1.7%
20. Motor Transportation	0.8%
21. Environmental, Safety, and Health	0.4%
22. Project Management	8.9%
23. Final Report	<u>1.7%</u>
	100.0%

(Audit Report, Exhibit II-1). The audit report states that “[a]pproximately 390 interviews were conducted with UE personnel, many of them more than once. Over 540 formal requests were made to review and analyze UE internal documents.” (Audit Report, page II-4).

8. There is a paragraph in the Arthur Young Management Audit Report entitled “Tone Of This Report,” which states as follows:

We have assumed that the purpose of the audit is to provide the PSC with a balanced and objective assessment of UE’s performance. Therefore, this report cites many instances of good performance, as well as opportunities for improvement. By its nature, the audit devotes more attention to opportunities to improve than it does to strengths and accomplishments. The reader is cautioned not to construe this emphasis as an indication that opportunities for improvement outweigh strengths and accomplishments. Indeed, in many areas, UE performance is exemplary; in others, change is required to improve performance.

(Audit Report, page II-5).

9. The Arthur Young Management Audit Report identified six major areas for potential improvement as follows:

- (1) Reduce coal and oil inventory levels.
- (2) Expand the scope of the capacity planning process to include the consideration of alternate resource capacity options.
- (3) Improve labor resource utilization within the Power Operations, Transmission and Distribution (T&D), and Controllers’ Functions

- (4) Develop a comprehensive information systems plan and improve system development methods
- (5) Renegotiate the cost of bank fees and refine cash management practices
- (6) Develop a strategic management planning process

10. Public Counsel identified several distinct acts or areas of conduct/performance in its March 16, 2006 filing which it contended warranted a management audit of Aquila:

- (1) Aquila's 2003-2004 case to encumber its utility franchise works or system in order to secure revised bank financing arrangements, Case No. EF-2003-0465;
- (2) Recent awarding of millions of dollars of bonuses to members of Aquila's management;
- (3) Aquila's failure to fund its Other Post-Employment Benefits (OPEBs) which was the subject of Public Counsel's complaint case, Case No. EC-2006-0171; and
- (4) South Harper Station generating facilities.

And in response to the Commission's question "what sort of remedy Public Counsel believes the Commission could impose after the results of the audit are known," Public Counsel responded as follows on March 28, 2006:

If the results of the audit show - as Public Counsel is confident they will - that Aquila suffers from significant mismanagement, the Commission can make adjustments in Aquila's next rate case. For example, it could reduce or eliminate management salaries. It could make a specific downward adjustment to Aquila's allowed return on equity, as the markets would do to a mismanaged competitive firm. While there may be other remedies, it is premature to speculate on what they might be before any audit is begun.

11. Regarding the discrete actions of Aquila identified by Public Counsel, the Commission can expect the following from the Staff in future Aquila rate cases.

- (1) Respecting Aquila's encumbrance/collateralization case, Case No. EF-2003-0465, since the Commission did not authorize the relief requested by Aquila, there is no further action required by the Staff.
- (2) Respecting management salaries and incentive compensation/bonuses, these are matters that the Staff always looks at in a rate case audit, and in the past the Staff has proposed adjustments, some of which have been accepted by the Commission and others of which have been rejected by the Commission.
- (3) Respecting Public Counsel's OPEBs complaint case, Public Counsel, on March 24, 2006, filed with the Commission in Case No. EC-2006-0171 a Notice of Dismissal requesting that the Commission dismiss Public Counsel's complaint and close the case. The Staff will determine in the context of Aquila rate cases whether Aquila is staying current with funding its OPEBs obligations. The Staff will propose an appropriate adjustment and /or other action if Aquila is not staying current.
- (4) Respecting Aquila's capacity and energy needs and the South Harper Station, the Staff, in Case No. ER-2005-0436 and on an ongoing basis, will impute to Aquila a peak load generating facility prudently built by Aquila and in lawful operation by the summer of 2005 represented by five combustion turbine generators capable of generating at least 500 MWs of peak load energy. (Aquila, in the Nonunanimous Stipulation And Agreement in Case No. ER-2005-0436, agreed that in future rate cases, regarding the 315 MWs of peak load capacity represented by the South Harper Station, it will not seek in rates an allowance greater than the depreciated value (including deferred taxes) of 315 MWs of peak load generation, with an original rate base value of \$140 million, plus any capital additions booked to the South Harper Station for expenses and liabilities incurred after October 31, 2005.)<sup>1</sup>

The Management Services Department recently completed a comprehensive audit of Aquila's customer service processes and operations. The final Staff report includes 52 recommendations to Aquila management for improvement in Aquila's billing, credit and collections, meter reading, payment remittance, call center, work order, and service disconnection and reconnection processes. The Staff has received Aquila's implementation plan in response to the Staff's

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<sup>1</sup> Aquila's resource planning filing under Chapter 22 of the Commission's rules is scheduled to be made by Aquila in early February 2007.



recommendations, and the Staff will receive this summer Aquila's first status report regarding progress on it implementing the Staff's 52 recommendations.

12. There are provisions of the Public Service Commission Law which specifically authorize penalties for violation of the Public Service Commission Law and authorize the Commission to seek recovery of said penalties.<sup>2</sup> The Staff is concerned that what the Public Counsel ultimately seems to be proposing is that the Commission direct the Staff to pursue a course of action that, apparently in Public Counsel's view, will lead to the Commission levying penalties, other than those provided for by the Public Service Commission Law, for Aquila's prior conduct and the Commission also taking action against Aquila's management that goes beyond mere financial adjustments. The Staff is concerned that what Public Counsel seems to be proposing with its request for a management audit of Aquila would place the Commission and the Staff in the realm of corporate management that should be left to the shareholders of Aquila. The Staff does not believe that the adjustments the Staff traditionally proposes as a result of a financial audit and/or a prudence review are those that the Public Counsel is suggesting that the Commission embark upon respecting Aquila. The discrete adjustments recommended by the Staff in rate proceedings are in conformance with statute and case law, and are proposed in order for the Commission to set just and reasonable rates,<sup>3</sup> rather than being intended to penalize utility conduct or performance.

13. The Staff notes that the Public Counsel proposes in its response to the Commission's Order to clarify its Motion that "[the Commission] could make a specific

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<sup>2</sup> Sections 386.560, .570, .580, .590 and .600 RSMo Cum. Supp. 2005.

<sup>3</sup> *State ex rel. City of West Plains v. Public Serv. Comm'n*, 310 S.W.2d 925, 928-29 (Mo. 1958): "... It would appear that the statutory power and authority which the commission has to pass upon the reasonableness and lawfulness of rates and to determine and pass upon the question of what rates are necessary to permit a utility to earn a fair and reasonable return (§§ 392.220, 392.230, 392.240) necessarily includes the power and authority to determine what items are properly includable in a utility's operating expenses and to determine and decide what treatment should be accorded such expense items. . . ."

downward adjustment to Aquila's allowed return on equity . . .” The Staff in its March 20, 2006 filing in this case set out a quote from the Commission's Report And Order in *Staff v. Southwestern Bell Telephone Co.*, Case No. TC-89-14, et al., which appears in the Commission's 2004 Report And Order in *Re Missouri Gas Energy*, Case No. GR-2004-0209. The quote relates to Missouri Gas Energy's (MGE's) request for a 25 basis point upward adjustment to its authorized rate of return for purported high management efficiency. The Commission rejected MGE's proposal and quoted as follows from its Report And Order in Case No. TC-89-14, et al.:

. . . The Commission has determined that it is not appropriate to adjust the rate of return SWB will be authorized to earn for management decisions. Now the Commission has determined that where it has made adjustments to ROE in other cases, these types of adjustments can rarely be supported by sufficient evidence to warrant such a decision. The difficulty of deciding how much value a certain management decision has in terms of ROE makes the determination almost impossible. The evidence in this case provides no real guide to the Commission on how to value the various allegations of inefficient management. The more appropriate method for making adjustments to a public utility's revenue requirement is where specific dollar adjustments can be addressed, not by adjusting the ROE.

12 Mo.P.S.C.3d at 597 (Commission quoting from its Report And Order in *Staff v. Southwestern Bell Telephone Co.*, 29 Mo.P.S.C.(N.S.) at 654). Unless otherwise directed by the Commission, the Staff has no intention of changing its position and proposing an adjustment that it recently opposed and the Commission, seemingly in agreement with the Staff, recently rejected.

Wherefore the Staff requests that the Commission issue an Order indicating the areas and matters it wants investigated and/or audited and the timeframe, if otherwise than in the manner indicated and suggested generally in Paragraphs 11 and 13 above.

Respectfully submitted,

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### **Certificate of Service**

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile, or electronically mailed to all counsel of record this 7th day of April 2006.

**/s/ Steven Dottheim**