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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its MPS and L&P Missouri Service Areas.	))))	Case No. ER-2005-0436

PREHEARING BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

Pursuant to the Public Service Commission's August 23, 2005 Order Regarding Consolidation and Procedural Schedule, the Office of the Public Counsel submits this brief. The format of this brief will follow that of the List of Issues. This brief will address only those issues on which Public Counsel witnesses have prefiled testimony.

REVENUE REQUIREMENT

Rate of Return

1. Return on Common Equity (Electric and Steam): What return on common equity should be used for determining Aquila's rate of return?

A determination of the cost of equity capital should encompass both the comparable earnings approach and the market approach. Public Counsel witness Dr. Ben Johnson performed both analyses.

Using the comparable earnings approach, the utility's cost of capital is derived from published data concerning the returns that firms earn on the equity funds that have been placed at their disposal. The comparable earnings approach is grounded in the economic theory of competition in the market for goods and services. This theory suggests that the return earned by the average firm in a competitive industry will tend to be equal to the opportunity cost of equity capital---the return which could be earned by investing and operating in another industry while

facing comparable risk. Dr. Johnson points out several caveats to the use of the comparable earnings approach:

> First, it is important to include a cross-section of companies in the study. This broader base prevents the possible selection of an unusual group of firms which earn returns significantly above or below the norm. Second, care must be taken to avoid the use of data from a group of firms which have a large amount of monopoly power. Otherwise, the returns included in the study may be biased upward to a significant degree by the presence of monopoly profits. Third, it is important to resolve any differences in risk. For instance, if the firms included in the study face a higher degree of risk than the firm in question, this difference must be recognized by adjusting downward the observed returns to reflect the cost of equity to a firm facing lower risk.

Dr. Johnson's application of the comparable earnings approach consists of four steps. First, he studied the rates of return on average common equity earned by unregulated (primarily industrial) firms. Second, on the basis of the historical earnings of these firms and an analysis of current economic conditions, he estimated the current cost of equity capital to the average unregulated (industrial) firm. Third, he examined the relative risk of utilities versus industrials and estimated the current cost of equity for various types of utilities, including electric companies. Fourth, he used the latter as a benchmark in deriving the comparable-earnings-based estimate of the Company's cost of equity.

The two groups of firms that formed the basis of Dr. Johnson's comparable earnings approach are the Federal Trade Commission's "All Manufacturers" group, a very broad-based group of industrial firms, and a group of approximately 900 companies monitored by Business Week. He examined historic earnings for these groups of firms over various periods

The second step of Dr. Johnson's comparable earnings approach is to estimate the current cost of equity capital to the average unregulated (industrial) firm on the basis of the historical earnings of these firms and an analysis of current economic conditions. Dr. Johnson evaluated changes in equity returns over the long run and during the recent past, as well as

current economic conditions, to estimate the current and near-future cost of equity for these firms. Dr. Johnson concluded that the average current and near-future opportunity cost of equity capital to a typical unregulated firm is 11.5% to 13.0%.

Dr. Johnson's third step is to examine the relative risk of utilities versus industrials and estimate the current cost of equity for various types of utilities, including electric utilities. As a starting point, Dr. Johnson notes that the equity risk of the average regulated utility is far lower than that of the average unregulated firm. He explains this concept:

> First, most public utilities enjoy territorial certificates that free them from competition within their market area; unregulated firms do not. As virtual monopolies, public utilities confront to a far lesser degree the possibility of market erosion. The average competitive firm, by contrast, must face the uncertainty of actions taken by its rivals, continually running the risk that their success will reduce its earnings. Second, because of the nature of their services, utilities face relatively minimal variations in demand. There is little likelihood, for instance, that the demand for basic telephone service or water and sewer service will drop substantially over a short period of time. In contrast, most competitive firms face uncertainty not only about the actions of their competitors, but also about the prospects of their entire industry. Third, utilities are far less subject to the uncertainties associated with fluctuations in the business cycle. Typically, the demand for public utility services holds relatively firm throughout a recession and does not increase sharply in periods of economic expansion. Fourth, public utilities are reasonably certain of recovering most of their costs most of the time. Although utilities argue that regulatory lag is a hindrance, most competitive firms would be thankful to have the same assurance as utilities that they will be able to recover increased costs from their customers, despite the lag problem. Because of these substantial risk differences, public utilities should not be provided with the opportunity to earn returns equal to or greater than the ones earned by unregulated and competitive enterprises, and, in my opinion, the equity markets for public utilities and for unregulated firms should be separated.

Dr. Johnson analyzed the different risks facing different segments of the regulated utility industry and concluded that electric utilities like Aquila are only slightly more risky than the least-risky utilities (water utilities). With respect to Aquila specifically, Dr. Johnson noted that the demand for MPS and L&P's primary services is far stronger and more stable than the demand for the products and services produced by most unregulated firms. Because to MPS and

L&P operate in a stable, conservative regulatory climate, they need not fear shifting market shares, changing technology and the vicissitudes of competition. Dr. Johnson disagrees with Aquila witness Hadaway about the need for a specific risk adjustment for Aquila. Dr. Hadaway argues that such an adjustment is necessary because Aquila's electric operations are relatively small, because Aquila plans a substantial amount of capital expenditures for its Missouri electric operations, and because Aquila does not have a fuel and purchased power adjustment clause. In response, Dr. Johnson notes that Aquila is smaller than some of Dr. Hadaway's proxy companies and larger than others. Dr. Johnson also points out that Aquila is not concentrated in a single, small service area. Aquila's service territory is large enough, and diversified enough, that it is not vulnerable to any extraordinary size related risks. Dr. Johnson disagrees with Dr. Hadaway's contention that Aquila's planned capital investments warrant a risk adjustment, because the added investment will benefit Aquila by reducing costs and/or enabling it to increase revenues. For instance, Aquila plans to construct base load generating capacity to be added to its system after 2009. This capacity will allow the Company to accommodate growth, enabling it to increase its revenues, and may also allow the Company to reduce its reliance on older, less efficient generating plants, which are more costly to maintain and operate. Dr. Johnson notes that Missouri has passed legislation authorizing the Commission to consider fuel adjustment clauses, and so Aquila's current lack of a fuel adjustment clause is not a reason for a specific risk adjustment.

Dr. Johnson's fourth and final step in his comparable earnings approach is to use the current cost of equity for various types of utilities, including electric companies, as a benchmark in deriving the comparable-earnings-based estimate of Aquila's cost of equity. Dr. Johnson testified that the cost of equity to the typical gas and electric utility is in the range of 9.75% to

10.75%. Dr. Johnson testified that the equity risks facing the Company in its electric operations are about the same as, or slightly higher than, those of the average electric utility. Factoring in Aquila's size, its geographic footprint, regulatory climate, ongoing construction program, and capital structure, Dr. Johnson concludes that the cost of equity to Aquila's MPS and L&P operating divisions is 10.0% to 11.0%.

Public Counsel witness Johnson also performed a market analysis. In developing this market analysis, Dr. Johnson used two closely related analytic processes involving data from the financial markets: first, he observed historic market returns earned by equity investors; and second, he prepared a Discounted Cash Flow (DCF) analysis. To minimize controversy and to help the Commission focus on key differences in the witnesses' respective analytical approaches, Dr. Johnson accepted the proxy group of 29 U.S. electric utilities used by Aquila witness Hadaway in his DCF analysis.

Dr. Johnson's study of historic market returns began with a review of total returns for the Standard & Poors 500, as reported by Ibbotson Associates in its annual Stocks, Bonds, Bills and Inflation Yearbook. He examined returns for the 78-year period of 1926 to 2004 for these large company stocks. This period covers many business cycles and stock market cycles, and although there are clearly fluctuations over the years, Dr. Johnson noted that: "a measure of central tendency can be observed if one looks at a long enough data series, or if one focuses on a time period which includes a balanced mixture of bear and bull markets. For instance, returns averaged 12.5% over the entire 78-year period." ***[cite]*** Dr. Johnson also evaluated average returns over the 30, 25, 20, 15, 10 and 5 year periods ending in 2004. The overall average of the returns earned by investors during these recent time periods tends to corroborate the very long term average results; Dr. Johnson computed an overall average for the 30, 25, 20, 15, 10, and 5-

year time periods ending in 2004 of 11.6%. Dr. Johnson also analyzed a number of other time periods, and concluded that, over long periods of time, the return required by equity investors in the average large unregulated company is somewhere in the neighborhood of 12.5%. He concedes that it is difficult to pinpoint a precise figure, because the actual returns fluctuate widely in response to changes in market psychology and other factors. .Of course, it is important to bear in mind that investors would expect substantially lower returns from investments in utility stocks, because of the risk differences between electric utilities such as Aquila and the unregulated companies analyzed in this portion of Dr. Johnson's testimony.

As the first step in his DCF analysis, Dr. Johnson determined the appropriate dividend yield to use. The noted that

> [t]he average dividend yield for the 29 electric companies have declined in recent years, moving from a high of 6.3% in 1995 to a low of 4.5% in 2004. Yields averaged 5.0% for the 3 year period 2002-2004, and 5.2% during 2001-2003. Yields for these 29 companies averaged 5.1% for the 5 year period 2000-2004, and 5.3% for the five year period ending in 2003.

After evaluating this data, Dr. Johnson selected a dividend yield of 5.0 to 5.5% for his DCF analysis. This compares to Dr. Hadaway's dividend yield of 4.54%, developed by comparing an estimate of dividends for 2006 with recent stock prices for each of the 29 companies.

Dr. Johnson's next step in his DCF analysis is to determine a growth rate. He notes that growth is a multidimensional phenomenon, and no single variable can be used to determine investor expectations concerning that growth. Historical growth statistics vary widely, depending upon the type of growth measured and the period chosen, so Dr. Johnson examined the historical pattern of growth in dividends, earnings, and book value for the 29 comparable electric utilities. Dr. Johnson noted that dividend growth has been negative in recent years. On average, the 29 companies reduced dividends by 0.2% from 2002 to 2004, and by 2.5% from

2001 to 2003. Similarly, dividends were reduced by an average of 0.3% from 2000 to 2004, and by 1.3% from 1999 to 2003. Dividends declined by 1.0% from 1998 to 2004. However, Dr. Johnson cautions that that, while historic growth in dividends is a valuable indicator of future growth in dividends, historic dividend growth is not always a good indicator of future dividend growth, particularly over the very long term future – which is what is relevant in a DCF analysis.

Dr. Johnson performed an alternate analysis that places less emphasis on periods in which dividends fluctuated drastically. This analysis excludes from consideration year to year dividend changes of greater than 10%. The effect of this procedure is to remove extreme swings in the dividend rate, particularly sudden dividend reductions, so that the extreme values are removed, without removing all of the data for that particular firm. Dr. Johnson performed similar analyses for earnings growth and growth in book value. Ultimately, Dr. Johnson selected a long term growth rate of 3.0% to 3.5% for use in his DCF analysis, despite the fact recent dividend growth has been low. Dr. Johnson's growth rate is conservative (i.e., favorable to Aquila) because it is greater than the recent historic rates of growth in dividends, earnings and book value.

Dr. Johnson disagreed with Aquila witness Hadaway's growth rate analyses for several reasons:

> First, it is not appropriate to rely on financial analysts' near term growth dividend projections, to the total exclusion of actual historical growth data. Second, there is no empirical or logical basis for using nominal growth in GDP as a basis for arriving at a dividend growth rate to use in the DCF approach. Historically, these firms' dividends have not been closely correlated with GDP, and there is no basis for assuming that they will track GDP in the future. Financial analysts' estimates of near-term future dividends show, at most, what certain stockbrokers and other analysts are anticipating will occur in the future. In this regard, it is important to realize that the DCF method requires use of long term growth expectations – something that cannot be gleaned from the short term dividend and earnings estimates published by financial analysts. Even if these financial analysts were infallible (they are not), this would not answer the question of what dividend

> growth the average investor, or the market as a whole, expects over the long term. Not all investors agree with Value Line or Zacks, or even pay much attention to their projections. Furthermore, these analyst projections are typically limited to the near future, yet the DCF method requires use of a long term growth rate – as indicated by Dr. Hadaway's use of a 150 year period in a portion of his analysis. The theory that underlies the DCF method requires consideration of growth for at least 30 years into the future – not just the handful of years considered by financial analysis. Similarly, I strongly disagree with Dr. Hadaway's heavy reliance upon historical growth in GDP as the predominant basis for estimating future dividend growth for these 29 electric utilities.

Dr. Johnson's DCF analysis led him to conclude that investors in the 29 electric utilities require on average a return of approximately 8.0% to 9.5%, composed of a dividend yield of 5.0% to 5.5% and a long term future growth rate of 3.0 to 4.0%. This 5.0% to 5.5% dividend yield is consistent with the recent historic range of yields for these 29 companies' stocks, placing the greatest emphasis on the yields experienced during the past 3 years. This yield is currently satisfactory to investors, given their current growth expectations, low returns available from money market instruments and other investment alternatives, and current attitudes about the risk and growth profiles of these firms. Although Dr. Johnson increased his recommended return on equity range by 0.4%, to cover the cost of issuing stock, he conceded (Johnson Surrebuttal, page 16) that these costs can be accounted for elsewhere as Staff witness Murry has done.

2. Capital Structure (Electric and Steam): What capital structure should be used for determining Aquila's rate of return?

Aquila has proposed a capital structure of 51.8% debt, and 48.2% equity. Aquila witness Hadaway testified that this hypothetical capital structure is based on based on the 2004 capital structure percentages of the 29 comparable companies. He also contends that this hypothetical capital structure is consistent with the Company's internal capital assignment process.

Public Counsel witness Johnson disagrees with Dr. Hadaway's proposed capital structure. Dr. Johnson notes that Aquila's recommended capital structure includes a larger percentage of equity capital and smaller percentage of debt capital than is appropriate and necessary for cost effectively financing the regulated operations. He also points out that Aquila witness Hadaway recommended the use of a smaller percentage of debt capital than is actually present in the Company's consolidated capital structure – despite the fact that the regulated utilities represent the least risky portion of the consolidated entities. Finally, Dr. Johnson notes that the Company's proposed capital structure is not consistent with the proposed cost of debt used by Dr. Hadaway, which was based upon Aquila's actual financial data. Using this hypothetical capital structure would force Aquila's utility customers to pay for hypothetical debt costs that do not exist in reality, and which exceed the level of capital costs which is actually necessary.

Dr. Johnson recommended that the Commission use Aquila's actual consolidated capital structure as of the end of 2004 (67.3% debt and 32.7% equity) to develop the allowed rate of return in this proceeding. The actual capital structure includes an appropriate, cost-effective mixture of equity and debt, and enables the Company to recover the actual debt costs incurred in financing the Missouri regulated utilities.

3. Cost of Debt (Electric and Steam): What cost of debt should be used for determining Aquila's rate of return?

Aquila requested a debt rate of 6.7% and 7.96% for the MPS and LP divisions, respectively, and Public Counsel witness Johnson agreed to use those rates.

Rate Base Issues

4. Generation Resources (Electric): What are the prudent types and amounts of generation resources to include in Aquila Networks-MPS's rate base?

5. South Harper (Electric): What costs related to the South Harper facility, if any, should be included in Aquila Networks-MPS's rate base?

a. When should allowances for funds used during construction be treated as beginning and ending, and what is the appropriate AFUDC rate?
b. What cost for test power should be treated as being included in Aquila Networks-MPS's rate base?
c. Should the costs of fee and professional services payments Aquila made to or for the benefit of the City of Peculiar for Aquila to enter into a Chapter 100 financing arrangement with the City of Peculiar be included in Aquila Networks-MPS's rate base?

The issue is whether or not certain costs related to the South Harper generation construction project financing should be reimbursed by ratepayers. On or about December 29, 2004 Company booked several accruals totaling $925,000 to MPS FERC Account No. 186. The accruals represent a deferral of certain costs the Company has classified as Chapter 100 Fees. These fees are composed of three items: 1) a $700,000 issuance fee that the City of Peculiar required and received for the Chapter 100 bonds, 2) the cost of the City's bond counsel (Aquila had been billed $95,000 as of December 31, 2004); and 3) a fee of $130,000 that Aquila paid to cover the cost of the City's financial advisor (McLiney and Company).

Public Counsel witness Ted Robertson recommended that these fees not be allowed in rate base. He testified that:

> The costs Company paid for the City of Peculiar to enter into the financing agreement were incurred solely for the benefit of that community and its citizens. The costs should have either not been incurred or paid by the City of Peculiar, not by Aquila. While it is accurate that the proposed financing of the South Harper project should decrease the total amount of property taxes paid and distributed within the entire Aquila Missouri regulated jurisdiction, Aquila's gratuity towards the City of Peculiar should not imply that the other ratepayers of Aquila should be required to pay for the extra benefits the City of Peculiar garnered in the transaction. For example, though it is expected that property taxes will not be incurred on the South Harper project, the City of Peculiar will receive, in addition to the $700,000 issuance fee it received, a significant amount of payments in lieu

> of property taxes ("PILOT") for several years into the future. OPC believes that the PILOT payments alone are a significant reason or justification enough for the payment of the Chapter 100 Fees by the City of Peculiar, and not the other ratepayers within the MPS jurisdiction.

d. South Harper Exclusions – should various legal, consulting and other costs included by Aquila as costs of construction be allowed rate base treatment?

The costs at issue here, shown on TJR-1 (Robertson direct testimony), consist primarily of legal expenses related to Aquila's prosecution of Case Nos. EO-2005-0156 and EA-2005-0248. In Case No. EO-2005-0156, Aquila sought Commission determination of the cost of the turbines/equipment and approval of the proposed Chapter 100 financing arrangement. In Case No. EA-2005-0248, Aquila asked the Commission to issue or clarify a certificate of convenience and necessity for the plant. The legal expenditures were incurred by Company solely due to its mismanagement of the South Harper power plant construction. Had the Company obtained the proper regulatory authorizations to transfer the turbines/equipment, enter into the Chapter 100 financing arrangement and construct the power plant, it is more likely than not that these costs would have never been incurred. As it now stands, the Missouri Western District Court of Appeals has determined that the Company did not obtain the proper authority to construct the power plant in Cass County. Thus, it is entirely possible that Aquila will be required to dismantle the South Harper plant. The Chapter 100 arrangement has already been determined void by Missouri courts. Public Counsel witness Robertson stated:

> [t]he legal costs incurred to support the Company's position on these issues should not be considered an appropriate addition to the construction cost of the power plant because they are not a normal expense expected to be incurred in the construction of a power plant. The legal costs did not add any value to the actual construction cost of the South Harper power plant, thus they will not provide any benefit to ratepayers even if the plant is ultimately allowed to continue operating. If the costs were not incurred to benefit ratepayers, then ratepayers should not be required to reimburse the Company for the expenditures.

Public Counsel Witness Robertson also recommended the disallowance of certain storage and CT rehabilitation costs incurred due to Aquila storing the CTs/equipment at the Richards-Gebaur air base and Ralph Green power plant site prior to its installation at the South Harper site. These costs were incurred due to Company's failure to utilize the CTs/equipment for its original purpose. The CTs/equipment was originally intended for the Aries II power plant project, but when that plan was abandoned, Company chose to store the CTs/equipment for an extended period of time. The costs to store and later rehabilitate the CTs and equipment would never have been incurred had the Company appropriately planned to bring the CTs and equipment onsite at the time they were actually needed for the South Harper power plant construction. The timing of the transfer of the assets – a paper transaction between affiliate entities – was entirely in the control of Aquila, and its decision to transfer the assets at a particular time was arbitrary. The timing of the transfer should not be allowed to detrimentally affect ratepayers.

e. If the costs related to the South Harper facility are not included in Aquila's rate base, should the cost of service reflect an alternative amount?

f. What total cost for the combustion turbines and related equipment transferred to Aquila, Inc. from Aquila Equipment, LLC and installed at Aquila's South Harper facility should be included in Aquila-Networks-MPS's rate base?

The Commission, to the extent it allows the South Harper facility in rate base at all, should use the amount agreed upon in Case No. EO-2005-0156 (so long as Aquila also agrees to that amount). If Aquila no longer supports that amount, then the total cost should be $60,582,750 (Case No. EO-2005-0156, Exhibit 12, Robertson Surrebuttal).

6. AAOs (Electric): Should the unamortized balance of the accounting authority orders the Commission issued for the Rebuild and Western Coal Conversion of Aquila's Sibley generating facility be included in Aquila Networks-MPS's rate base?

The Commission's most recent definitive statement on this issue was in Commission's Report and Order in Case No. GR-98-140. There the Commission stated that the purpose of an AAO was to mitigate the effects of negative regulatory lag and that shareholders and ratepayers should share its cost:

> The Commission finds that the unamortized balance of SLRP deferrals should not be included in the rate base for MGE. The AAOs issued by the Commission authorize the Company to book and defer the amount requested but do not approve any ratemaking treatment of amounts from the deferred and booked balances. AAOs are not intended to eliminate regulatory lag but are intended to mitigate the cost incurred by the Company because of regulatory lag.

The Commission should not approve rate base treatment in this case of the Company's Sibley and Ice Storm AAO deferred balances. AAOs should not be used to insulate utilities from all risk associated with regulatory lag. By including the AAO amortization in expense and excluding the AAO unamortized balance from rate base (and including the associated deferred tax as a rate base offset) shareholders and ratepayers both will share in the negative regulatory lag experienced by Company.

Public Counsel witness Ted Robertson summarized one of the fundamental flaws in the approach advocated by Staff and Aquila:

> Staff and Company's position fails to consider that the AAO deferred balances arise from the adoption of an abnormal regulatory accounting process. Recent Missouri Commission decisions have recognized this fact and understood that the management of the utilities exercise a great deal of control over the construction projects that their companies undertake. Management has great control over the timing of the construction of plant and complete discretion over the filing of general rate increase requests to recover the costs associated with new plant, thus at least to some extent, any negative regulatory lag experienced by Company is of its own making.

7. Deferred Taxes – AAO (Electric): Should deferred income taxes associated with the Sibley and Ice Storm accounting authority orders be determined and applied as an offset to Aquila Network-MPS's rate base?

Deferred income taxes should be determined and applied as an offset to MPS rate base. Aquila takes the following positions on this issue: 1) there are no deferred income taxes associated with the Sibley AAOs due to Company utilizing flow-though tax treatment for the amortization of the expenses, and 2) there are Ice Storm AAO deferred income taxes but they should be treated as an offset to rate base only if the unamortized AAO balance is also included in rate base.

With respect to the first Aquila position, Public Counsel witness Robertson testified that:

> the Commission has never authorized the Company to utilize flow-through tax treatment for the Sibley AAOs deferred expenses. Flow-through tax treatment implies that no tax timing difference (i.e., deferred income tax) is created due the AAO expense amounts be treated the same for ratemaking and income tax purposes. However, in MPS Case No. ER-90-101 (the original cost recovery case for the first Sibley AAO), both Staff and the OPC contended that the Company did not appropriately account for deferred income taxes associated with the AAO.

Furthermore, Mr. Robertson noted that the Commission, in Case No. ER-90-101, included the following finding:

> The Commission finds that the deferred income tax related to the AAO deferral which is included in deferred tax reserves should be used to reduce rate base a part of the process of setting rates in this case...

The Commission has not changed its position on this issue in subsequent cases, nor has it authorized the Company to use flow-through tax treatment for any AAO costs.

Even if Aquila failed to track and book the deferred income taxes related to the Sibley AAOs, the Commission should still adopt an offset to ratebase. Public Counsel witness Robertson calculated and recommended deferred income tax balances of $917,288 and $475,833, for the periods ending December 31, 2004 and June 30, 2005, respectively (Robertson Direct, page 15, lines 8-15), as an appropriate substitute for the offset amounts. In addition, Mr. Robertson identified that the Company does track and book deferred income taxes associated

with the Ice Storm AAO. He recommended that a rate base offset for the Ice Storm AAO be applied in the amount of the deferred income taxes associated with that AAO: approximately $1,319,091 and $1,002,508 for the periods ending December 31, 2004 and June 30, 2005, respectively. (Robertson Direct, page 21, lines 1-19),

8. Deferred Tax Balances: (Electric and Steam) Should deferred tax debit balances related to non-rate base accruals and reserves be included in the accumulated deferred income tax balances deducted from plant in service in the determination of Aquila Networks-MPS's and Aquila Networks-L&P's rate bases?

Alternatively,

Should certain deferred tax timing differences be included in the accumulated deferred tax balances (added/deducted) from plant in service I the determination of rate base?

9. Accounts Receivable Program (Electric): Should customer accounts receivable be treated as being sold for purposes of determining Aquila Network-MPS's and Aquila Networks-L&P's cash working capital included in rate base?

10. 20 West 9th: (Electric and Steam) What cost should be included in Aquila Networks-MPS's and Aquila Networks-L&P's rate bases for Aquila's 20 West 9th headquarters/annex?

The issue pertains to investment and operating costs associated with Aquila's headquarters campus (i.e., 20 West 9th headquarters, 850 Main annex and 800 Main parking garage) buildings. Public Counsel witness Robertson testified that the costs associated with maintaining and operating the complex have been inappropriately allocated to Aquila's Missouri regulated utilities. He explains that when Aquila quit its energy trading operations, and sold many of its unregulated and all of its international business operations, it left the headquarters complex largely vacant. Mr. Robertson calculated the vacancy rate:

> by starting with the actual planned employee capacity of 847 for the buildings as indicated by the Company in its response to OPC Data Request No. 865. I then adjusted the planned capacity by a vacancy rate of 7%. The resulting occupancy rate (i.e., 93%) I then multiplied by the 847 to arrive at an expected normal

> occupancy for the complex of 788. I then subtracted the August 2005 actual occupancy of 332 people from the normal occupancy number to determine that there are currently 456 unused workstations when compared to the original design capacity of the buildings. Dividing the 456 unused workstation spaces into the expected 788 occupied workstations yields an excess capacity factor of 57.87%. I then reduced associated rate base and operating costs allocated to the MPS regulated retail operations by the excess capacity factor of 57.87%.

In response to Mr. Robertson direct testimony on this issue, Aquila witness Empson tried to justify the underutilization of the headquarters complex in that it allowed Company to provide employees with additional individual workspace. Mr. Robertson sums up this issue as follows:

> The drastic reduction in the employee level at the HQ Complex is a direct result of the restructuring Company was forced to undertake and now the Company wants to assign to its Missouri-regulated operations an increased share of HQ Complex costs which were previously assigned to the operations that were exited. Therefore, whether Company assigns 58 square feet or 78 square feet or 100 square feet to the size of the remaining employees' individual workstations does not matter. The issue is whether the property is being fully utilized as intended, and if it is not, should the costs of its underutilization be recovered from Missouri ratepayers.

11. SO_2 Emissions Costs (Electric): What level of SO_2 emissions costs should be included in rate base?

Staff witness Vesely calculated that Aquila's annualized emission allowance level should be 5,939 allowances. Mr. Vesely's computation starts with the Aquila's 2005 forecast of 16,367 emission allowances. Mr. Vesely then reduced that amount by 10%. Then subtracted the 8,791 free allowances provided by the EPA to arrive at his final annualized emission allowance level.

Public Counsel witness Robertson proposed an annualized emission allowance level of 3,068 (2,871 fewer allowances than Staff). The difference between Mr. Robertson's allowance level and that proposed by Staff is driven by Aquila's estimate of a huge future increase in Sibley power plant emission allowances. Mr. Robertson testified that:

> Company's estimate of Sibley's needs far exceeds the actual level of emission allowances required by the power plant in recent years. The estimate is inflated

because the actual allowances required by the power plant is inflated above normal due to an unusual situation. The unusual situation being, as I described in my direct testimony, the difficulties Company has encountered with the fulfillment of the low-sulfur coal contract it had with the C. W. Mining Company.

The dollar value for this rate base issue is $276,500 for L&P and $217,377 for MPS.

Expense Issues

12. SO_2 Emissions Costs (Electric): What level of SO_2 emissions costs should be included in expense?

In his direct testimony (MPS Exhibit, Schedule C-6), Public Counsel witness Robertson calculate the appropriate level of SO2 emissions allowances expense to include in the cost of service. Columns (a) through (e) show the required annual emission allowances (after subtracting the EPA free allocations) multiplied by the $700 per emission allowance cost proposed by the Company. The result is compared to the expense amount recorded on the Company's books for the test year and then adjusted for the appropriate electric jurisdictional factor. Lastly, the OPC proposed electric jurisdictional amount is compared to the Company's proposed expense adjustment to determine the OPC adjustment shown on line 19. This issue pertains only to MPS, Public Counsel did not propose any adjustment for L&P.

13. Generation Resources (Electric): What are the prudent types and amounts of generation resources for determining fuel and purchased power expense for Aquila Networks-MPS and Aquila Networks-L&P?

14. Spot Market (Electric and Steam): How should prices for power Aquila purchases on the spot market be determined?

15. Purchased Power (Electric and Steam): How should prices for power based on purchased power contracts be determined?

16. Coal Prices: (Electric and Steam) On what prices should Aquila's coal fuel expense be based in setting rates?

17. Natural Gas Prices: (Electric and Steam) On what prices should Aquila's natural gas expense be based in setting rates?

18. Fuel Oil Prices: (Electric and Steam) On what price should Aquila's fuel-oil-in-inventory expense be based in setting rates?

19. 20 West 9th: (Electric and Steam) What expense for Aquila's 20 West 9th headquarters/annex should be used in setting Aquila Networks-MPS's and Aquila Networks-L&P's rates?

The issue pertains to investment and operating costs associated with Aquila's headquarters campus (i.e., 20 West 9th headquarters, 850 Main annex and 800 Main parking garage) buildings. Public Counsel witness Robertson testified that the costs associated with maintaining and operating the complex have been inappropriately allocated to Aquila's Missouri regulated utilities. He explains that when Aquila quit its energy trading operations, and sold many of its unregulated and all of its international business operations, it left the headquarters complex largely vacant. Mr. Robertson calculated the vacancy rate:

> by starting with the actual planned employee capacity of 847 for the buildings as indicated by the Company in its response to OPC Data Request No. 865. I then adjusted the planned capacity by a vacancy rate of 7%. The resulting occupancy rate (i.e., 93%) I then multiplied by the 847 to arrive at an expected normal occupancy for the complex of 788. I then subtracted the August 2005 actual occupancy of 332 people from the normal occupancy number to determine that there are currently 456 unused workstations when compared to the original design capacity of the buildings. Dividing the 456 unused workstation spaces into the expected 788 occupied workstations yields an excess capacity factor of 57.87%. I then reduced associated rate base and operating costs allocated to the MPS regulated retail operations by the excess capacity factor of 57.87%.

In response to Mr. Robertson direct testimony on this issue, Aquila witness Empson tried to justify the underutilization of the headquarters complex in that it allowed Company to provide employees with additional individual workspace. Mr. Robertson sums up this issue as follows:

> The drastic reduction in the employee level at the HQ Complex is a direct result of the restructuring Company was forced to undertake and now the Company wants to assign to its Missouri-regulated operations an increased share of HQ Complex costs which were previously assigned to the operations that were exited.

Therefore, whether Company assigns 58 square feet or 78 square feet or 100 square feet to the size of the remaining employees' individual workstations does not matter. The issue is whether the property is being fully utilized as intended, and if it is not, should the costs of its underutilization be recovered from Missouri ratepayers.

20. SERP: (Electric and Steam) Are the costs of Aquila's supplemental employee retirement plan (SERP) an expense Aquila should recover from Aquila Networks-MPS and Aquila Networks-L&P ratepayers?

21. L&P Transition Costs (Electric and Steam): Are the transition costs of the merger of St. Joseph Light & Power Company with Aquila an expense Aquila should recover from Aquila Networks-MPS and Aquila Networks-L&P ratepayers?

Company proposes to include in the determination of the MPS and L&P cost of service certain costs that it has characterized as transaction and transition costs related to Aquila's purchase of the St. Joseph Light & Power Company. no portion of the SJLP purchase premium or the purchase transaction costs associated with the merger should ever be recovered by the Company from rates paid by MPS or L&P customers. Any premium and transaction costs Company incurred should be treated below-the-line in the determination of rates for this and all future MPS and L&P rate cases, and costs associated with the actual transition (sometimes called "costs to achieve") should only be allowed if they can be proven to truly benefit ratepayers. Aquila has not tracked the costs and related benefits, and so has not been able to meet its burden of proving that the merger benefits have outweighed the merger costs.

Furthermore, the costs at issue were incurred in calendar years 1999 through 2003, with most occurring in calendar year 2001. All of the costs therefore are outside of the test period adopted in this case, and so – absent specific Commission deferral authority – are not properly included in this rate case. Aquila has never sought, and the Commission has never granted, specific deferral authority, so it would violate the matching principle to allow

recovery of these costs in this case.

22. FAS 106 Funding: (Electric and Steam) How should Aquila's FAS 106 funding deficiency be addressed in this case?

Recovery of $1,447,631 related to a FAS 106 curtailment in 2001 for the L&P division should not be allowed in rates set in this case.

Alternatively,

FAS 106 Funding: How should Aquila's FAS 106 funding deficiency, if any, be addressed in this case?

23. FAS 106 Funding: (Electric and Steam) Should the computation of Aquila's FAS 106 funding deficiency include the time value of the delay in the contributions to the fund?

Public Counsel witness Robertson explains this issue as follows:

> the Company has violated the requirements of Missouri Revised Statutes Chapter 386.315 regarding the funding of SFAS 106 costs recovered in rates. According to Company's response to MPSC Staff Data Request No. 263.1, Aquila intentionally failed to provide funding that matches its SFAS 106 expense during the years 2003, 2004 and 2005 for MPS and four of five years of the 2001 to 2005 period for L&P.

Mr. Robertson concludes that it is readily apparent that the Company should be required to fully fund the SFAS 106 plan for the contributions it intentionally eliminated. Obviously, this make-up funding should not impose any burden on ratepayers for the earnings on investment that the Company gave up by not timely making contributions.

Alternatively,

FAS 106 Funding: Should the computation of Aquila's FAS 106 funding deficiency, if any, include the time value of the delay in the contributions to the fund?

24. South Harper Expenses (Electric): What expenses related to the South Harper facility should Aquila recover from Aquila Networks-MPS's ratepayers?

a. PILOTS: Should the cost of payments-in-lieu-of-taxes (PILOTs) made as part of a Chapter 100 financing arrangement in connection with the South Harper facility be included as an expense Aquila recovers from Aquila Networks-MPS's ratepayers?

Public Counsel witness Robertson recommended the disallowance of the PILOT payments Aquila proposes to include in the South Harper construction cost. Mr. Robertson testified that:

> Prior to entering into the Chapter 100 financing arrangement, Company did not obtain Commission approval for the transaction. It transferred property to the City of Peculiar without first obtaining the Commission's authorization to enter into the transaction, thus the arrangement may be void. That is, it does not exist. If the financing arrangement does not exist, the costs for it which Company seeks to recover from ratepayers do not exist and they should not be allowed in the determination of regulated rates.
>
> Furthermore, the Missouri Western District Court of Appeals has ruled that the bonds associated with the Chapter 100 financing arrangement are also void. Given that both the Commission, and the Appeals Court, has yet to authorize the Chapter 100 financing arrangement, it is my belief that it does not currently exist. Costs associated with a financing arrangement that does not have the proper authorization of the regulatory bodies that govern its existence are not known and measurable, and thus not allowable in rates.

b. Property Taxes: Should the cost of property taxes on the South Harper facility be included as an expense Aquila recovers from Aquila Networks-MPS's ratepayers?

Because of the now-invalid Chapter 100 financing arrangement, Aquila did not pay property taxes on the South Harper facilities in the test year. While it is possible that Aquila will have to pay property taxes in the future, it is by no means a sure thing. And even if it were clear that Aquila did have to pay taxes, the amount of such taxes is unknown. In short, property taxes for South Harper clearly fail the "known and measurable" test and should not be allowed in rates.

c. Fees: Should the amortization of costs of fee and professional services payments Aquila made to or for the benefit of the City of Peculiar for Aquila to enter into a Chapter 100 financing arrangement with the City of

Peculiar in connection with the South Harper facility be included as an expense Aquila recovers from Aquila Networks-MPS's ratepayers?

The issue is whether or not certain costs related to the South Harper generation construction project financing should be reimbursed by ratepayers. On or about December 29, 2004 Company booked several accruals totaling $925,000 to MPS FERC Account No. 186. The accruals represent a deferral of certain costs the Company has classified as Chapter 100 Fees. These fees are composed of three items: 1) a $700,000 issuance fee that the City of Peculiar required and received for the Chapter 100 bonds, 2) the cost of the City's bond counsel (Aquila had been billed $95,000 as of December 31, 2004); and 3) a fee of $130,000 that Aquila paid to cover the cost of the City's financial advisor (McLiney and Company).

Public Counsel witness Ted Robertson recommended that these fees not be allowed in expenses. He testified that:

> The costs Company paid for the City of Peculiar to enter into the financing agreement were incurred solely for the benefit of that community and its citizens. The costs should have either not been incurred or paid by the City of Peculiar, not by Aquila. While it is accurate that the proposed financing of the South Harper project should decrease the total amount of property taxes paid and distributed within the entire Aquila Missouri regulated jurisdiction, Aquila's gratuity towards the City of Peculiar should not imply that the other ratepayers of Aquila should be required to pay for the extra benefits the City of Peculiar garnered in the transaction. For example, though it is expected that property taxes will not be incurred on the South Harper project, the City of Peculiar will receive, in addition to the $700,000 issuance fee it received, a significant amount of payments in lieu of property taxes ("PILOT") for several years into the future. OPC believes that the PILOT payments alone are a significant reason or justification enough for the payment of the Chapter 100 Fees by the City of Peculiar, and not the other ratepayers within the MPS jurisdiction.

25. Corporate Restructuring: (Electric and Steam) Should there be a disallowance of corporate restructuring expenses for Aquila Networks-MPS and Aquila Networks-L&P and, if so, in what amount?

26. Low Income Weatherization Assistance (Electric): Should an amount for low-income customer weatherization assistance programs be included in Aquila Networks-MPS's and Aquila Networks-L&P's cost of service? If so, what amount should be included, how should it be funded, which programs should be included, and what kind of review should be ordered by the Commission

27. Demand Side Management (Electric): Should an amount for energy efficiency services to residential and commercial customers be included in Aquila Networks-MPS's and Aquila Networks-L&P's cost of service? If so, what amount should be included, how should it be funded, which programs should be included, and what kind of review should be ordered by the Commission?

CLASS COST OF SERVICE/RATE DESIGN

28. Rate Design/Cost-of-Service (Electric): How should the Commission determine what, if any, shifts in class revenues for Aquila Networks-MPS and Aquila Networks-L&P should be made in this case?

The Commission should use the results from the cost of service study method presented by Public Counsel witness Meisenheimer in Case No. EO-2002-384 and updated in Ms. Meisenheimer's rebuttal testimony in this case as a guide to identifying potential interclass shifts.

Ms. Meisenheimer's direct and rebuttal testimonies in this case describe the cost and rate design methods recommended by Public Counsel.[1] Ms. Meisenheimer's rebuttal testimony updated the CCOS studies submitted in this case to reflect testimony provided during the hearing in EO-2002-384 which followed the filing of direct testimony in this case.[2]

The first modification incorporates the Time of Use (TOU) allocators developed by the Staff in EO-2002-384. Ms. Meisenheimer's testimony at hearing in EO-2002-384 acknowledged that Public Counsel supports the TOU allocation developed in that case.[3]

The second modification changes the allocation factors applied to certain accounts from the FERC 500 and 900 series as recommended by SIEUA Witness Maurice Brubaker in his surrebuttal testimony in EO-2002-384 and consistent with the allocation factors illustrated in

[1] Meisenheimer Direct, pages 3-14 and related schedules; Meisenheimer Rebuttal, pages2-5 and related schedules.
[2] Meisenheimer Rebuttal, page 2.

examples contained in the 1992 NARUC Manual. Ms. Meisenheimer's testimony at hearing in EO-2002-384 also addressed these allocations.[4]

The cost, usage, and revenue data used in Ms. Meisenheimer's CCOS study in this case are the same as those she used in EO-2002-384. [5]

Although Public Counsel believes that the Commission must consider all relevant factors, including new evidence in deciding this case, contrary to certain parties' claims, Public Counsel CCOS studies updated in rebuttal are neither the same as those presented in EO-2002-384 nor are they an attempt to litigate the same issues again. The results of Public Counsel's revised studies simply illustrate the results of updates based on evidence presented at hearing EO-2002-384 that had not been quantified. The updated results are relevant and should be considered by the Commission.

Public Counsel's CCOS study results are provided in Table 1. and Table 2.[6]

Table 1. CCOS Results Aquila Systems -MPS

	Residential	SGS	LGS	LPS	SC
Class Revenue %	53.19%	16.83%	13.81%	15.99%	0.18%
Revenue Neutral Shift	$3,382,298	($2,816,311)	($2,016,701)	$1,364,064	$86,650
% Change	1.96%	-5.15%	-4.49%	2.63%	15.07%

[3] Meisenheimer Rebuttal, page 2.
[4] Meisenheimer Rebuttal, page 2.
[5] Meisenheimer Rebuttal, page 2.
[6] Meisenheimer Rebuttal, pages 3-4.

Table 2. CCOS Results Aquila Systems -LP

	Residential	SGS	LGS	LPS
Class Revenue %	46.02%	8.44%	19.82%	25.72%
Revenue Neutral Shift	$189,619	($1,331,991)	($998,599)	$2,140,970
% Change	0.45%	-17.25%	-5.51%	9.10%

29. Rate Design/Cost-of-Service (Electric): How should any revenue increase for Aquila Networks-MPS or Aquila Networks-L&P that results from this case be implemented in rates?

i) In designing rates based on class revenues, the Commission should move classes no more than half way to the revenue neutral shifts indicated by Public Counsel's Class Cost of Service studies, limited by the amount of any rate increase such that, no customer class should receive a net decrease as the combined result of: (1) the revenue neutral shift that is applied to that class, and (2) the share of the total revenue increase that is applied to that class.[7] The first step of this rate design recommendation is to identify one half the revenue neutral shifts. These are shown in Table 3 for the MPS system and Table 4 for the L&P system. Table 3 and Table 4 show the class revenue percentages, dollar amount of revenue neutral shifts and percentage change from current revenues associated with one half of the revenue neutral shifts indicated by Public Counsel's CCOS studies.[8]

[7] Meisenheimer Rebuttal, pages 4-5.
[8] Schedule BAM RC-REB MPS, Page 2, and Schedule BAM RC-REB LP, Page 2.

Table 1. CCOS Results Aquila Systems -MPS

	Residential	SGS	LGS	LPS	SC
Class Revenue %	53.71%	16.40%	13.50%	16.20%	0.19%
Revenue Neutral Shift	$1,691,149	($1,408,156)	($1,008,351)	$682,032	$43,325
% Change	0.98%	-2.58%	-2.25%	1.32%	7.54%

Table 2. CCOS Results Aquila Systems -LP

	Residential	SGS	LGS	LPS
Class Revenue %	46.12%	7.72%	19.28%	26.89%
Revenue Neutral Shift	$94,810	($665,996)	($499,300)	$1,070,485
% Change	0.23%	-8.63%	-2.76%	4.55%

As the second step in designing rates, the Commission should mitigate any adverse impact of a rate increase to a reasonable extent by insuring that no class faces an increase in rates when another would otherwise receive a decrease. Public Counsel's rate design method is flexible in that it can be applied for any level of rate increase or decrease. Examples illustrating this rate design for various adjustments in the Company's total revenue requirement are shown in Ms. Meisenheimer's Rebuttal testimony. [9]

ii) Aquila and the Industrials failed to submit update studies based on testimony presented at hearing in EO-2002-384 and, therefore, to the extent that the Commission finds any deficiencies with those studies, the Commission should not rely on them in determining this case.

The Staff submitted updated studies but made no specific rate design recommendations based on the new studies.

iii) The residential customer charge should not be increased because the current rate of $6.95 covers the customer related costs.[10]

Alternatively, to 28 and 29,

What is the appropriate way to adjust class revenues for any revenue increase that results from this case?

RELIABILITY ISSUES

30. Service Reliability (Steam): Should Aquila be directed to study any alleged recent reliability problems on its steam system, identify solutions, and report its findings to the Commission and interested parties?

31. System Resource Study and Plan: (Steam) Should Aquila be directed to perform a study of steam production resources to include the results of the reliability review and to identify economical alternatives for the provision of steam service, and report its findings to the Commission and interested parties?

FUEL COST RECOVERY

32. IEC (Electric and Steam): If the Commission adopts an interim energy charge, how should it be structured?

a. What natural gas costs/prices should be included in the charge?
b. What coal costs/prices should be included in the charge?
c. What purchased power costs/prices should be included in the charge?
d. What SO_2 emission credits should be included in the charge?
   i. Should Aquila be required to use pet coke as a fuel to reduce SO_2 emissions?
e. Should the IEC be established and trued-up on a divisional basis (for MPS and for L&P separately) or on a unified basis (MPS and L&P combined?
f. Additional items to consider include treatment of off-system sales and hedging program cost/benefits.

[9] Schedule BAM RC-REB MPS, Page 3, and Schedule BAM RC-REB LP, Page 3.
[10] Meisenheimer Direct, pages 14-15.

33. IEC Rate Design (Electric and Steam): If the Commission adopts an interim energy charge, how should the cost of the charge be allocated to customer classes in setting rates?

a. How should natural gas costs be allocated to customer classes?
b. How should coal costs be allocated to customer classes?
c. How should purchased power costs be allocated to customer classes?
d. How should SO_2 emission credits be allocated to customer classes?
e. How should off-system sales and hedging program cost/benefits be allocated to customer classes?

The Commission should only adopt an interim energy charge pursuant to an agreement of the parties, with treatment of items a-e addressed in the agreement. However, to the extent that the Commission approves an IEC without full agreement of the parties, Public Counsel opposes an across the board increase based on class revenue percentages and believes an equal-cents-per-kilowatt-hour basis is more appropriate.[11]

Like other fuel costs, the expected cost that underlie an interim energy charge are energy related and should be apportioned based on an allocator that reflects energy use. This is consistent with the 1992 NARUC Manual's treatment of fuel and purchased power costs recorded in FERC accounts 501 and 547 as energy related and account 555 as energy and demand related. To do otherwise would disproportionately allocate these costs to Residential customers.[12] Allocating the IEC related costs on class cost of service creates an allocation of these costs that is approximately six percent higher than if the incremental costs were based on energy.[13]

ANALYSIS OF FUEL OPTIONS (Steam and Electric)

34. Should Aquila have considered alternatives to high Btu Western Coal for burning at Sibley and Lake Road, including petroleum coke and various emission control options?

[11] Meisenheimer Surrebuttal, page 2.
[12] Meisenheimer Rebuttal, page 7.
[13] Meisenheimer Rebuttal, page 8.

Respectfully submitted,

OFFICE OF THE Public Counsel

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By:_____

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been emailed to all parties this 10th day of January 2006.

/s/ Lewis R. Mills, Jr.

By:_____