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-2007-0004**

POST-HEARING BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

On July 3, 2006, Aquila, Inc., submitted proposed tariff sheets designed to implement a general rate increase for retail electric service provided by Aquila to customers in its Aquila Networks – MPS and Aquila Networks – L&P service areas. The submitted tariffs carry an August 2, 2006 effective date. On July 5, 2006, the Commission suspended the tariffs until May 30, 2007.

An evidentiary hearing was convened during the weeks of April 2 and April 9, 2007. In an order issued August 22, 2006, the Commission established April 27, 2006 as the deadline for post-hearing briefs. This brief is filed pursuant to that order. This brief will address three issues: 1) return on equity; 2) accounting authority orders; and 3) the fuel adjustment clause.

RETURN ON EQUITY

Generally:

In its opening statement, Aquila acknowledged that its ROE witness, Dr. Hadaway, retooled his ROE recommendation shortly after the Commission's December 2006 decisions in ER-2006-0314 and ER-2006-0315. Given that, in ER-2006-0314, the Commission declined to even discuss the testimony of a witness whose recommendation fell outside of the zone of reasonableness, it is not surprising that Dr. Hadaway's new ROE recommendation made it into the zone – albeit by a scant few basis points. Dr. Hadaway does deny using any improper results-driven approach (Tr. 326-327), but as a witness in ER-2006-0314 himself, it is clear that the Commission's dismissal of a fellow witness would have been very much on his mind as he reworked his analysis.

Dr. Hadaway admits that his entire 50 basis point construction risk adder is based on Aquila's projected – estimated – construction expenditures over the next six years. (Tr. 322-323) He also admits to comparing more recent Aquila estimates to older estimates from other utilities. (Tr. 416-417) The Commission should give little weight to the construction risk adder; the allegedly greater construction risk of Aquila as compared to other utilities is simply too speculative.

Although Aquila witness Hadaway singled out Aquila's allegedly greater construction risk, he failed to take into account risk factors that companies in his comparable group face that Aquila does not face: risks from nuclear operations, risks from competition, risks from hurricanes, risk from non-regulated operations, risks associated with merger activity and risks associated with downgrades by ratings agencies. (Tr. 333-369) While Dr. Hadaway quibbled to some extent (Tr. 333-334) with the theory that nuclear operations pose additional risk, he generally agreed that the other factors tend to increase a utility's risk.

Furthermore, Staff witness Parcell testified that, taking all risk into account, Aquila is not any riskier than the average electric utility:

> A Yes. You -- you can't take potential risk of a utility of any other company and put them on a bulletin board and say, Well, you have risk of fuel, you have risk of inflation, you have risk of this, that and the other and assign a numeric value to it and add it up or -- or, worse yet, just choose the ones you

want.

What I was saying is analysts like myself, as well as investors, utilize the broader approach used by analysts such as Standard & Poor's. And one thing Standard & Poor's has done, they've developed a – a business profile scale of one to ten such that gas utilities tend to be in the lower to mid so-called wires company are in the lower to mid, and generation companies were in the mid to high. And then merchant companies were the very highest. And for a -- a -- an integrated company such as Aquila, the business profiles tend to be in the range of five to seven. And Aquila is currently a six. And -- which is deemed satisfactory, and it's the mid point of a -- of a generation and distribution transmission company.

So they are right smack dab in the middle of where other integrated companies are with the business profile. Business profile is a proxy of a business risk. **So when all things are considered, they're average risk.** (Tr. 496-497; emphasis added)

Aquila witness Hadaway made a big deal out of repeating his opinion that so-called “wires companies” (utilities that have only distribution functions, or only transmission and distribution functions) are less risky than vertically-integrated electric utilities that have a generation function as well. But that is certainly not a given; Staff witness Parcell testified that some wires companies, and he used the example of Potomac Electric Power Company or PEPCo, do not consider themselves less risky than vertically integrated utilities. (Tr. 500-501) And the Commission itself is surely aware of the risks facing Ameren's Illinois wires companies. In fact, another Aquila witness, Mr. Fetter, testified that:

“In most cases, a transmission and distribution utility would be -- would operate at a lower risk level. But as we've seen in states like Illinois and Maryland, even that issue can be in play where full recovery of prudently incurred commodity costs are not ensured.
So in the normal scheme of things, T&D would be less risky. But each utility has to be viewed on its own circumstance. (Tr. 606)

So a blanket assertion that all wires companies are more risky needs to be taken with a grain of salt.

SIEUA/AGP witness Gorman testified with respect to the Commission’s recent awards of 10.9 percent and 11.25 percent that:

> I would offer my opinion to the Commission that the authorized returns on equity were higher than necessary to fairly compensate those utilities and to maintain their financial integrity and support construction activities on behalf of those utilities. (Tr. 521)

Mr Gorman testified that he took Aquila's risks into account when proposed a 10 percent ROE. (Tr. 527-528) He proposed a somewhat lower ROE of 9.8 percent in Case No. ER-2007-0002, the current Union Electric Company rate case. (Tr. 534) He agreed with Staff witness Parcell that Standard and Poor's business profile score of 6 indicates that Aquila has risks similar to the average electric utility (Tr. 529-531)

The Commission should bear Aquila's track record in mind when it deliberates on the proper ROE to award. As Public Counsel noted in the recent Aquila management audit case (EO-2006-0356):

> Until such time as Aquila provides evidence to the contrary, in setting rates for Aquila's Missouri customers, the Commission should keep in mind Aquila's lack of attention to those customers and its failure to provide protections for those customers. This is particularly important when the Commission is deliberating on the appropriate return on equity for Aquila. Whether or not specific adjustments to return on equity are offered in Aquila rate cases, the Commission is always faced with a range of proposed returns. If the Commission considers factors beyond the mathematical calculations provided by analyses such as Discounted Cash Flow or Risk Premium, then Aquila's lack of attention to its Missouri customers and failure to protect those customers are factors that the Commission should definitely consider.

<u>Relationship of a Fuel Adjustment Clause to ROE</u>:

If the PSC approves a FAC, then the reduction in the risk associated with fuel costs must be factored into the determination of the proper ROE by an appropriate and commensurate downward adjustment.

Aquila witness Hadaway testified that, all else being equal, a FAC would stabilize the revenues of Aquila, and if one is awarded in this case, it would result in less earnings volatility.

(Tr. 404-405) Dr. Hadaway also acknowledged that such a reduction in earnings volatility would decrease Aquila's business risk. (Tr. 405)

Mr. Gorman, testifying on behalf of SIEUA/AGP, calculated the impact this reduction would have on the authorized ROE:

> A Well, typically, what I recommend for the implementation of -- of a significant mechanism that doesn't eliminate the risk but simply transfers it from investors to -- to customers is -- is -- is based on the market's assessment of how much less compensation they are -- the market is willing to take for greater certainty of cost recovery, which is effectively what is a fuel adjustment mechanism accomplishes.
>
> In the current yield spread between a single A utility bond investment and a BBB utility bond investment is about 30 basis points. And I have recommended in several proceedings recently that that yield spread of 30 basis points be recognized if a fuel adjustment mechanism is implemented.
>
> And in this case, if a fuel adjustment mechanism that significantly eliminates the utility's cost recovery risk of fuel and purchase power energy is put in place, then an authorized return on equity would change from 10 percent without a fuel adjustment mechanism to 9.7 percent with one. (Tr. 532-533)

Just and reasonable rates will not be fixed if the Rate of Return does not properly reflect the risk factor for fuel costs. Public Counsel has provided Russell Trippensee's and Ryan Kind's expert testimony that provides sound regulatory reasons why it opposes granting Aquila authority to employ a fuel adjustment clause. The FAC process singles out fuel costs, the most significant factor in the ratemaking calculus, for special treatment outside of a comprehensive rate case that results in unjust and unreasonable rates. The FAC upsets the tender balance of risk factors at work in the ratemaking process.

The underlying premise is that just and reasonable rates result when the risk factors (weather, supply shortages, volatile fuel markets, and other factors that affect prices) give the utility the incentive to mitigate these risks with efficient management to reduce fuel costs that maximize the opportunity to generate earnings (the authorized ROE) under those rates. In turn, this ratemaking process protects ratepayers from frequent adjustments, an unstable rate structure, and the shift of the entire risk of imprudent utility management and unmitigated fuel costs. (Exhibit 403, Trippensee Direct, pp. 7, 8)

The FAC recovers the fuel cost associated with serving the customer ***in total*** through a process that allows Aquila to “effectively eliminate any earnings variability related to fuel costs for those customer classes who have a FAC. . .” (Exhibit 403, Trippensee Direct, p. 7)

This virtually eliminates “the risk of earnings variability related to fuel costs” and will greatly reduce it for Missouri jurisdictional operations. (Exhibit 403, Trippensee Direct, p. 7) This reduction in the business risk resulting from a significant decline in the potential variability of earnings would result in unjust and unreasonable customer rates that compensate stockholders for a risk they no longer have. (Exhibit 403, Trippensee Direct, p. 8)

If the Commission adopts a FAC, then it must reflect the reduction in risk in an appropriate downward adjustment in the ROE. Any process that mitigates the impact of fuel adjustment clauses on earnings should be considered in the authorized rate of return.

Section 386.266.8 RSMo 2000 (2005 Supp) provides in pertinent part:

> The commission may take into account any change in business risk to the corporation resulting from implementation of the adjustment mechanism in setting the corporation’s allowed return in any rate proceeding, in addition to any other changes in business risk experienced by the corporation.

“If the financial impacts of these decisions are removed via a mechanism that assures cost recovery, the incentive to operate the utility efficiently is also reduced because the risk to which management would be adverse has been reduced or eliminated.” (Exhibit 403, Trippensee Direct, p. 9)

The reduction in risk in rate design would also reduce the incentive to find new efficiencies. Ratepayers are not protected with the removal of the financial incentives for management efficiency because this leaves only after-the-fact regulatory prudence reviews as an incentive for management efficiency. (Exhibit 403, Trippensee Direct, p. 9)

The PSC must consider all relevant factors which have any bearing upon setting just and reasonable rates. Section 393.270 (4), RSMo; State ex rel. St. Louis Water Company v. Public Service Commission, 316 Mo. 842 (Mo 1927); State ex rel. Laclede Gas Co. v. PSC, 535 SW 2d 561 (Mo App 1976)

The Commission's principal interest is to serve and protect ratepayers. State of Missouri ex rel. Capital City Water Company v. P.S.C., 850 S.W.2d 903 (Mo. App. W.D. 1993). The protection given to the utility is merely incidental. State of Missouri, ex rel, Crown Coach Company v. P.S.C., 179 S.W.2d 123 (Mo. App. 1944). The testimony of Russell Trippensee demonstrates that the FAC alters the ratemaking process to the detriment of ratepayers. If the PSC does not account for the reduced risk in a FAC, then its decision is unlawful, unreasonable, and an abuse of discretion. A "proper determination" of rates must be based upon those factors that have a material bearing on the rates and must give "due regard" to a reasonable return in relation to all other facts. State ex rel. Missouri Water Co. v. PSC, 308 SW 2d 704 (Mo 1957) Public Counsel's evidence will demonstrate that the change in risk due to the FAC is a material and relevant factor that must be given due regard and be factored into the proper ROE.

Adjustments to the Zone of Reasonableness

The Commission, in its two most recent electric utility rate cases (ER-2006-0314 [KCPL] and ER-2006-0315 [Empire]), has clearly and definitively indicated its ongoing commitment to its "zone of reasonableness" analysis. Indeed, its reliance on that analytical tool is so great that it dismissed out of hand the entire body of testimony of an otherwise highly qualified expert simply because his conclusion on ROE was outside of the zone. Because of this significant reliance, it is incumbent on the Commission to carefully examine the data on which its calculation of the zone of reasonableness is based.

The Commission should not simply take an average of all the commission-awarded ROEs as reported by Regulatory Research Associates (RRA); its analysis must also include an examination to determine that the awards were set in rate cases that represent that commission's best analysis of the overall return on equity for the utility. The record in this case reveals that several of the data points in Exhibit 240 (the RRA report) should be excluded.

The first of these is the 11.9 percent return awarded by the Iowa Public Utilities Board to MidAmerican Energy for a specific windpower project. Dr. Hadaway testified that that award was not given in a rate case, and was not determined to be the utility's actual cost of equity capital: "It was done in a special proceeding like the FERC has done to encourage transmission investment. The Iowa Commission was willing to establish an ROE and track the ROE to encourage investment in those projects." (Tr. 396) In effect, it is an incentive ROE awarded to MidAmerican to encourage or reward the building of a large (545 MW) wind generation project. Including an incentive ROE that only applies to one specific project in an analysis of other commissions' cost of equity capital determinations is not proper. Dr. Hadaway appeared to concede that this data point should be excluded. (Tr. 423-424)

It is also not proper to include the Missouri Commissions own ROE determinations. Including return rates set by the Missouri Commission to establish a zone of reasonableness to guide the Missouri Commission is circular reasoning. The point of the zone of reasonableness analysis is to give the Missouri Commission a frame of reference as to what other commissions around the country are doing; including its own decisions in the analysis skews the result. Trying to judge the reasonableness of one's own actions by including those actions in the analysis is logically flawed. A simple hypothetical example illustrates this point: say there were ten ROE decisions in a year, eight from non-Missouri commissions at 10 percent and two from the Missouri Commission at 15 percent. The average ROE of those ten awards is 11 percent, but the average of the non-Missouri awards is only 10 percent. By including its own decisions in the analysis in this example, the Commission has inflated the apparent zone of reasonableness by a full 100 basis points.

Of course, the actual effect of including the Missouri Commission's decisions in establishing a zone of reasonableness based on 2006 decisions is not as extreme as this simple example, but it suffers from the same logical infirmities. Aquila witness Hadaway acknowledged that the two ROE awards in the Missouri electric utility rate case decisions in the fourth quarter of 2006 (ER-2006-0314 and ER-2006-0315) were, respectively, 104 basis points and 69 basis points higher than the average awards in that quarter. (Tr. 401) They were, respectively, 50 basis points and 15 basis points higher than any other ROE award in that quarter. (Tr. 400) In other words, the two most recent Missouri electric utility ROE awards were not just high, they were clearly extreme outliers with respect to the other awards at that time.

Taking the Iowa incentive award and the two Missouri awards out of the calculation gives an average ROE for 2006 of 10.22 percent and a median ROE of 10.20 percent. (Exhibit 410; Tr. 394)

The Commission should also exclude the Wisconsin commission's award of 11.00 percent to Northern States Power because it does not represent the determination of a utility's cost of equity capital. In Case No. ER-2007-0002 (the Union Electric Company rate case heard just before the instant case), Staff witness Steve Hill discussed with Commissioner Clayton Wisconsin's long-standing "policy of awarding rates of return that exceed the cost of capital."

(Exhibit 411, page 3008, lines 5-7) The Missouri Commission has announced no similar policy, and it appears that Wisconsin has at long last realized that such a policy doesn't work: "The [Wisconsin] Commissioners believed 20 years ago that if they awarded high returns and got high bond ratings, they would be rewarded by lower rates. That has not turned out to be the case, so they're reassessing their position on that." (Exhibit 411, page 3009, lines 7-11)

Taking the Iowa and Wisconsin incentive awards and the Missouri awards out of the RRA calculation gives an average ROE of 10.18 percent and a median ROE of 10.20 percent. (Exhibit 413; Tr. 404) While these adjustments are not huge, they are critical to establish a baseline for the zone of reasonableness that is truly representative of the other state commissions' determinations of utilities' actual costs of equity capital. It is worth noting that Dr. Hadaway's recommendation of 11.25 percent is so high that even these relatively modest corrections cause it to fall outside the zone.

There has been a notable downward trend in commission-awarded ROEs for several years. (Tr. 409) In fact, counsel for Aquila admitted (Tr. 288-289) and Dr. Hadaway later confirmed (Tr. 409-410) that the RRA average ROE for first quarter 2007 has dropped again: from an unadjusted average of 10.36 percent for 2006 to 10.3 for first quarter 2007. The average ROE as presented by RRA has not exceeded 11.00 percent since 2003. (Tr. 410)

What makes this continuing downward trend especially relevant is that commission-awarded ROEs tend to lag behind the market. (Tr. 411; 528) This is because the data generally comes from periods before the implementation of rates. (Tr. 411) Although Dr. Hadaway recognizes the downward trend, his recommendation of 11.25 percent is higher than the annual average as reported by RRA **for any year in this century**. (Exhibit 414)

ACCOUNTING AUTHORITY ORDERS

The Office of the Public Counsel asks the Commission to deny rate base treatment for the unamortized deferred cost balance allowed by accounting authority orders for the Capacity Life Extension and Western Coal Conversion of the Sibley generating facility. To include these balances in the rate base is inconsistent with the purpose of the AAO mechanism as a remedy to mitigate the impact of negative regulatory lag. Denying rate base treatment allows a sharing of the risk between shareholders and ratepayers in the face of extraordinary expenses incurred between rate cases and the applicable test years. Aquila's request, supported by the Staff, is an unjust and unreasonable burden on ratepayers and is detrimental to the ratepayers and the public interest. It shifts the risk to the ratepayer and allows Aquila to earn a return on a bookkeeping entry. The deferred costs in those unamortized balances include depreciation expenses, property taxes, and carrying costs. Carrying costs – by far the largest portion of the balances – represent an earnings return for the regulatory lag period. The inclusion of the unamortized balances in the rate base makes the ratepayer pay a "return on a return on," a stacking of earnings generated on earnings.

Aquila was authorized to defer depreciation expenses, property taxes, and carrying costs associated with the capacity life extension and western coal conversion projects at its Sibley generating station. In the AAOs, the commission did not decide if the AAOs would receive rate base treatment, but left that determination for future rate cases. In The Matter Of Missouri Public Service For Authority To File Tariffs Increasing Rates For Electric Service Provided To Customers In The Missouri Service Area Of The Company. In The Matter Of The Application Of Missouri Public Service For Issuance Of An Accounting Order Relating To Its Electrical Operations. 1990 Mo. PSC LEXIS 34; 30 Mo. P.S.C. (N.S.) 320; 118 P.U.R.4th 215, (Case Nos. EO-90-114 and

ER-90-101, and subsequent reauthorization n Case Nos. EO-91-358 and ER-93-37 October 5, 1990.) (Exhibit 405, Robertson Direct, pp. 3-4) Project expenses were deferred meaning that the expenditures were not recognized on the income statement of the year the costs were incurred, but instead were booked to a balance sheet account and amortized to an income statement expense account over 20 years. (Exhibit 405, Robertson Direct, pp. 4-5) Aquila's case filing asks for this 20 year amortization period in the rate case; no other party contests that issue. (Tr. 186-187)

In the Sibley AAO in EO-90-114, deferred expenses were property taxes and depreciation incurred after the plant was placed in service and also the carrying charges on those costs. Case No. EO-91-358 deferred depreciation and carrying charges. (Exhibit 406, Robertson Rebuttal, pp.9-10)

The carrying costs and depreciation expense are not actually dollars of investment capital funded by Aquila, but are accounting entries on its financial books. (Exhibit 406, Robertson Rebuttal, pp. 9-10) Even though these are book entries rather than actual capital outlays of real dollars by Aquila, these property taxes, depreciation and carrying costs will be recovered through the amortization included in the cost of service. (Exhibit 406, Robertson Rebuttal, pp. 9-10). If the unamortized costs are included in the rate base, Aquila will also earn a return on those book entries. Public Counsel witness Robertson provided a concise statement why rate base treatment is unjust and unreasonable and a detriment to ratepayers: "Since the carrying costs represent an earnings return on the investment for the regulatory lag period, rate base treatment would add an additional earnings on top of those amounts." (Exhibit 406, Robertson Rebuttal, pp.10-11)

The PSC's foundation is that its principal interest is to serve and protect ratepayers. <u>State of Missouri ex rel. Capital City Water Company v. P.S.C.</u>, 850 S.W.2d 903 (Mo. App. W.D. 1993). The protection of the utility is merely incidental. <u>State of Missouri, ex rel. Crown Coach Company v. P.S.C.</u>, 179 S.W.2d 123 (Mo. App. 1944).

An Accounting Authority Order is the Commission's approval of specific accounting measures designed to mitigate the negative effects of regulatory lag. Management decisions can change the cost of service while rates remain unchanged, which in turn can change the rate of return and profitability. The sole purpose of an AAO and its deferred cost recovery is to mitigate the effect of regulatory lag when a company incurs a capital outlay caused by "unpredictable events, acts of government, and other matters outside the control of the utility or Commission." These occurrences are typically termed as unpredictable, infrequent, unusual and extraordinary. In the Matter of St. Louis County Water Company, Case No. WR-96-263 (Report & Order, December 31, 1996).

As the Commission stated in In The Matter Of The Application Of Missouri Public Service For The Issuance Of An Accounting Order Relating To Its Purchase Power Commitments. 1991 Mo. PSC LEXIS 56; 129 P.U.R.4th 381; 1 Mo. P.S.C. 3d 200 (Case Nos. EO-91-358 & EO-91-360), December 20, 1991:

> Lessening the effect of regulatory lag by deferring costs is beneficial to a company but not particularly beneficial to ratepayers. Companies do not propose to defer profits to subsequent rate cases to lessen the effects of regulatory lag, but insist it is a benefit to defer costs. . . . . It is not reasonable to defer costs to insulate shareholders from any risks. 1 Mo. P.S.C. 3d 200, 207 (1991).

The Commission has recently followed and reaffirmed this well-established purpose and scope of an AAO when it denied rate base treatment for AAO deferred expenses. In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area. (Case No. GR-98-140) 2000 Mo. PSC LEXIS 1876, October 31, 2000 The PSC denied rate base treatment because "AAOs are not intended to eliminate regulatory lag but are intended to mitigate the cost incurred by the Company because of regulatory lag." (Exhibit 406, Robertson Rebuttal, p. 19) The Commission found that Public Counsel's position (identical to

OPC's position in this case) was just and reasonable and supported by the evidence. The Commission held that it was undisputed that "it is the purpose of the AAO to lessen the effect of the regulatory lag, not to eliminate it nor to protect the Company completely from risk." (Exhibit 405, Robertson Direct, pp. 9-10; Exhibit 406, Robertson Rebuttal, p. 20; Exhibit 408, Robertson Surrebuttal, pp. 3-4; Tr. 207-211) The Commission's reasoning in the MGE case is sound and consistent with the unique nature of this extraordinary regulatory remedy to avoid hardship on the utility because of extraordinary expenses that arise through no fault of the company. Since that decision, the Commission has not reconsidered its position or applied a different theory. Contrary to Staff's argument, Aquila's last three rate cases cannot be considered an abandonment of the MGE case since those case were "black box" settlements which were silent on that issue and the agreements specifically provide that these settlements apply only to that case and cannot be used for any purpose in any future rate case or any other rate case or proceeding against any signatory party. To date, the MGE case stands as the most recent (and comprehensive) application of the AAO's purpose and its relationship to the rate base and the shift of regulatory lag risk.

By including the AAO amortization in expense and excluding the AAO unamortized balance from rate base, shareholders and ratepayers share in the negative regulatory lag. The AAO allowed Aquila to capture and recover costs it normally would not have had the opportunity to recover. According to standard accounting and ratemaking procedures, depreciation, property tax and carrying cost expenses that Aquila deferred are not capital costs that require rate base treatment. With the AAO, Aquila avoided the adverse financial impact caused by regulatory lag. If the PSC includes the unamortized balance in rate base, shared risk shifts away from the Aquila and the entire burden is saddled on the ratepayers. And as an additional benefit, Aquila stacks its earnings with a return on its earnings. (Exhibit 405, Robertson Direct, p. 11; Exhibit 406, Robertson Rebuttal pp. 11-15; Tr. 207-209)

This AAO issue should not place Aquila in a better position than it would have achieved had plant investment coincided with rate synchronization. The AAO deferred balances arise from "an abnormal regulatory accounting process." (Exhibit 406, Robertson Rebuttal, p. 11) The PSC has consistently recognized this fact and understood that the management has significant control over the timing of construction of plant and total control over the timing of rate increase cases that include recovery of new plant costs. Given this management control, a portion of any negative regulatory lag comes from the company's actions. (Exhibit 406, Robertson Rebuttal, p. 11; Tr. 207-211)

The PSC should not bestow a windfall on Aquila at ratepayer expense because of regulatory delay that ratepayers could not control. An AAO as a regulatory method that steps outside of the normal accounting and regulatory process to avoid hardship and provide some reasonable measure of relief for the company and its shareholders due to extraordinary circumstances should not come at a high and unreasonable priced for the ratepayer and result in a detriment to the ratepayer and the public interest. The AAO issues caused by regulatory lag must be resolved in a fair manner for both ratepayers and Aquila so that the AAO remedy can be a just and reasonable vehicle for regulation.

FUEL ADJUSTMENT CLAUSE

Public Counsel believes that the FAC proposed by Aquila would not be in the public interest. Public Counsel witness Ryan Kind has presented detailed and extensive discussion of the policy and regulatory implications of the FAC. (Exhibit 401, Kind Direct, pp. 6-15) He has also discussed the Commission's discretion in approving FAC applications as well as the factors the Commission should consider for a FAC. (Exhibit 401, Kind Direct, pp. 6-15) If the

Commission does decide to award Aquila a FAC, Public Counsel strongly encourages the Commission to structure it along the lines of the proposal of SIEUA/AGP witness Johnstone. (Tr. 928-929) If the Commission does award Aquila a FAC, it should be structured so that only variable costs that are related to fuel are included. Public Counsel agrees with Staff witness Featherstone that:

> [F]uel handling … has no business in a fuel mechanism of any sort, in an IEC mechanism or fuel cost mechanism. There are a host of costs that have no business being in a fuel cost mechanism. I would only be interested in seeing a fuel clause that would address the variable costs….
> …
> There are rail car maintenance. There is the unit train leasing cost. All of these types of costs have -- they're -- they're semi-variable at best. They're simply not a direct variable charge. And they can be predicted and can be analyzed separate. They do not have to be a part of the fuel cost, and I would recommend that they not be. There is depreciation on the unit trains. That typically has been charged to the fuel accounts. There's property taxes on rail trains, and that's -- that's charged consistent with the fuel costs. Those are the kind of costs that should not in any way, shape or form be part of the this mechanism. (Tr. 734, 736-737)

Aquila makes a number of arguments about why it should be awarded a fuel adjustment clause. The more substantive ones have been addressed in testimony and the prehearing brief. However, two new ones came up in opening statements that will be addressed here. The first is that they were fashionable thirty years ago. In its "mini-opener" on the FAC, Aquila notes that FACs "came into vogue" thirty years ago. (Tr. 542) Webster's New Universal Unabridged Dictionary (Deluxe Second Edition 1979) defines vogue as "1. the mode or fashion prevalent at any particular time; ... 2. popularity...." Of all the strained arguments about why a FAC should be awarded to a utility, the fact that such mechanisms were fashionable or popular thirty years ago is perhaps the most strained.

The second argument that Aquila raised at the hearing is that a FAC is necessary because "the 12-month test period that is used to set rates is populated with expenses that are based on estimates. And no matter how thoughtful or well-intentioned, estimates are still estimates." (Tr. 542) In fact, Aquila used the word "estimates" six times in two paragraphs talking about how rates are set using a test year. This is simply wrong. The whole point of a test year is to use actual data, not estimates. While there may be some annualizations or normalizations or even some modeling, there are no estimates. In fact, the "known and measurable" standard that the Commission typically uses – and which it explicitly adopted in its Order Establishing Test Year and Deferring Decision on a True-Up issued on August 2, 2006 in this case – prohibits the use of estimates in setting rates.

Aquila witnesses argue that credit ratings agencies view FACs positively, but Aquila witness Fetter admitted that Fitch did not raise the credit ratings of any Missouri utilities when the legislature passed Senate Bill 179, and was not aware that any ratings agency did. (Tr. 573)

Aquila witness Fetter also testified that the most effective tool the Commission has to ensure that a utility is conducting itself properly under a FAC is a prudence review. (Tr. 586) The Commission should be aware that neither Mr. Fetter nor Ms. Brockway – who together have some twenty-six or more years of utility regulatory experience dealing with FACs – could cite a single instance in which imprudence was found in a prudence review. (Tr. 587-588; 847) Ms. Brockway testified that in one particular case, when she was a New Hampshire commissioner, "I pretty well thought there was something going on there, but **in an after-the-fact prudence review, there was no way to get to the bottom of it** and no way to find imprudence that would stand up in a court of law...." (Tr. 847; emphasis added; see also Tr. 884) This Commission should also keep in mind the number of times it has a found a gas company to be imprudent in Actual Cost Adjustment cases. This all inexorably leads to the conclusion that the prudence review – the "biggest hammer" as Mr. Fetter calls it – is an ineffective tool. Because the prudence review is a weak mechanism, the Commission, if it adopts a FAC, is taking a leap of faith and assuming that Aquila will act prudently and properly and keep the welfare of its customers at the forefront. Given the findings in the Staff's recent management audit of Aquila, this is a big leap indeed.

Staff witness Featherstone also testified about the effectiveness of a prudence audits:

> [By Commissioner Gaw] Q So that the inefficiencies, I would assume, would be considered imprudent if they exist?
> [By Mr. Featherstone] A If -- if you find them and if -- if you can discover them. And if you can present the necessary evidence, it is a -- a daunting task and a very slippery slope, particularly in prudency reviews where in very subtle ways the parties that are making the claim of imprudence, the burden shifts suddenly and sometimes in absolute terms to -- to those parties, and it becomes very difficult to present those arguments and present those circumstances and facts. And that's if you can find them. (Tr. 715-716; see also Tr. 719-730, 745)

Mr. Featherstone also testified that it is his experience that the Staff is not able to get all the information it needs to evaluate the prudence of particular transactions, and that there may not even be documentation of some transactions. (Tr. 744-745)

Not only is a prudence review likely to be an ineffective tool, but it is also a huge resource sink. Mr Fetter acknowledged that a prudence review would have to evaluate **hundreds of thousands of transactions** and possibilities for each year. (Tr. 591-592) In contrast, Mr. Fetter admitted that giving a utility a significant financial incentive to be prudent would be a "heavy incentive." (Tr. 593) Aquila witness Williams is only aware of the PGA/ACA process "on the periphery." (Tr. 630) But even with that limited awareness, he knows that ACA cases sometimes take years to complete. (Tr. 632) And AARP witness Brockway – with real world experience as a regulator dealing with FACs and prudence reviews – notes that "there's a there's a tremendous amount of attention that has to be paid to a lot of details. It's not always possible to tell exactly what happened that led from one event to another." (Tr. 879) She also pointed out the tremendous resource needs that prudence reviews impose on state regulators. (Tr. 880)

Aquila acknowledges that Senate Bill 179 merely gave the Commission the power to authorize a fuel adjustment clause, and that the Commission has some discretion in whether or not to authorize a fuel adjustment clause in any particular case for any particular utility. (Tr. 628) The Commission must exercise its discretion based upon the competent and substantial evidence on the whole record. (Section 386.510, RSMo.) A decision of the Commission is an abuse of discretion if it is "clearly against the logic of the circumstances and is so arbitrary and unreasonable that it shocks the sense of justice and indicates a lack of careful consideration.'" Sexton v. Jenkins & Assoc., Inc., 41 S.W.3d 1, 4 (Mo.App. 2000); Lohmann v. Norfolk & W. Ry. Co., 948 S.W.2d 659, 668 (Mo.App. 1997).

One of Aquila's arguments about why it needs a fuel adjustment clause is that a general rate case takes so long to complete that it can always be behind the curve when fuel costs are rising. Of course, the converse is also true: in times of declining fuel costs, the amount of time it takes to complete an over-earnings complaint works to Aquila's advantage. Furthermore, Aquila has another protection in times of rising fuel costs; the Commission can grant interim relief. (Tr. 648-649)

Under Aquila's proposed fuel adjustment clause, customers bill will go up if Aquila burns more fuel, even if prices don't change at all. (Tr. 647-648) Improper maintenance of generating stations can lead to those plants operating less efficiently. (Tr. 745) Under a fuel adjustment clause, a utility can earn more by skimping on maintenance: any reduction in maintenance expense levels relative to test year levels flows to the utility's bottom line, and any increased fuel usage from inefficient operation of plants is picked up by customers through the fuel adjustment clause. The only thing stopping Aquila from operating in this manner is the fear of a disallowance based on a finding of imprudence in a prudence review, and the evidence demonstrates how little fear a utility is likely to have of prudence reviews.

Aquila's standard for determining prudence leaves plenty of wiggle room. Aquila readily admits that situations could arise in which it could make choices that cost ratepayers more than other choices, but not be found imprudent. (Tr. 652)

One of Aquila's main arguments in favor of adopting a FAC is that fuel prices are volatile. Yet Aquila admits that it can – and does – reduce volatility by hedging. (Tr. 653-654) Indeed, Aquila's 2006 Form 10-K filed with the Securities Exchange Commission (Exhibit 415) shows that Aquila has locked in 100 percent of its coal for 2007, and (at the time of filing its 10-K) had locked in 62 percent of its 2008 coal needs. Aquila also has hedged much of its natural gas price risk; as of the end of 2006, it had "financial contracts in place to hedge approximately 76% of its expected on-peak natural gas and natural gas equivalent purchased power price exposure for 2007." (Exhibit 415) Hedging is generally considered a prudent thing for a utility to do, although there can be some arguments about whether particular strategies or particular hedges are prudent. Yet, at the same time it is asking the Commission to shift fuel cost risks to ratepayers, Aquila admits that it has stopped even trying to lock in future coal prices (Tr. 656) Aquila apparently plans to let its future coal prices float with the market because of its pending request to merge into Great Plains Energy. (Tr. 656) If the Commission allows a fuel adjustment clause under these circumstances, ratepayers will be exposed to any market fluctuations in coal prices.

One of the arguments that Public Counsel raises against allowing Aquila a FAC is that Aquila has not done a good job of long-term resource planning, and so has a generation fleet that is too dependent on natural gas and purchased power. Of course, Aquila flips that argument around and argues that it needs a fuel adjustment clause precisely because it is so dependent on natural gas and purchased power. Aquila sponsored the testimony of Robert Davis, an outside expert employed as an engineer with the firm of R.W. Beck, to support its argument that its generating fleet has been properly planned and is properly matched to Aquila's load. Mr. Davis' analysis is so sketchy and full of shortcuts as to be entirely worthless for this purpose. His testimony is not credible and has no evidentiary value because it was based upon unverified facts and assumptions and did not consider relevant and material facts.

First, his model doesn't match Aquila's real world actions of relying on spot market purchases and making spot market sales. (Tr. 683) Second, his model does not take into account generating unit commitment constraints and the cost of unit commitments, even though they have to be taken into account in the real world. (Tr. 687) Third, he did no analysis to determine whether the information and assumptions provided to him by Aquila were accurate or reliable. (Tr. 684-685) Fourth, he made an assumption that Aquila had no opportunity to participate in any base load or intermediate units in the last five years, but he never even bothered to review responses to RFPs Aquila issued in that time period to see if that was a valid assumption. (Tr. 687) Mr. Davis' analysis was so limited that he did not even know what state the Aries plant is located in. (Tr. 690) And this is despite the fact that (at least up to the time South Harper entered the picture), the Aries plant and the issues surrounding it were the most contentious resource planning issues that Aquila has been involved in. Fifth, Mr. Davis advanced the dubious theory that the lack of a FAC will tend to lead a utility to overbuild base load capacity, even though the actual build-out of capacity on his client's system effectively disproves that theory. (Tr. 692-693) Sixth, Mr. Davis failed to assess the desirability of adding more wind to

Aquila's portfolio (Tr. 683-684) Seventh, Mr. Davis bases his conclusions on the assumption that capacity can only be added in large discrete increments. Staff witness Lena Mantle thoroughly refutes this assumption:

> [Mr. Davis concludes that Aquila's fleet is consistent with the optimal configuration] because capacity can only be purchased in "chunks." It is correct that it would be highly unlikely that Aquila would have the exact increments necessary to be consistent with the lowest cost plan, but, again, Mr. Davis is considering only the lowest cost to serve Aquila. He did not consider that if Aquila had a larger amount of base or intermediate capacity than his optimum plan, Aquila would have had more fuel price stability and any excess low-cost energy could have sold on the energy market to off-set the increased fixed costs. Therefore, while Mr. Davis may consider the plans to be consistent, I consider them inconsistent with a preferred plan that minimizes price volatility and rates in the long run. (Exhibit 218, Mantle Surrebuttal, p. 12)

Even though Mr. Davis tried to prove that Aquila's resource mix was proper, and even though his analysis was fraught with shortcuts and untested assumptions, he was still unable to show that Aquila has a proper resource mix. Mr. Davis' analysis shows that Aquila should have 41 more MWs of baseload capacity and 153 MWs of intermediate capacity. (Exhibit 37, Davis Rebuttal, p.8) Given that Aquila's total capacity is about 2000 MWs (Exhibit 37, Davis Rebuttal, Schedule RLD-2, p. 8 of 16[1]), this is almost ten percent (41+153/2000=9.7%). Looking at it from the other direction, Mr. Davis' analysis shows that **Aquila has almost 200MW more gas-fired peaking capacity than it should**. This deviation from the optimum resource mix will almost certainly increase because Aquila still needs significant amounts of additional capacity by 2008. (Exhibit 24, Rooney Direct, p. 3, line 22; the exact number is HC and will not be set forth in this brief.)

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[1] Although this exhibit was marked as HC, Aquila agreed at the hearing that only the tables at pages 11-16 of the exhibit are still considered HC. (Tr. 680-681)

As Public Counsel said in its Opening Statement, a FAC to a ratepayer means more and higher "Fees And Charges" while a FAC to Aquila means "Free And Cheap," that is, increased costs can be flowed through to ratepayers in a FAC without additional cost or very little cost to the shareholders. The impact of the FAC pass through becomes more costly and detrimental to the customer if the company fails to take steps to reduce fuel costs and its associated costs such as transportation. If the company does not stand to lose revenue or reduce its rate of return and earnings and will recover its costs, it will not spend funds or time to reduce costs.

Staff witness Featherstone explained why a FAC removes the incentives that traditional ratemaking provides to operate a system efficiently:

> I think they have much less incentive under a fuel pass-through fuel clause. It's human nature. It takes a lot of work to operate an electric system. It takes a lot of work to negotiate contracts. If you have a total pass-through, if you pass those on to your consumers, you may not fight with your coal supplier as much as if it's coming out of your pocket or you may not operate your plant in [as efficient a] manner. (Tr. 715)

AARP witness Brockway notes that FACs tend to make utilities less effective at controlling costs:

> I would say that the fact of having a fuel clause is one thing that led some people to think, it was one argument that was made by people for restructuring, an introduction of competition. It was argued that **fuel clauses made the utilities inefficient and unattentive**, and that the private sector could do a better job. (Tr. 848; emphasis added)

SIEUA/AGP witness Johnstone explained why it so important under a FAC to maintain the incentives that are part of traditional regulation:

> Many parties have referred to that as skin [in] the game. I think that if you take a long perspective on our economic system, a couple hundred years ago there was a book written called An Inquiry Into the Wealth of Nations by Adam Smith, and it talked about an invisible hand.
> The point is that our economic system has been set up in a way that responds to the profit motive. It's produced tremendous growth in this country, and it's as

> though we want to take this major piece of the company's expenses, I think 46 percent is the number, and pretend that the profit motive no longer works.
> I think that's just an unreasonable proposition, and we're far better off if we can find a regulatory system which will indeed preserve a measure of the profit motive and the incentives that have been a part of regulation in the past. (Tr. 890)

Aquila's original FAC request failed to comply with the Commission's filing requirements (4 CSR 240-3.161(2)) for FACs in a number of areas. Some of the deficiencies were remedied as the case progressed, but even as late in the process as the evidentiary hearing, many areas were still not in compliance. Public Counsel witness Ryan Kind enumerated those areas:

> [By Mr. Conrad] Q. That's actually lines 14 and 15, [4 CSR 240-3.161(P)]. What was it about the proposal filed by the utility that you found wanting?
> [By Mr. Kind] A. Well, in addition to the fact that they really didn't spell out the testing procedures in their testimony, they didn't provide a schedule. My interpretation of the rule in Section P is that utilities, when they're required to provide a schedule, that we should get a schedule that shows unit by unit when those units will be tested, and I -- when I wrote this testimony, I searched for that schedule and could not find one.
> …
> [By Mr. Kind] [W]ith respect to O, item O, under that subsection of the filing requirements they're supposed to specify the resources that they'll utilize over the four-year period in which the fuel adjustment clause would be in effect, and in the case of this utility, they've got a major capacity shortfall coming up just a year from now. So they're unable to specify what resources will be utilized over the four-year period for about 15 percent of their capacity needs. With respect to Item P, I've already discussed that. And then with respect to Item Q, do they have a long-run IRP process in place, and I would say that, you know, that's -- an appropriate process, I would say no. In the case of this utility, for years they've done analysis to say we should be doing a significant amount of DSM. They've never followed up and actually implemented their findings that came out of that process. And as I mention in my testimony, it's just been a generally flawed process up to now in terms of what they've been doing with their IRP analysis. Certainly if the Commissioners had questions, I could get into some of those details. And then the other item is that they're supposed to come up with a complete examination -- in Item R, they're supposed to have a complete examination of the forecasted investments that they would make in order to comply with environmental regulations, and their analysis of the environmental investments that will be necessary is incomplete by their own admission. On Schedule BMA-1, page 2 of Block Andrews' testimony, he refers there in the second sentence to a partial completion of a draft study to determine the cost of

> dollars per ton removed basis for adding controls to reduce SO-2 emissions on Aquila owned and operated units. So they're obviously deficient in that area as well with respect to the requirement that they will have performed a complete examination of forecasted investments. (Tr. 901-902; 927-928)

CONCLUSION

Only three issues remain for the Commission to decide in this case.

With respect to the Return on Equity issue, Public Counsel suggests that the Commission should award Aquila an ROE consistent with Staff witness Parcell's recommendation or SIEUA/AGP witness Gorman's recommendation. If the Commission allows Aquila to implement a FAC, it should reduce the ROE award by 30 basis points.

With respect to the Accounting Authority Order, the Commission should find that the unamortized balance should not be included in the rate base for Aquila. The purpose of the AAOs is to lessen the effect of the regulatory lag, not to eliminate it nor to protect the Company completely from risk. The AAOs in this case have accomplished that purpose and it is neither just nor reasonable or in the interests of the ratepayers and the public to include this balance in rate base.

With respect to the Fuel Adjustment Clause, the Commission should not allow Aquila to use a FAC. If the Commission decides, against Public Counsel's recommendation, to allow Aquila to use a FAC, it should be structured like the one proposed by SIEUA/AGP witness Johnstone.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been emailed to all parties this 27th day of April 2007.

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