

Exhibit No.:
Issue: *CW Mining Coal Contract*
Witness: *Graham A. Vesely*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Surrebuttal Testimony*
Case No.: *ER-2007-0004*
Date Testimony Prepared: *March 20, 2007*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

GRAHAM A. VESELY

FILED

MAY 2 2007

**Missouri Public
Service Commission**

AQUILA, INC.

**d/b/a AQUILA NETWORKS – MPS ELECTRIC
AND AQUILA NETWORKS-L&P—ELECTRIC**

CASE NO. ER-2007-0004

**Jefferson City, Missouri
March 2007**

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

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Staff Exhibit No. 231
Case No(s). ER-2007-0004
Date 4/12/07 Rptr KF

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

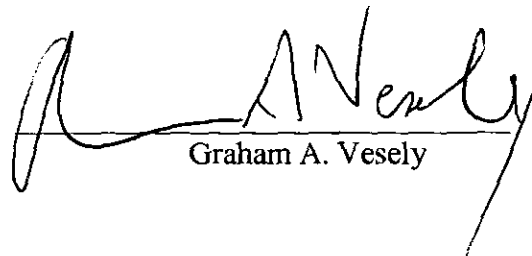
In the matter of Aquila, Inc. d/b/a Aquila)
Networks-MPS and Aquila Networks-L&P, for)
authority to file tariffs increasing electric rates)
for the service provided to customers in the)
Aquila Networks-MPS and Aquila Networks-)
L&P service area.)

Case No. ER-2007-0004

AFFIDAVIT OF GRAHAM A. VESELY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

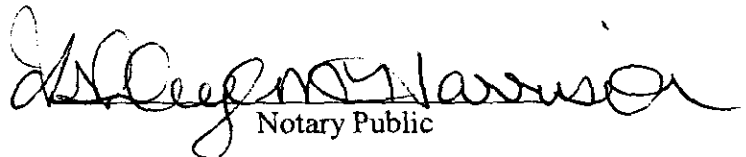
Graham A. Vesely, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 8 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.


Graham A. Vesely

Subscribed and sworn to before me this 13th day of March, 2007.



ASHLEY M. HARRISON
My Commission Expires
August 31, 2010
Cole County
Commission #06898978


Notary Public

1 **SURREBUTTAL TESTIMONY OF**

2 **GRAHAM A. VESELY**

3 **AQUILA, INC.**

4 **d/b/a AQUILA NETWORKS-MPS - Electric**

5 **AQUILA NETWORKS-L&P - Electric**

6 **CASE NO. ER-2007-0004**

7 Q. Please state your name and business address.

8 A. Graham A. Vesely, 615 East 13th Street, Kansas City, MO 64106.

9 Q. By whom are you employed and in what capacity?

10 A. I am a Regulatory Auditor for the Missouri Public Service Commission
11 (Commission).

12 Q. Are you the same Graham A. Vesely who filed Direct Testimony in this case?

13 A. Yes, I am. I filed direct testimony on SO2 emissions allowances, transmission
14 expense, the C.W. Mining coal contract, and other areas.

15 Q. What is the purpose of your Surrebuttal Testimony?

16 A. I will respond to the Rebuttal Testimonies of Aquila witnesses Abby F. Herl
17 and H. Davis Rooney, on the issue of the C.W. Mining coal contract.

18 **EXECUTIVE SUMMARY**

19 Q. Please summarize your testimony.

20 A. In the area of coal prices I discuss why Staff believes that the higher coal price
21 of the replacement contract entered into after CW Mining defaulted on the original contract
22 should be included in the refundable portion of the IEC, instead of in permanent rates as
23 Aquila requests. This contract became effective January 1, 2004 and from the beginning CW

1 Mining failed to meet the contract terms. CW Mining claimed it was unable to fully supply
2 the required delivery quantities and, finally, in 2005 refused to make any further deliveries to
3 Aquila. Aquila is currently in litigation with this supplier. Staff has been informed that a trial
4 was held in court on February 12, 2007, but has no details of what took place.

5 Q. What is the essence of the above Aquila witnesses' disagreement with Staff's
6 position?

7 A. Aquila's arguments fall into the following three categories:

- 8 1. Aquila had no "policy, requirement, or expectation that would prompt even a
9 cursory review of labor relations/practices for a supplier" (Herl Rebuttal, pg. 5,
10 lines 17-18). The only two criteria for selecting a supplier are credit
11 worthiness/financial stability, and having the right quantity and quality of coal.
- 12 2. "The delay in the contract was expected to be temporary" (Rooney Rebuttal,
13 pg. 5, line 13); therefore Aquila decided to be bound by the contract as long as
14 it did. Indeed, Aquila believed it could not have terminated the contract before
15 CW Mining did, or would itself have been in breach.
- 16 3. CW Mining terminated the contract in 2005 and has since not delivered any
17 coal to Aquila under that contract. The price of the replacement coal is known
18 and measurable and should be used to set permanent rates in this case.
19 (Rooney Rebuttal, pg. 3, line 18).
- 20 4. If the higher cost of replacement coal is used in base rates, Aquila will refund
21 anything it collects in damages as a result of a court judgment, after litigation
22 costs, by employing either a fuel adjustment clause (FAC), or a refunding
23 approach used once in past Case No. ER-82-39.

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1 Q. How do you respond to the first point above?

2 A. If Aquila did not have such a practice in the past, it certainly should in the
3 future make a point to make at least a cursory review of the state of a company's labor
4 relations, and its general reputation, before entrusting a little-known supplier with a major,
5 multi-year contract. Aquila itself estimates the damages from the terminated CW Mining
6 contract at "nearly \$54 million" (Herl Rebuttal, pg.5, line 13). A cursory review by Staff
7 indicates CW Mining is not a publicly traded company which, in and of itself, is not a red
8 flag; it does mean, however, that the usual wide variety of information about the company is
9 not readily available. Much more unusual, though, is the fact that CW Mining also does not
10 have a company website. In fact, Staff's cursory review of the Internet turned up nearly
11 nothing about CW Mining other than unfavorable reports and news of labor-related disputes.
12 Noticeably absent were the typical postings that might simply describe CW Mining's business
13 activities; after all, CW Mining held itself out to the public as a supplier of coal.

14 Aquila states that it evaluates a supplier's credit worthiness and financial stability. It
15 is Staff's understanding that CW Mining was known to Aquila only for having in the past
16 supplied the Company on one or two occasions with coal purchased on the spot market. If
17 Aquila had merely performed the same cursory review of CW Mining that I have described, it
18 might have, at least, been negatively impressed by the lack of information that CW Mining
19 made publicly available. This may well have influenced Aquila's decision whether to select
20 CW Mining as its one and only source of bituminous coal needed to run the Lake Road
21 generating station, as well as Aquila's largest wholly-owned power plant, the Sibley
22 generating station. Sibley is also one of Aquila's lowest cost production facilities.

1 During the process conducted in 2003 to select a coal supplier, Aquila documented
2 that Andalex Resources' (Andalex) available coal was priced as favorably as CW Mining's,
3 although the Andalex coal exhibited less desirable burn characteristics. Andalex was a
4 supplier known to Aquila for reliably fulfilling multi-year coal supply contracts. Even a
5 cursory background check of CW Mining, let alone a thorough one, would likely have led
6 Aquila to take a closer look at Andalex, and the rest of the list of possible suppliers that
7 Aquila was aware of. Aquila also had the option of re-issuing its request for proposal (RFP)
8 to seek offers from additional coal suppliers.

9 Q. Regarding statements made by CW Mining in the course of its earlier spot coal
10 transactions with Aquila, do you have any observations?

11 A. Yes, I do. Aquila has provided Staff with a letter from CW Mining, dated
12 October 18, 1999 (copy attached hereto as my HC schedule 1), in which CW Mining, among
13 other things, made the following two noteworthy statements:

- 14 • ** _____
15 • _____
16 _____ **

17 Q. Have you seen any information that sheds light on whether CW Mining
18 followed through on its declared intention to greatly expand its coal production?

19 A. Yes, I have. In her Rebuttal Testimony (pg. 6, lines 19-20), Aquila witness
20 Herl states that she saw data conveying that CW Mining's coal production in 2001 and 2002
21 was 1,100,000 tons, and 850,000 tons, respectively. These figures suggest that CW Mining in
22 no way followed through with the statements I cited above from the October 18, 1999 letter.

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1 | Aquila should have taken this glaring discrepancy between CW Mining's words and its
2 | actions as a reason to doubt CW Mining's reliability.

3 | Q. Does Staff believe it was correct for Aquila to assume that the delay in coal
4 | supply would be temporary?

5 | A. This question relates to Aquila's actions after it awarded the contract to CW
6 | Mining. I have presented Staff's concerns about Aquila's actions before it made the decision
7 | to award a contract of such critical importance to CW Mining without even a cursory
8 | background review of labor relations. Such a review would not have made Aquila aware of
9 | any labor dispute that had not already taken place, including the one cited by the supplier as
10 | the reason for terminating the contract; it would have, however, revealed the unusual lack of
11 | information available on CW Mining. This being said, Staff believes the outcome of
12 | litigation will determine whether Aquila is entitled to recover damages, and will likely shed
13 | light on how well Aquila handled its legal rights and obligations once it awarded the contract,
14 | and after CW Mining began to fail to perform. Aquila has informed that the trial took place in
15 | the U.S. District Court of Utah on February 12, 2007. Based on this outcome, Staff may
16 | recommend, in a future prudence review, a disallowance of some costs incurred as a result of
17 | the terminated CW Mining contract. In forming its belief that the coal supply delay would be
18 | temporary, Aquila was relying solely on the assurances of CW Mining, while in reality it was
19 | clearly becoming impossible for CW Mining to actually meet the coal amount scheduled to be
20 | delivered in the first year (2004) of the contract. Failure to meet the coal quantity delivery
21 | specified for 2004 would seem to be a contract breach on CW Mining's part that was
22 | recognizable as such, say, by the end of the third quarter 2004. The importance to Aquila of
23 | having the yearly (including 2004) contract delivery quantities substantially met is obvious;

1 since Aquila requires a steady supply of coal to keep its power plants operating, a larger than
2 scheduled delivery of coal in 2005, for example, would not make up for a serious shortage in
3 the quantity delivered in 2004. Thus, not only did the CW Mining supply contract specify the
4 overall duration of the contract in term of years, but it also specified the amount of coal to be
5 delivered during each year of the contract.

6 Q. Does Staff believe Aquila could not have terminated the contract with
7 CW Mining and sought to secure a replacement supplier?

8 A. Again, Staff will look to the court for guidance on whether, as a result of CW
9 Mining's actions, Aquila should have terminated the contract and/or commenced the search
10 for a replacement contract earlier than it did. As coal prices were rising throughout the period
11 in question, being able to secure a replacement source of coal at an earlier time than actually
12 occurred may well have resulted in a lower price than that which Aquila eventually was able
13 to secure from the new supplier. The outcome of the court case should help resolve these
14 questions. In the meanwhile, it is important to provide Aquila an incentive to continue to
15 pursue its case against CW Mining. Aquila's actions have been encouraging so far in pursuing
16 its legal options, but the process must be continued. Including the price of the replacement
17 coal in the ceiling of the Interim Energy Charge (IEC) recommended by Staff would provide
18 for a built-in, time-tested, mechanism for making any recommended refunds once the results
19 of Aquila's lawsuit against CW Mining are known, and have been considered.

20 Q. Is Staff's position on this matter still consistent with that taken previously in
21 Case No. ER-2005-0436, or have there been any developments that have led Staff to modify
22 its recommendations?

1 A. Staff's position remains the same, and there have not been any developments
2 that would lead to a major change in position. Staff's key recommendations are for Aquila to
3 actively pursue its legal claims against CW Mining, and to provide for an IEC that would
4 enable Aquila to collect the higher costs of the replacement coal in interim rates, while putting
5 in place a mechanism for making any eventual refunds deemed appropriate after the legal
6 process has run its course. During the processing of Case No. ER-2005-0436, Staff
7 envisioned that the legal suit against CW Mining would be resolved by now, thereby enabling
8 Staff a decision on how to treat the financial fallout from that prematurely terminated
9 contract. As things stand, that is still not possible, so Staff sees no other option but to
10 continue recommending the previously proposed course of action.

11 Q. Is it true, as Aquila witness Rooney claims, that Staff has made an adjustment
12 that will understate Aquila's coal costs?

13 A. No, Staff believes this is not correct. Aquila has in the past stated that Staff's
14 actions ignore the known cost of coal, but in reality the actual eventual cost of coal to Aquila
15 is clearly still not known, pending the outcome of its lawsuit. It can be said, though, that the
16 price Aquila is paying under the replacement contract likely establishes the top of the range of
17 its coal costs. Under the scenario in which Aquila recovers no damages in court and is not
18 found by the Commission to have otherwise acted imprudently, the replacement cost would
19 then represent the effective cost to Aquila for this type of coal (bituminous/high Btu) and
20 would be at the top end of the range being recommended by Staff for an IEC in this case. On
21 the other hand, if Aquila recovers its damages in court, it would end up paying an effective
22 price similar to that originally specified in the CW Mining contract (i.e., set as the bottom end
23 of the IEC range). The IEC then would provide a means for refunding the appropriate amount

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1 of court-ordered damages recovered by Aquila from CW Mining. This fact, as well as Staff's
2 desire to keep Aquila interested in pursuing its contractual rights vis-a-vis CW Mining,
3 accounts for why Staff recommends the replacement coal costs only be included in the
4 refundable portion of the IEC, rather than in permanent base rates as Aquila proposes. Staff is
5 attempting to take an even-handed approach that does not pre-judge the outcome of the court
6 case, while still providing a proven mechanism for making refunds as determined at some
7 future point by the Commission.

8 Q. Is Staff's position, that the ultimate cost of this type of coal is not yet known,
9 more consistent than Aquila's claim that the replacement coal is the definitive cost?

10 A. Yes, Staff believes so. In my Surrebuttal Testimony filed in Case
11 No. ER-2005-0436 (pg. 4, lines. 19-22, and pg. 5, lines 1-2), I stated:

12 Since Aquila is litigating the wrongful termination of the coal contract
13 by CW Mining, the actual effective cost of the high-Btu coal used for
14 blending at both Sibley and Lake Road is not known at this time.
15 According to Staff's understanding, Aquila's position respecting the
16 litigation with CW Mining is that the coal supply contract was breached
17 and that Aquila demands full performance by CW Mining.

18 Q. On what does Staff base its understanding that Aquila itself does not consider
19 the book closed on the CW Mining contract and, thus, the ultimate cost of coal to Aquila?

20 A. From the beginning of litigation, Aquila's position, as set out in the letter to
21 CW Mining dated April 25, 2005 (copy attached hereto as my HC schedule 2), from the law
22 firm retained by Aquila, Shook Hardy & Bacon, has been that CW Mining had no right to
23 terminate the contract in the manner that it did.

24 Q. Does this conclude your surrebuttal testimony?

25 A. Yes, it does.

Schedules 1 and 2

Deemed

Highly Confidential

In Their Entirety