STATE OF MISSOURI
PUBLIC SERVICE COMMISSION

TRANSCRIPT OF PROCEEDINGS

Hearing

April 9, 2007
Jefferson City, Missouri
Volume 7

In the Matter of the Tariffs of Aquila, Inc., d/b/a Aquila Networks - MPS and Aquila Networks - L&P Increasing Electric Rates for the Services Provided to Customers in the Aquila Networks - MPS and Aquila Networks - L&P Service Area	Case No. ER-2007-0004

CHERLYN D. VOSS, Presiding
REGULATORY LAW JUDGE
JEFF DAVIS, Chairman,
CONNIE MURRAY,
STEVE GAW,
ROBERT M. CLAYTON, III
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P R O C E E D I N G S

JUDGE VOSS: It's my understanding that there is an outstanding motion?

MR. WOODSMALL: Yes, your Honor. Over the weekend, we discussed the matter, and SIEUA, AG Processing, the Federal Executive Agencies, would like to drop the depreciation issue. There is no monetary settlement. We're just dropping the issue.

I'd also note that during the hearing, we made a motion on the record to strike some of Mr. Williams' testimony. We'd also like to drop that.

JUDGE VOSS: Okay.

MR. WOODSMALL: And I -- I guess that portion of his testimony can be accepted for all -- unless we get to that later.

JUDGE VOSS: Okay. And is Staff going to still -- not -- wait. He was an Aquila witness. That's correct. I guess we'll just take up his issues because he's going to be back on the stand.

Later, when he's back on the stand, they can make a motion to put it all into evidence. So is that -- are you going to reduce it to writing, or are you just --

MR. WOODSMALL: I wouldn't propose to.

JUDGE VOSS: Okay.

MR. WOODSMALL: As I said, there's no monetary settlement of it. It's just we concede that issue.

JUDGE VOSS: Okay. Thank you.

MR. SWEARENGEN: I guess I could state for the record, if they're drawing their objection to the receipt of Mr. Williams' testimony on depreciation, I would re-offer that portion of his testimony.

JUDGE VOSS: Well, that portion was about four pages of his rebuttal, and I think there were some questions about all the testimony and that we're going to wait until the fuel adjustment clause issue.

MR. SWEARENGEN: That's fine. Thank you.

JUDGE VOSS: Then that brings up the next witness on the ROE issues. We'll take up, again, all three of the issues again at one time. And I believe that will be the company witness, Mr. Wittman -- Winterman. I'm sorry.

MR. SWEARENGEN: I believe the issue Mr. Winterman was supposed to testify on has been resolved, and we have no more witnesses on cost of capital.

JUDGE VOSS: All right. In that case, we'll bring Mr. Parcell up from Staff.

MR. THOMPSON: Thank you, your Honor.

JUDGE VOSS: Unless there's anything else anyone would like to resolve. That would be fine.

JUDGE VOSS: Okay.

DAVID PARCELL,

being first duly sworn to testify the truth, the whole truth, and nothing but the truth, testified as follows:

DIRECT EXAMINATION

BY MR. THOMPSON:

JUDGE VOSS: Your witness.

MR. THOMPSON: Thank you, your Honor.

Q (By Mr. Thompson) State your name, please.

A My name is David C. Parcell, P-a-r-c-e-l-l.

Q Are you the same David C. Parcell that prepared or caused to be prepared direct testimony identified as Exhibit 221, rebuttal testimony identified as Exhibit 222 and surrebuttal testimony identified as Exhibit 223?

A Yes.

Q And do you have any corrections to that testimony?

A I have -- excuse me. Two quick corrections to the first one, which is, I guess, 221, my direct testimony, both on the same page and the same line.

If you'd please turn to page 24, page 24, line 15. On page 24, line 15, there are numbers that appear. The first one is 10.2. That should be 9.5.

The second number is 9.6. That should also be 9.5. And with these corrections, line 15 now matches

Schedule 8 as well as the table on page 24, lines 7 and 8. And those are my only corrections.

Q Thank you. Taking those corrections into account, if I were to ask you the questions today that are set out in those three pieces of testimony, would your answers be the same?

A Yes.

MR. THOMPSON: Your Honor, I would offer Exhibits 221, 222, 223.

JUDGE VOSS: Are there any objections to the admission of these exhibits? Hearing none, they're admitted.

(Exhibit Nos. 221, 222 and 223 were offered and admitted into evidence.)

MR. THOMPSON: And I'd tender the witness for cross-examination.

JUDGE VOSS: St. Joseph? Kansas City? Jackson County? Which brings us up to Public Counsel. Mr. Mills?

MR. MILLS: No questions.

JUDGE VOSS: AARP?

MR. COFFMAN: No questions.

JUDGE VOSS: Do you have a mic over there, Mr. Coffman?

MR. COFFMAN: No. I'm -- do I need one?

JUDGE VOSS: I'll just make sure --

MR. CONRAD: He can go in 305.

JUDGE VOSS: This is true.

MR. COFFMAN: I'll move to one when I have something, your Honor.

JUDGE VOSS: Okay. Commercial Group? Federal Executive Agencies?

CAPTAIN HOLLIFIELD: No questions, your Honor.

JUDGE VOSS: Sedalia Industrial Energy Users Association?

MR. WOODSMALL: Just a couple, your Honor.

CROSS-EXAMINATION

BY MR. WOODSMALL:

Q Good morning, Mr. Parcell.

A Good morning.

Q It's my understanding you've testified at FERC; is that true?

A Yes.

Q And have you ever testified on behalf of the Missouri Commission at FERC?

A Yes.

Q And can you tell me, did you approach the analysis in this case similar to the methodology you used when you represented the Missouri Commission?

A I've been in, I guess, three to four cases -- I've got to think this through, so we'll talk while I'm doing it.

I've been in three or four cases at FERC representing the Missouri Commission. I believe they are all in the early 1990s through the mid to late 1990s.

During that period of time, the FERC was going through what I would describe as a transition whereupon it was -- it was moving from the use of a -- of a single stage DCF to a two-stage DCF.

And my testimony in each of those cases was -- was directed toward what I would regard as -- as FERC policy, FERC methodologies because if you don't do your analyses according to their precedent, you really don't get into any consideration of the orders.

So my approach in those cases, I always used a DCF, always used the CAP-M. In that regard, it's the same as my testimony here.

On the other hand -- excuse me -- pardon me. The -- in some of the latter cases I used there, I used a two-stage DCF with the FERC employees because that was consistent with FERC policy.

And in that regard, I'm not using two-stage here. In fact, I've never used a two-stage DCF except FERC. So I think I'm responsive to your question. I hope so.

MR. WOODSMALL: Thank you. That's all I have.

JUDGE VOSS: Okay. That brings us to Ameren. I don't believe they're here. And Mr. Swearengen, you're up.

MR. SWEARENGEN: Thank you, Judge.

CROSS-EXAMINATION

BY MR. SWEARENGEN:

Q Mr. Parcell -- or is it Dr. Parcell?

A Mr.

Q Mr. Parcell, I'm Jim Swearengen. I represent the Aquila in this proceeding. I think we met --

A Yes, we have.

Q -- briefly before you took the witness stand this morning. I just want to make sure I understand that correction that you made on page 24 of your direct testimony on line 15.

What you're -- what you're doing there is -- is making your calculations which shows up on line 7 and 8, the 9.5 percent, consistent -- that -- the 9.5 is the correct number. Is that your -- your testimony?

A Yes.

Q Okay. Mr. Woodsmall asked you a minute ago if you had testified at the Federal Energy Regulatory Commission on behalf of the Missouri Commission, and you said that you had in three or four cases back in the mid '90s; is that correct?

A Yes.

Q And he -- he prefaced his question to you about the method or methodology that you may have used in that case and asked you to contrast that perhaps to the method you're using in this proceeding. Do you recall that?

A Yes.

Q And I really wasn't sure of your answer. I think you said in this case before the Commission, you're filing testimony on behalf of the Staff of the Commission, and you're not -- but you're not using a two-stage DCF calculation?

A That's correct. And I should have stated when I answered his questions that those cases that I've testified before the -- before FERC on behalf of the Missouri Commission were Interstate Natural Gas Pipeline cases where -- and that's where the FERC used the two-stage DCF. In electric cases, the FERC does not use a two-stage DCF.

Q Let me ask you, then, in those -- those three or four cases where you testified on behalf of the Missouri Public Service Commission back in the '90s, they were natural gas, pipeline rate cases?

A That is correct.

Q Okay. And you did use a two-stage DCF in those proceedings; is that -- that true?

A That's true in the -- in the latter ones. First one I testified in was -- it's a subsidiary of Syncorp (ph.). It was then called Mississippi River or Mississippi Valley Pipeline Company. That was like '91 and '92.

At that point in time, FERC was not using two-stage. And I don't believe I did a two-stage.

Q Okay.

A The second case I did was Williams Natural Gas Office Pipeline. And if memory serves me corrects, that also was not in the days of two-stage DCF.

The third case was Panhandle Eastern. Likewise, that was not a two-stage DCF. And, you know, actually, I believe those are the three cases I've testified on behalf of this Commission.

I filed testimony in subsequent cases where the -- where I think there was -- the two-stage DCF was in effect, but I did not actually testify in those cases, just filed testimony. I can't recall today as I sit here.

Q You can't recall the names of the cases where you utilized the two-stage DCF method before the FERC?

A No. I would have records on my computer that would tell me that, but I can't recall sitting here.

Q And then you made the comment something to the effect that with regard to your testimony before the FERC that if you don't do it their way, you don't get any consideration. Those weren't your exact words, but can you refresh my recollection what your testimony was on that point?

A That's the bottom line. When the FERC goes to a hearing process and the ALJ writes a proposed or initial decision and the Commission ultimately writes a final decision, they start off by quoting the -- the relevant cases, which are the Transkill case and the -- and the Northwest Pipeline case.

In each of those, that's when they delineated the process of having a two-stage DCF, and that's what they use. And if you filed testimony on the cost of capital issue and you don't do that, you really don't get any consideration.

Q Okay. Thank you.

A Nor does your client, I should add.

Q Thank you. Let me -- let me ask you this: Is this the first time you've testified before the Missouri Public Service Commission?

A No.

Q You've testified before this Commission previously?

A Yes.

Q And in what cases? Can you tell me?

A Yes.
Q Or is that shown somewhere in your testimony?
A It's not -- if you want me to be exact, I've got a list of every case I've testified on right in front of me. I could tell you.
Q Please. I'm just interested in the cases in which you've testified before this Commission.
A Certainly. Certainly. In 1977, I testified in Kansas City Power & Light case, ER-77-188. My client -- are you interested in my client?
Q No, I am not.
A Okay.
Q That was ER-77-188?
A Yes.
Q Okay. Thank you. In 1980 -- '83, I testified in the Laclede Gas, GR-83-233.
Q Okay. Thank you.
A In 1984, a Union Electric Company case, ER-84-168. In 1985, Kansas City Power & Light, ER-85- 28. In 1987, St. Louis County Water Company, WR-87-2. In 1987, Union Electric Company, EC-87-115.
Also in 1987, Union Electric had a gas case, GR-98-62. In 1990, Associated Natural Gas, GR-90-152. In 1997, Union Electric Company, GR-97-393. And I believe that's it.

Q Okay. Thank you. Now, in any of those cases that you just listed, did you testify on behalf of the Staff of the Missouri Commission?
A Yes.
Q In all of those cases or just some of them?
A Well, that's why I asked if you wanted the client. I could have told you as I went through.
Q No. Did you testify on behalf of the Staff in all of those cases or --
A No. Some was staff and some was counsel.
Q Okay.
A I can tell you from memory the middle '80s, there were some cases involving KCP&L and Union Electric whenever they were putting their new power plants into rate base.
And I know I testified in those cases. And Laclede Gas was the Staff, and, I believe, St. Louis County Water Commission. But I'm not sure about that. I could tell you each one if you'd like me to.
Q Let me ask you this: In connection with the preparation of your testimony with this case, did you make yourself familiar with recent decisions of this Commission involving cost of capital for electric utility companies?
A Yes.
Q I'm going to ask you some questions about some

of those decisions.

MR. SWEARENGEN: Your Honor, I don't know whether anyone has asked earlier in this case that the Commission take administrative official notice of these recent cases, but I would like to do that now for -- if it would be all right. And I can read the cases and the dates and the numbers. I don't think it's necessary to make exhibits of these cases.

JUDGE VOSS: I know with some of the other issues there were many cases listed, and I asked the company to submit a list --

MR. SWEARENGEN: Okay.

JUDGE VOSS: -- File a list of cases to take notice of.

MR. SWEARENGEN: And I just have three. I could just mention them at this point in time, if that would be okay.

JUDGE VOSS: That's fine.

MR. SWEARENGEN: The first one would be Empire District Electric Company, Case No. ER-2006-0315. And the report and order in that case was issued on December 21, 2006.

The second would be a case involving Kansas City Power & Light Company, Case No. ER-2006-0314. The report and order was issued in that case on December 21, 2006.

And the third one is an earlier case also involving the Empire District Electric Company, Case ER-2004-0570. And the report and order in that case was issued on March 10, 2005. Those three cases.

JUDGE VOSS: For clarification, is it the report and order that you're taking notice in those cases?

MR. SWEARENGEN: Yes, ma'am.

JUDGE VOSS: Just not anything in the official transcript in those cases?

MR. SWEARENGEN: Just the report and order that were issued in those three cases.

JUDGE VOSS: I think we've already taken notice of those. Does anyone have anything else they'd like taken notice of? Okay.

MR. SWEARENGEN: Thank you.

Q (By Mr. Swearengen) Mr. Parcell, if I understand your testimony correctly, you are supporting a -- a rate of return -- or recommending a rate of return on common equity for Aquila in this case in a range of between 9 percent and 10.25 percent; is that right?

A That is correct.

Q And the mid point of that is 9.625; is that right?

A That's also correct.

Q And I assume that -- that you would be happy if the Commission awarded the 9.6 percent; is that -- would that be a fair statement?

A I'm not sure if happy was the right word. I think I would be pleased they agreed with me, though.

Q What about if the Commission awarded the company a 10.25 percent ROE? That would also be within your range, correct?

A That is within my range. Yes.

Q Now, did you say that you were familiar with these recent cases, these recent decisions issued by this Commission where rate of return was litigated involving electric utilities?

A I reviewed two of those three you just discussed a moment ago.

Q Which two did you review?

A The latter two, the Empire District and KCP&L. The Empire District was on the '06 docket.

Q Okay. So would I be correct that -- and you would understand that in the Empire case you just referred to -- the Commission awarded Empire a return on common equity of 10.9 percent?

A That's my recollection, yes.

Q And in the Kansas City Power & Light case that you referred to, the award was 11.25 percent; is that correct?

A That's also my recollection.
Q Do you have your direct testimony in front of you there?
A Yes, sir.
Q I am looking at one of the schedules that you have attached to that. Up in the upper right-hand corner, it says Exhibit blank DCP-1, Schedule 8, page 4 of 4. Do you have that in front of you?
A Yes, sir.
Q Now, in coming up with your recommendation for rate of return in this case, am I correct in understanding that you used a -- a comparison group of five companies?
A As well as Dr. Hadaway's reference group. Yes.
Q Okay. Well, let's -- let's focus, first of all, on your Schedule 8, page 4 of 4. At the top, is that where you show, under the heading Comparison Group, Cleco, Empire District Electric, MGE, Hawaiian Electric Industries, and Pepco Holdings?
A That is correct.
Q Okay. And then I think you said -- or you made reference to the fact that you also made use of Dr. Hadaway's reference group. And that's also -- his reference group is also set out on that same page; is that correct?
A That is also correct.

Q And he had some 24 companies in his group; is that true?
A Yes.
Q Are you familiar with any recent decisions of this commission in which the Commission voiced an opinion with regard to the sample size of proxy companies in connection with cost of capital issues?
A Nothing that I specifically recall, no.
Q Okay. Is it your testimony that the results from your five company sample group that's set out at the top of Schedule 8 provide the Commission with an adequate estimate of the cost of equity for Aquila's MPS and L&P electric divisions?
A Yes. And, in fact, the -- the situation here, the DCF results from a -- that I performed from my group and Dr. Hadaway's group are virtually identical, so I don't see any distinction there.
Q Okay. Thank you. Let me ask you if you would turn to page 24 of your direct testimony, please.
A Sure. I'm there.
Q And I think it is the page where you made the correction earlier this morning.
A Yes.
Q And there you have a table, I think, on lines 7 and 8, that illustrate the range of results of your DCF

analysis that you performed both on your sample set of five companies and on Dr. Hadaway's sample set of 24 companies; is that correct?

A It shows some results, yes.

Q And I think the table shows that the mean and median DCF results from your sample set are 8.1 percent and 8.3 percent respectively?

A Yes.

Q And for Dr. Hadaway's companies, for his 24 companies, you computed an 8.2 percent mean and an 8.0 percent median; is that correct?

A Also correct, yes.

Q Okay. Then down at the bottom on page 24, in discussing your conclusion from those analyses, you say that the -- I have focused on the upper portion of the DCF calculations because current financial conditions, low interest rates and high market to book ratios for utilities have the effect of driving DCF results to low levels by historic standards. Correct?

A Correct.

Q And is that still your testimony?

A Indeed, it is. If you look on line 19, for example, you see my broad range for DCF is 8 to 9 and a half. For the purpose of my recommendation, I use 9 to nine and a half. So I do not consider the numbers in the eights.

Q That was going to be my next question. That's why you used the high end calculations of 9 and a half percent; is that right?

A That is correct.

Q If you could now turn, please, to your Exhibit DCP-1, Schedule 8, page 4 of 4.

A Yes.

Q And there at the top, you have various titles to several columns. Did you see that?

A Yes.

Q If you can look at the column entitled First Call, EPS Growth?

A Yes.

Q Am I correct in understanding that that's where you show the growth figures that you used to arrive at your high end DCF calculations?

A Yes. Those are the highest growth rates. Those are the ones that produce 9.5 percent.

Q Okay. Thank you. And focusing at the top again on your five company sample group, the First Call EPS Growth average is 4.9 percent; is that right?

A Yes.

Q And if I look at the sample group, your sample group, there's one company, Cleco (ph.), that has a

projected growth rate of 10.5 percent; is that right?
A Correct.
Q And then there are two companies that have projected growth rates of 4 percent; is that right?
A Also correct.
Q And two with 3 percent?
A Yes.
Q Would it be fair to say that if you compare Cleco with the other -- Cleco with the 10.5 percent growth rate with the other four companies, two of which have four, two of which have three, that Cleco could be characterized as an outlyer?
A Only if you consider a single growth rate. If you look at the DCF rates, they're not an outlyer. They're the highest, but they're not an outlyer.
Q Look at --
A If you consider a single growth rate, which I've said in my testimony you should do, their single growth rate is the highest, but they also are lower than others on some other growth rates. So for that one growth rate, they are an outlyer.
Q They are an outlyer when compared to the other -- other four?
A On the single growth rate, yes.
Q Okay.

A And the highest, I might add.

Q If you eliminated Cleco, the 10.5 percent, from your calculation, then, would you agree that the average growth rate for the remaining four companies would be 3.5 percent?

A It would be less.

Q What would it be?

A I haven't calculated it.

Q Can you do that?

A Sure. 3.5? Is that what you said.

Q Yes.

A Even I can figure it out.

Q And 3.5?

A Yes.

Q So I was right?

A Lawyer math.

Q That's right. Thank you, sir. Good. Now, my next question is if in your DCF calculation you substituted that 3.5 growth rate for the 4.9, would your DCF result compute to 8.1? In other words, if you added 3.5 and the 4.6, and I get an 8.1 percent.

A So hypothetically, you're saying I would remove Cleco from the proxy group.

Q Right. From your five company proxy group.

A Which means I've got to recalculate the yield.

And I'm going to ignore all the growth rates except earnings per share. Is that your hypothetical?

Q No. I'm just having you substitute the 3.5 average for the 3.9 average.

A You can't do that because Cleco is also the yield average.

Q If you -- if you -- if you substitute the 3.5 for the 4.9, what do you get mathematically?

A Well, you've got -- one group company is where you've got the yield, and one group company's without the yield. It's a mismatch. You have five companies in your field and four companies in your growth rate.

Q If you do just the mathematical calculation, what do you get?

A If you add 4.6 to 3.5, which I don't know what that means mathematically, that's 8.1. Again, it -- it has no meaning.

Q Okay. Thank you. Now, you are familiar with a concept that this Commission has utilized in several recent cases that has been described as the zone of reasonableness? Are you familiar at all with that?

A Yes, I am.

Q Okay. And what is your understanding of that?

A My understanding, and I'm -- I'm basing this understanding upon my reading of the KCP&L decision, is that you look at the average authorized returns on equity over some period of time, whether it's three-quarters or a year, and you take that number and -- let's say you took the -- the calendar year 2006 where the average was 10.36 percent, the average return on equity for electric utilities. And you've got 100 basis points to top in the ranges, and you subtract 100 basis points from the bottom of the range and arrive at 11.36. And, in fact, I discussed that in my rebuttal testimony.

Q Okay. Thank you. Now, turning back to your Schedule 8, page 4 of 4, if you would look at the Hadaway reference group?

A Yes.

Q And, once again, your average First Call EPS growth rate for this group is 5.3 percent?

A Yes.

Q And in Dr. Hadaway's sample group, there are two companies, Northeast Utilities, that has a growth rate of 12 percent; is that right?

A Yes.

Q And then PPL, Corp. with a 10 and a half percent growth rate; is that right?

A That's correct.

Q If you'd look at Dr. Hadaway's proxy companies, are there any -- is there any other company in that group that has a growth rate higher than 7 percent?

A No.

Q Now, I noticed there are, I think, five companies in Dr. Hadaway's reference group for which you do not have a First Call EPS growth rate?

A That's correct. There are none.

Q Is that because First Call did not provide an estimate on those? Is that the reason?

A First Call reported there were no analyses that provided forecasts.

Q Okay.

A First Call just reports what is provided to them.

Q Okay. So you've got in your 5.3 percent calculation, there are 19 companies, then, out of the 24; is that right?

A That would follow. Yes.

Q Now, if you would eliminate the Northeast Utilities, 12 percent, and the PPL Corporation, 10 and a half percent, would the First Call EPS growth rate be 4.2 percent, the average?

A I don't know.

Q Do you have any reason to -- to doubt that?

A I don't -- you're asking me to eyeball an average of 17 companies.

Q Can you -- do you have a calculator up there? Can you make the calculation?
A Sure. I get 4.08.
Q You get 4.08 percent?
A Yes.
Q Okay. Now, I think you said earlier that you wouldn't make this type of calculation. But if you substitute it, that 4.08 percent growth rate for the growth rate that you used in the DCF calculation for Dr. Hadaway's sample group, what would the result then be? Would you get something less than 8 and a half percent?
A If I add 4.3, which again, includes companies that you don't have included in the growth rate for, so you've got a classic mismatch, but hypothetically and mathematically, if I add 4.3 to 4.08, I get 8.38. But it's a mismatch of numbers. It has no meaning.
Q I understand.
A And it's not my recommendation either.
Q You said earlier that you had some knowledge of these two recent cases involving Kansas City Power & Light and the Empire District Electric Company?
A Yes.
Q Are you familiar with the plans that Kansas City Power & Light Company has to build a new coal-fired plant referred to as IATAN II?

A I don't have much knowledge of it because I'm not involved in any cases involving KCPL.

Q Do you have any knowledge that that is a fact, that KCPL has plans to build a new coal-fired unit referred to as IATAN II?

A I know they built a plant. And, in fact, I think they're building a plant that Aquila's involved in, but I don't know the name of it.

Q What do you know about that plant?

MR. THOMPSON: Your Honor, I'm going to object at this point. I think this is irrelevant to this man's testimony in this case.

MR. SWEARENGEN: Well, I don't think it's irrelevant. I think the fact that KCPL is involved in that plant and he's admitted that Aquila also has a bearing on the risk profile of both of those companies. So it's certainly relevant to a cost of capital issue.

MR. THOMPSON: I don't think the risk profile of KCP&L has any particular bearing on this case.

JUDGE VOSS: I think I'm going have to sustain that. I don't see direct correlation. You have the order.

MR. SWEARENGEN: I'll be glad to make that.

Q (By Mr. Swearengen) You just testified that you believed Aquila is also involved in that plant; is that right?

A In a plant. Yes.

Q And it's the plant that Kansas City Power & Light's involved in?

A And, again, I've read information that describes the proposed merger of the two. And some of the information I've read indicates there is a plant that they're both involved in. That's the basis of my answer.

Q Well, let me ask you this question: If, in fact, Aquila is involved in the construction and owner of a new power plant, would that be a factor to be considered with respect to Aquila's risk profile?

A Repeat that, please.

Q If, in fact, Aquila is involved in the instruction and ownership of a new base load power plant, would that be a factor to be considered in connection with Aquila's risk profile?

A Not by itself. No. The -- total risk profile of Aquila was before a consideration in that case. And that's what I've done in my testimony. But trying to -- to micromanage or take part and add the parts up is -- is not the way to go about it.

Q So you would -- your testimony would be that -- that Aquila's participation in the construction and ownership of the IATAN II power plant is not a risk factor that the Commission could consider?

MR. THOMPSON: Objection. Asked and answered.

JUDGE VOSS: Sustained.

Q (By Mr. Swearengen) Is fuel price risk something that an electric utility such as Aquila might experience?

A I don't want to sound like Bill Clinton, but what do you mean by fuel price risk?

Q Why don't you define that term?

A I didn't bring it up. You did.

Q Can you give us a definition of fuel price risk?

MR. THOMPSON: Your Honor, I think he's already indicated he has no idea what counsel means by that term. I object.

Q (By Mr. Swearengen) So you have no idea by what I mean by fuel price risk?

A Well, I've been doing cost of capital testimony for 37 years now. And I -- and I know that electric and gas utilities use fuel as a -- both a by-product and as product they sell and that fluctuations in the price of those commodities impact their revenues, and, therefore, their profits, if that's what you mean by fuel price risk.

Q Thank you. And would you agree that this affects the risk profile of those companies?

A It -- it goes to a matrix of other factors that -- that affects the risk profile. But, again, it's not an additive process where you go pick and choose certain risks and assign numeric value to them and come out of something.

That's why you have people like Standard & Poor's who assigned the risk profile, for example, to Aquila of F-6 which is deemed satisfactory. It's the middle range of generation utilities. Standard & Poor's considers fuel price risk like everything else, like all the parts that's in there.

And all those factor are there when Standard & Poor's gives Aquila a risk profile of six, which is the middle of the road for a generation company. That's what's important to me as an analyst, not individual risk factors which Standard & Poor's would consider in its risk profile.

Q Do you have your rebuttal testimony in front of you?

A Sure.

Q I'm looking at page 14.

A Fourteen?

Q Yes.

A Sure.

Q Down there on -- beginning on line 16, you mention four proceedings involving four different companies in which you have personally been involved?

A Recently, yes.

Q Yes. Of those four companies that are listed there at lines 18 through 21, are any of those what we would call gas utilities?

A Two.

Q And which ones would those be?

A I think the Virginia Natural Gas and PPL Gas.

Q And the other two would be electric utilities?

A That is correct.

Q And would I be correct that the average return for those four that you show on there was approximately 10.25 percent?

A That looks about right. Yes.

Q Mr. Parcell, is it true that at the present time and for the last several months, short-term interest rates have been higher, are higher and have been higher than long-term interest rates?

A If you look at Treasury bills -- and I'm on my Schedule 2, page 2 of 3 where I show these factors.

Q What part of testimony -- what piece of testimony is it?

A Direct testimony.

Q Schedule 2?

A Page 2. If you look at DCP dash blank, these -- Exhibit blank, DCP-1, Schedule 2, page 2 of 3 --

Q Okay.

A -- the second and third column is U.S. Treasury bills, three months, U.S. Treasury bonds ten year. If you look at that the last few months, the short-term Treasury bills are higher than long-term Treasury bills, and it was just referred to as an inverted yield curve which normally is a sign that interest rates about are going to drop. Utility bonds still yielded more at the short-term rates.

Q Is -- is a situation where the economy is experiencing an inverted yield curve a normal situation?

A It's more normal than it was 20 years ago. It's not nearly as rare as it used to be. So I wouldn't call it normal, but I wouldn't call it extremely abnormal either.

Q Turning back to your Schedule 8, page 4 of 4, your Exhibit DCP-1 --

A Sure.

Q -- where you -- the lower half, you listed 24 companies in Dr. Hadaway's reference group. Would you agree that Aquila competes in the same capital markets as the 24 companies shown on his group?

A Yes. Well, they raise capital, the same capital, if that's what you mean.

Q The same company markets that, those 24 companies?

A Yes. And the top five as well.

MR. SWEARENGEN: Okay. Thank you. That's all I have.

JUDGE VOSS: We'll come up for questions from the Bench. Commissioner Murray?

COMMISSIONER MURRAY: I don't have any at this time. Thank you.

JUDGE VOSS: Commissioner Gaw?

COMMISSIONER GAW: Not right now.

JUDGE VOSS: Commissioner Appling?

COMMISSIONER APPLING: No questions at this time.

JUDGE VOSS: I had -- I had a question.

CROSS-EXAMINATION

BY JUDGE VOSS:

Q Mr. Swearengen was asking you about that Schedule 8, page 4 of 4 to your direct testimony. And he had you pull out the First Call EPS number --

A Yes.

Q -- the growth --

A For Cleco. Yes.

Q -- and then adjust your total growth number and substitute into an equation. And you said that that was a

mismatch and not valid. Could you explain that to me?
A Sure. If you -- if you'll stay on Schedule 8, page 4 for a moment, you see the yield that he had me use to add to that was a 4.6. That's the average of five companies. Well, the growth rate he had me look at in the first column was an average of four companies.
So I'm -- I'm adding the yield of five companies to the growth of four companies. And you'll note that the Cleco has the lowest yield. So if they dropped out, the yield would go up.
Q Thank you. And there was a similar comment -- let's see. You didn't get to fully answer. I had a question when you were asked about the specific risk elements and how that should be factored into an equation. And you said that it's not an additive process. Could you explain that a little bit more to me?
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. The -- the perception of higher total risk for this company as stated with this company goes back to 2002, 2003 years when their unregulated operations imploded on them and almost destroyed the company.

But that had nothing to do with the regulated utility operations. And, in fact, that hurt the utility operations for a while there that this profile recently was an eight and now it's a six. So it jumped two notches from eight to six just by getting rid of the unregulated operations. It brought them back to where a normal integrated company would be, which where they are considered now from a business risk standpoint.

JUDGE VOSS: Thank you.

COMMISSIONER MURRAY: I have a question.

JUDGE VOSS: Okay. Commissioner Murray.

CROSS-EXAMINATION

BY COMMISSIONER MURRAY:

Q On your exhibit, your Schedule 7 --

A Yes.

Q -- you show Value Line safety there. And then the footnote indicates that a five is the most risky, I believe; is that correct?

A Yes. That's correct.

Q So what period in time did Value Line rate Aquila as the highest risk?

A They -- they let -- this is the current Value Line. So from -- have Value Line's perspective looking at Aquila as a -- as the left-over of those operations, Value Line still recorded them as a five at that point in time.

Q And you say that's current?

A That's current. Yes.

Q So Value Line evaluates them differently than S&P?

A Yes. S&P looks at them from a debt standpoint. And S&P is -- is -- is -- is -- normally, the debt rating agencies are the conservative people of the world because they're advising people on default.

The most recent Value Line is focusing primarily on the -- on the merger. And, in fact, there's a more sturdy Value Line that says that the -- the risk right now is the merger might go through on its present form. So Value Line is focusing on the uncertainty as an equity investment from the standpoint that here's now, not what's left of the utility operations, but what's going to happen to the equity and investors and what price they're going to get.

So a lot of that is what's driving Value Line. That's the March -- even the March 30 Value Line is focusing on that.

Q Is it correct that you make no adjustment for risk?

A No upward adjustment because, again, if you look at Standard & Poor's, from S&P's standpoint, they're of an average risk nature, the utility operations from the standpoint of a regulated utility.

Q I just asked you is it correct that you made no adjustment for risk. Yes or no?

A That is correct. Yes.

COMMISSIONER MURRAY: Okay. Thank you.

JUDGE VOSS: Commissioner Gaw?

COMMISSIONER GAW: I'm still thinking, but I'm -- I'm going to pass.

JUDGE VOSS: Okay. Are you still -- Commissioner Appling?

COMMISSIONER APPLING: No questions.

JUDGE VOSS: Okay. Recross based on questions from the Bench? Mr. Mills?

RECROSS EXAMINATION

BY MR. MILLS:

Q Mr. Parcell, I think you -- in response to a question by Judge Voss, you said that wires only companies are viewed as less risky than integrated utility companies; is that correct?

A Yes.

Q And -- and how -- how significantly less risky are they? First all, do you agree with this assessment?

A I agree to a certain extent. Let me give you a real life example. I'm testifying in Merlin on Friday of this week in a case involving Potomac Electric Power Company.

Now, Pepco sold all of its generation assets several years ago to, believe it or not, Murant and became a wires company. And then Murant declared bankruptcy and defaulted on all their -- all their contracts.

That also drove Pepco down to a downgrade. In the current case, though, Pepco and its witnesses are not willing to accept a lower rate of return because they are a wires only company. They say it does not apply to them. So wires companies don't think they're less risky.

So that's, again, that's a case I'm involved in right now. And I was involved in a sister company of Del Marva Power & Light. I actually testified on behalf of the Delaware staff, and they did accept a margin of just a few basis points. They got an authorized return of 10.0 percent.

Q And -- and what sort of rate increases are they looking for in Maryland?

A Huge. It's a make-up case. They -- they tried deregulation for five years. And when they realized it didn't work, the rate freeze expired, so we're talking about 50 or 60 percent increases.

Q And -- and in response to a question from Commissioner Murray, you talked about a -- a March 30 Standard & Poor's --

A Value Line.

Q I'm sorry. Value Line. And Value Line is looking at proposed acquisition of Aquila by Great Pines Energy and considers that as a risk factor?

A It's a risk factor in that, according to Value Line, it's not going to be approved in its current form.

Value Line says, from an equity investor standpoint, it's still a risky company because of the uncertainties.

Q Approved in its current form by whom? By regulators?

A No, by stockholders, shareholders.

MR. MILLS: Thanks. That's all the questions I have. Thank you.

COMMISSIONER GAW: Judge, let me -- let me follow up before we get too far along here and go back to Judge Mills.

CROSS-EXAMINATION

BY COMMISSIONER GAW:

Q I wanted to just explore this -- this issue about -- about the comparative risk of transmission and distribution companies to vertically integrated companies that contain generation within their profile for a minute.

Do you think that there is a difference in a scenario where the generation company has been -- has been sold off to an unrelated company and a -- and a situation where there's merely a separation into different corporations but still a common parent ownership of the T&D company and a generation company within a -- within an organization in regard to -- to risk profile?

A It -- it can be. And, again, Pepco was a perfect example. Pepco has two sister companies, two other subsidiaries that belong to Pepco Holdings, Inc., or PHI. One's Del Marva Power & Light which operates in Virginia, Delaware and Maryland. And the other is Atlantic City Electric.

In the case of Del Marva and Atlantic City, those two companies were part of what was called Connective prior to their merger to Pepco, and they had done what you're suggesting. They created a separate subsidiary and transferred all their generation assets to the separate subsidiary so they stayed under the umbrella of being Connective.

Q Okay.

A And then Connective and Pepco merged to form Pepco Holdings. Well, Pepco had already sold its generation off to Murant. And in this case, since Murant turned out not to be financially viable and declared bankruptcy, and that did create a risk factor, not only to Pepco, but also del Marva and Atlantic City were put on credit watch, even though they were separate subsidiaries.

So you would think they'd be as shiny as a wall or -- financially, there was no ring fence in there. So in that case, Del Marva and Atlantic City were treated no better than Pepco even though they had a separate subsidiary, because any litigation that affected Pepco and Pepco Holdings could eventually filter down to -- to Del

Marva. And, again, that's especially true for Standard & Poors because Standard & Poor's, unlike Moody's & Fitch, they look at the whole corporate family when they assign bond ratings.

And unless there's some specific ring fence, which is rare these days, everyone in the family gets basically the -- the same bond rating. So that was a situation where it did not help them.

Q Okay.

A What we want -- what we want -- one subsidiary bought is generation from a sister company and subsidiary bought its generation from a separate -- separate bankrupt company and they both went on credit catch at the same time for the same reason, so it did not help them.

Q Okay. All right. The -- so when you have a situation where there is -- let me give you this scenario first, and I want -- so I can understand how you look at the risk in comparison to companies that are vertically integrated.

If you have a transmission and distribution company in a retail choice state that has no affiliates that are selling generation or owning generation, is that risk profile consistently a lower risk than a vertically integrated utility in a non-retail choice state?

A I'm -- I'm not sure what you're asking me to

say. Would you repeat it one more time?
Q Yeah. Yeah. Let's -- let's assume that the comparison here is a transmission and distribution company.
A Okay. Integrated company.
Q No generation.
A Oh, a wires company.
Q Wireless.
A Wireless.
Q No generation is owned, and they're -- and by an affiliate of that company and no -- they also do not sell generation. They're not a marketer either any of the affiliates.
A They buy it. It's delivered.
Q It's all -- and they're in a position to just -- just be -- just owned distribution and transmission. That's all.
A Okay.
Q And no affiliates that are involved in generation.
A A true wires company.
Q Yes. Comparing that to a company in a -- where the profile is a non-retail choice state and it's vertically integrated, is the wires company more risk in that scenario generally, or -- or could that depend on

other things?

A Well, it -- it would depend somewhat on the stability and the reliability of its contracts.

Q Explain that -- explain that just a little bit, if you would, so that's clear.

A Well, I -- I'm interpreting your question to mean that the wires company does not actually buy the electricity. They just deliver it.

Q So that's all they're doing?

A So any risk to the cost of electricity would be borne by ratepayers.

Q Yes. In my scenario, all -- they are getting -- they are getting a rate of return that's been established by some entity, a Public Service Commission, in -- in their state, but they are not bearing the risk of the -- the fluctuation of price or any of -- any of those things that sometimes happen?

A Right. Right. The City of Richmond is that way. And the people at risk then are not the utility or the City but the ratepayers. Because if the raw product price goes through the roof, the ratepayers pay for it and have no choice.

Q Yes.

A So that's where part goes to the ratepayers and less goes to the utility.

Q Yes. And in that situation, can you compare the general risk of a company of that sort to a vertically integrated company in a non-retained choice state?
A Well, a vertically integrated company would have not transferred that portion of the risk to its ratepayers, to the stockholders. So there would be -- would be some difference in risk in those two -- those two examples.
Q Okay. So generally, would the wires company, as you like to use that term, be a lower risk, generally?
A Yes.
Q All right. Now, I want you to go to a -- a transmission and distribution company that does have affiliates that sell generation into the marketplace and in a retail choice state and -- and give me some idea of how that compares to the wires company that doesn't have the affiliation that I just described. It doesn't have any affiliation with the generation company.
Can you -- can you give me a general comparison of risk between those two?
A I'll try. What you've got there is a situation where the -- some of the risk of the generation is borne by a non-regulated subsidiary of the same utility. I'm sorry. Of the company that owns the utility, sister company.

So the -- the risk and potential rewards, if you will, of generation there is borne by the holding company, therefore, which is the shareholders. And the -- as long as the -- the contracts were fair, it is probably not a great deal -- I also need to know how much of the generation is sold to non-utility affiliates because that would be a truly competitive market, and whether the utilities have to buy from the parent.

And the most stringent of those four, it would be almost the same from a utility standpoint as a wires company.

Q And the situation where it's not in the purest of those forms and you -- and you're in a situation perhaps where there is uncertainty into -- into the ability to -- to actually have buyers from your generation and the price that you're going to receive from that generation from the -- in the affiliate, does that change that dynamic?

A Well, it does. That's almost the situation that Aquila was in in 2002. They had this generation capacity which they're selling in the open market. And according to what I've read, it was a market that was more supply and demand. It was a very bad situation for them that almost bankrupted the company, including the utility.

So if you got that situation where you have a lot sold in the outside market, you assume a lot of risk.

Q Okay. Now, with that -- with that type of a scenario, is it -- is it possible, then, for a company that is designated as a wires company or transmission and distribution company that has affiliates with -- that -- that are dealing with generation in a riskier market to actually have a higher risk profile than a vertically integrated company might have in a non-retail choice state?

A It could, again, without the so-called ring fence. And the -- the non-utility generating arm of a subsidiary could create enough risk that you get the utility downgraded.

It almost happened, like I said, in the case of the Pepco subsidiary because they were on credit watch, and it probably did happen in the case of Aquila in 2002, 2003.

Q Now, the reason I'm asking this question is because there was -- there had been some argument made that transmission and distribution companies are always lower risk profile than vertically integrated company in a non-retail choice state.

And I want to make sure I'm following you. But I think what I'm hearing you say is -- you correct me if this is incorrect, is that that is not always the case?

A That is correct. And, in fact, in my rebuttal testimony, I was asked some questions this morning about some -- some cases that I cited.

Well, the cases that have come up since that testimony involved Appalachian Power Company, a case in Virginia, and they're owned by a America Electric Power, and it's pretty much an integrated company.

And the Commission's final order is not out. But the Hearing Examiner came out with his opinion just a couple weeks ago and gave Appalachian a 10.1 percent. And that's very much an integrated company.

So you still see integrated companies with the appropriate risk profiles coming out with similar returns to what distribution is probably for the very reasons you're referring to.

COMMISSIONER GAW: Okay. That's all I have. Thank you, sir. Thank you, Judge.

JUDGE VOSS: Commissioner Murray?

CROSS-EXAMINATION

BY COMMISSIONER MURRAY:

Q I -- I may not have been listening carefully enough, but something you said in answer to Commissioner Gaw puzzled me, and I just need to clear up what you're actually saying.

I thought I heard you say that in a retail choice state, a pure wires company that was merely selling the electricity would not be wearing any risks, it would all be to the ratepayers?

A No. I said a portion would be transferred to the ratepayers and that portion is the risk associated with increasing prices of the products as opposed to -- a utility might get stuck with it, not the --

Q All right. Stop.

A The ratepayers. That's what I said.

Q All right. My follow-up question, then, is that is only if you assume that the utility is able to pass through all of its fuel costs, all of its increasing costs to the ratepayers; is that correct?

A That is correct.

Q And if you --

A To the extent that is true, correct.

Q If you have the rate set at a current level and then the costs to the utility increase, it is, indeed, the utility that is bearing the risk, is it not?

A That's correct. But the question he asked me, as I interpreted it and I thought I even stated this was that the -- the company could pass the costs along. Therefore, the utility was not a risk. That was my perception of the question, and that's the way I answered it.

Q Okay. You thought that was -- it was a part of the hypothetical in the question. I -- I didn't hear -- I guess I didn't hear the question phrased.

A That was my understanding, yes.

Q Because I immediately thought of retail choice states where the rates had been frozen and ratepayers certainly did not bear the risk of the increasing costs.

A Right. And those are states liked Maryland, for example, where the freeze has ended and so we're talking 50 or 60 so. So the shoe has dropped.

Q Right.

A And that -- the ratepayers are back in the -- the risk bucket.

Q Well, potentially. Politicians are in there as well.

A Well, I'm testifying on Friday. I'm not going to comment on that one.

COMMISSIONER MURRAY: Okay. Thank you.

JUDGE VOSS: Are there any more questions from the Bench?

COMMISSIONER GAW: No.

JUDGE VOSS: Okay. Mr. Mills, did you have any additional redirect?

MR. MILLS: No, thank you.

JUDGE VOSS: AARP, did you have any redirect based on questions from the Bench?

MR. COFFMAN: No.

JUDGE VOSS: Federal Executive Agencies?

CAPTAIN HOLLIFIELD: No questions.

JUDGE VOSS: Sedalia Industrial Energy Users Association?

MR. WOODSMALL: (Mr. Woodsmall shakes head.)

JUDGE VOSS: Aquila?

MR. SWEARENGEN: Just one or two, please.

RECROSS EXAMINATION

BY MR. SWEARENGEN:

Q Mr. Parcell, Commissioner Gaw was asking you initially about the comparative risk of transmission and distribution utilities versus vertically integrated companies, and you had a dialogue about that with him.

And I'm trying to reconcile that with the statement that you made in your direct testimony concerning whether or not it would be fair to request Aquila's utility customers to pay higher rates to offset losses resulting from the company's non-regulated operations. That -- that's still your testimony, isn't it?

A Yes. In fact, I think that's Dr. Hadaway's testimony as well.

Q Correct. And to the extent that the regulatory

Commissions that set the rate for these various transmission and distribution companies that we've talked about in this case look at the risks of the parent corporation and reflect that in the rates of the -- that are set for the transmission and distribution operations, they would be running afoul of -- of your pointer, would they not?

A There's two questions there. The first question is if -- if I may. The first question is can you look at risk of the parent and say that risk should be assigned to a subsidiary? The answer to that is no.

The second question is has the risk of the parent impacted the subsidiary and made its risk greater, i.e., by downgrading of bonds. And the answer to that question is yes. So there's two questions there. One's no, one's yes. The utility can still be impacted, as in the case of Aquila, by the operation of its parent or a subsidiary sister company.

Q So to that extent where you say it could be impacted, that would only occur if the regulator would allow that to happen; is that right?

A No, no. The regulator couldn't stop it from happening. Classic case of Aquila. The -- the parent company through the operations of a non-regulated subsidiary has disastrous results. The entire operation got downgraded, and it affected the risk profile and the -- the cost of debt, et cetera, for the utilities. The Commission had nothing to with that, couldn't stop it.

Q I understand that. My question was not whether they could stop that from happening, but if the Commission could stop an adverse effect of that from happening through rates.

Wouldn't you agree that the Commission ultimately decides what rate to set for the utility company?

A The Commission cannot offset single B bond ratings. You cannot allow the cost, but you can't change the ratings.

Q I understand that. And if you do not allow the costs, then it does not affect the rate charge to the customer; is that correct?

A It doesn't. But then that could have an effect down the line. So even there, there's no guarantee. There's no good result from having a -- a non-regulated subsidiary go bankruptcy.

I mean, it -- you can't -- you can do all kinds of things. You can try and fix it, but you can't fix it all. You can't totally insulate it.

Q You're not --

A That's the classic case for Aquila.

Q You're not suggesting in the case of these other transmission and distribution companies that the Commissions did not exercise their authority by allowing these costs to be passed on when they shouldn't have been?
A See --
MR. THOMPSON: Objection. It's irrelevant to this case.
MR. SWEARENGEN: That's all I have. Thank you.
JUDGE VOSS: Are there any other questions from the Bench? I'm seeing -- just making sure. It's time for redirect. Does Staff have substantial redirect?
MR. THOMPSON: I don't have any redirect. Thank you.
JUDGE VOSS: Well, then, I think we're going to take about a 15-minute break and come back at about seven or eight after because the Chairman wants me to call him.
So before I officially excuse Mr. Parcell, I want to make sure that he doesn't have any questions to filter through me to you.
(Break in proceedings.)
JUDGE VOSS: After speaking with the Chairman, who has no questions, Mr. Parcell, you are excused. And I believe the only other witness on this issue would be Mr. Gorman.
MR. WOODSMALL: Yes, your Honor.

MICHAEL GORMAN,

being first duly sworn to testify the truth, the whole truth, and nothing but the truth, testified as follows:

DIRECT EXAMINATION

BY MR. WOODSMALL:

Q Would you state your name for the record, please?

A Michael Gorman.

Q And have you prepared testimony in this case?

A I have.

Q And who did you prepare testimony on behalf of?

A The Federal Executive Agencies, Sedalia Industrial Energy Consumers Group and St. Joe Industrial Group.

Q Do you have before you what has been marked as Exhibit 507, direct testimony, 508, rebuttal testimony, and 509, surrebuttal testimony?

A I have copies of those, yes.

Q Do you have any changes to make to that testimony?

A I do have a change in my direct testimony. At page 22, line 20, the source, Thompson Financial and a comma should be inserted. And line 20 should read, Estimates, Thompson Financial, and Reuter's First Call. That concludes my corrections.

Q With those corrections in mind, if I were to ask you the same questions contained therein, would your answers today be substantially the same?

A They would be. Yes.

Q And are those answers true and correct to the best of your knowledge and belief?

A They are. This was one issue in my direct testimony where I referenced Aquila's current Standard & Poor's business profile core of eight. That was actually changed in the last half of last year down to six.

The company used a proxy business profile score of six at the end. For their presentation, I did not take issue with that. But by the time I filed my testimony, their actual Standard & Poor's business profile score had been changed to six. But it was not an issue that changed any -- any of the presentation of my testimony.

MR. WOODSMALL: Thank you. With that, your Honor, I'd offer Exhibits 507, 508 and 509 and tender the witness for cross-examination.

JUDGE VOSS: Are there any objections to the admission of those exhibits? Hearing none, they're admitted.

(Exhibit Nos. 507, 508 and 509 were offered and admitted into evidence.)

MR. WOODSMALL: Thank you, your Honor.

JUDGE VOSS: And based on the order of issues, AARP is first. Mr. Coffman, do you have any questions? I hear somebody's buzzer going off. Those are supposed to be turned off, please. Sorry, Mr. Gorman. I should have reannounced it. They mess up the web casting. Is Mr. Coffman in the room?

MR. WOODSMALL: No.

JUDGE VOSS: Okay. I didn't see him back there. Okay. Public Counsel, your witness.

MR. MILLS: I have no questions.

JUDGE VOSS: Staff?

MR. THOMPSON: No questions.

JUDGE VOSS: Aquila?

MR. SWEARENGEN: Thank you, Judge. Just a few.

CROSS-EXAMINATION

BY MR. SWEARENGEN:

Q Mr. Gorman, I'm Jim Swearengen. I represent Aquila in this proceeding.

A Good morning, Mr. Swearengen.

Q I've met you previously.

JUDGE VOSS: I'm not hearing you for some reason.

MR. SWEARENGEN: You're not hearing me because I've turned it off.

JUDGE VOSS: Okay.

MR. SWEARENGEN: We have been talking about the zone of reasonableness, and I have imposed the zone of silence. It's a concept that I will develop in greater detail with this witness.

JUDGE VOSS: Okay.

MR. WOODSMALL: Make for short cross.

MR. SWEARENGEN: If counsel will let me.

Q (By Mr. Swearengen) In all seriousness, Mr. Gorman, I do have just a few questions for you. Let me ask you, you've testified before this Commission before --

A Yes.

Q -- is that correct? And in connection with the preparation of your testimony for this case, did you review the most recent decisions that this Commission has issued involving cost of capital for electric utilities?

And I'm talking about the December decisions involving the Kansas City Power & Light Company and the Empire District Electric Company.

A Yes.

Q Okay. And would you agree with me that KCPL was award an 11.25 percent ROE?

A Yes.

Q And the capital structure for KCPL in that case was 53.69 percent, as I recall, equity.

A Well, I believe that's correct. I'll accept it subject to check.
Q Okay. Thank you. And Empire, on the same day, was awarded a 10.9 percent return on equity. Do you recall that?
A I'd have to verify it was the same date, but I believe that was the correct return on equity.
Q And Empire's capital structure in that case consisted of about 49.74 percent equity. Do you recall that?
A That's my understanding, but I'll accept that subject to check.
Q Did -- were you in those cases for anybody?
A No.
Q Insofar as your knowledge of those decisions as reflected by those reports and orders, do you have any disagreement with what the Commission did in those cases regarding return on common equity?
A Well, I didn't come prepared to critique those orders. But 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.
Q Okay. Thank you. Let me ask you this,

Mr. Gorman: Is it your testimony that the determination of Aquila's cost of common equity in this case should be based primarily on observable and verifiable actual current market costs?
A To the extent available, yes.
Q Okay. And you've testified to that effect --
A Yes.
Q -- in this case? And is it also your testimony that in determining the appropriate return on common equity the Commission should consider and take into account a broad range of actual capital market costs during the period that the rates established in this case will be in effect?
A Yes.
Q And you've also testified to that effect in this --
A To the extent that information is available, it should be given consideration.
Q And is it your understanding and would you agree that the rate that the Commission authorizes in this proceeding will likely be in effect for at least the next year?
A I would expect so. Yes.
Q And could they be in effect possibly longer than that?

A Yes.
Q Would you agree that at the present time and, in fact, for the last few months that short-term interest rates have been higher than long-term interest rates?
A For the last few months, that's correct. Yes.
Q And I think Mr. Parcell testified earlier this morning. Were you in the hearing room when he was here?
A Yes.
Q I think he indicated that that was the case and said that's what economists mean when they say that the yield curve is inverted. Do you recall his statement to that effect?
A Yes. I agree with that.
Q You agree with that? And I think I asked him if that was a normal situation, and he said something to the effect that it's more normal than it used to be. How would you characterize an inverted -- an inverted yield curve in terms of whether it's a normal situation?
A Well, in terms of normal, it depends on the Federal Reserve's efforts to control inflation and to control money supply. The short-term interest rates are largely controlled by the Fed.
When the Fed believes inflation pressure is significant, they will often tighten the money supply, which drives up short-term interest rates, which can

impact the economy in such a way that it can mitigate inflation growth expectations.

While the Fed can control short-term interest rates, they really have no control over long-term interest rates. Long-term interest rates are controlled strictly by the marketplace. And it is the market's expectation of what inflation and credit risk is over the long-term.

The intermediate to long-term is what controls the market's development of bond prices, and, hence, long-term interest risk. So to an extent, short-term interest rates are more controlled by government or bureautic -- bureautic agencies whereas long-term interest rates are controlled almost exclusively by the marketplace.

Q Let me ask you this question: As a general proposition, would you agree that usually investors demand or expect higher yields for longer term investments as opposed to shorter term investments?

A Typically, there's more uncertainly in a longer term. So generally speaking, the market does demand a higher compensation to assume that greater risk.

Q And is that, among other reasons, because those who invest in longer term securities are giving up the use of their money for a longer period of time?

A Uh-huh. Well, it depends on the liquidity of the investment they're taking. But there's more uncertainty in the long term. So that it -- it gives rise to the expectation of greater risk in long-term securities versus short-term investments.

Q And investors in long-term securities are using -- usually give up their ability to use money for something else during that period; is that true?

A That is correct.

Q So is that sometimes called the opportunity cost?

A Well, I mean, there's opportunity cost and short and long-term investments. But it -- to the extent you lock your investment up for a long period of time, that would -- that is not liquid.

There's not a secondary market for that investment. Then there would be a premium built in, I would expect, to that investment valuation to enhance their -- their return available to a investor for locking up an investment.

MR. SWEARENGEN: Thank you. That's all I have. Thank you.

JUDGE VOSS: Okay. I don't have any separate questions for this witness, but I would assume that the commissioners do. I sent them an e-mail. And we got so rapidly to Aquila's cross-examine, so, hopefully, they will be down shortly. We'll go ahead and do redirect of the issues that have been raised, if there is any.

MR. WOODSMALL: I'd kind of like to just go to silence. No redirect.

JUDGE VOSS: Let's see. Actually, before I say that --

MR. SWEARENGEN: It's not code of silence. It's cone of silence.

MR. WOODSMALL: Either way.

JUDGE VOSS: Well, then we will after, you know, ten minutes on the record take another break while I find out what the Commissioners would like to do. So let's come back at 10:30.

(Break in proceedings.)

JUDGE VOSS: We're back on the record. Questions from the Bench. Commissioner Appling?

CROSS-EXAMINATION

BY COMMISSIONER APPLING:

Q Mr. Gorman, how are you doing this morning?

A Very good. Thank you.

Q What are you recommending for Aquila? Ten?

A Ten percent.

Q Ten percent. What's the average across this country? Do you have any idea?

A For 2006, excluding some that didn't relate strictly to regulated operations for electric utilities was around 10.3 percent.

Q 10.3?

A Yeah. The industry average authorized return on equity for regulated operations has been decreasing by approximately 20 basis points over the last few years. So in '05, it was about 10.5. In '04, it was about 10.7.

Q I'm sure, without a doubt, that you have followed Aquila's ups and downs over the last two or three years, haven't you?

A Yes. Okay. So what -- what -- why do you say 10 versus 10.3 for this company?

A Well, two reasons. First, cost of capital in today's marketplace justifies a return of around 10 percent for a company with Aquila's regulated risk profile.

And, second, there are some going-forward risks that I think justify a 10 percent rather than something a little less than 10 percent for Aquila.

Specifically, I've recognize their current construction activities. I've recognized the -- the limited financial isolation of the Missouri operations relationship to the total company and the need for the Missouri operations to be able to track capital of necessary infrastructure investments here in Missouri.

So that, I believe, would support a 10 percent return on equity as being a little higher than what I would recommend for other utility companies such as what I've recommended recently for Ameren and some other companies that -- that don't have those -- the same degree of risk that I think Aquila does, but lower than the industry average from prior years because the prior year trend is for reducing authorized return on equity down to where the -- the debt cost was adjusted many years ago.

Authorized returns on equity have simply not caught up to the market in reducing utilities' common equity costs in line with what the market is doing immediately. So that is the general thought process I went through in --

Q Right.

A -- in arriving at my 10 percent return on equity recommendation.

Q What -- what were your thoughts -- and I read your testimony, but I -- that was before Easter, so what was your thoughts on the fuel adjustment clause?

A Well, my recommendation is based on the company's current operating risk profile and that -- that it does not include a fuel adjustment mechanism.

And how I reflected the current operating risk in the company is to consider the target Standard & Poor's business profile score the company originally identified as a target, which is the S&P business profile core of six. They actually achieved that late last year.

Business profile risk assessment takes into consideration many factors which compose the total operating risk of a utility company. Those would include management strengths, management's ability to manage the operating expenses of the utility, management's ability to grow the system in terms of adding new customers and maintaining existing customer bases of the regulatory Commission.

The second major element of operating risk which equates to the regulatory agency's regulatory process and what kind of regulatory mechanisms they put in place to allow the utility a reasonable opportunity to recover to financial operating cost of business.

And third is -- is the service area economy. This Missouri operations are growing customers, which is -- is positive in terms of service area economy risk and general macroeconomic conditions, which may impact the utilities and -- and give an indication of whether or not its customers can afford its current rate structure, which -- which gives some insight as to whether or not the revenues that the Commission determines are appropriate for the utility to recover will actually be recovered without significant uncollectible expenses or loss of major customers because of the non-competitive rate structure.

Q Now, Aquila has sold off over the last few months a portion -- some portions of their -- their company. Is that making them more attractive to -- to investors and all that?

A Yes, sir. I think it is significantly reducing their -- both their financial and their operating risk. A lot of the businesses they've sold dealt with their merchant and energy trading businesses, which are very high operating risk enterprises.

They've also sold some other regulated utility operations and are concentrating their efforts in a smaller number of jurisdictions, much more manageable service area. But they are -- will be operating and going forward.

But the proceeds of those asset sales have also been used to reduce their outstanding debt, and that has caused a significant improvement in their balance sheet, much reduction in the financial risk of the enterprise.

So the combination of reduced financial risk by increasing the common equity ratio and reducing debt interest expense and eliminating very high non-regulated operating risk companies and reducing the number of regulatory jurisdictions they operate in has significantly, in my opinion, improved the financial outlook of this company.

Q Mr. Parcell this morning, I think, kind of plugged in a number of six as far as their risk factors are concerned. Do you agree with that?

A Yeah. What he was quoting was Standard & Poor's. It's a credit rating agency's assessment. And Standard & Poor's evaluates a company's business risk on a scale of one, which is lowest operating risk, to ten, which is highest operating risk.

Most integrated utilities companies, integrated electric utility companies, have S&P business profile scores in the range of four to six. So Aquila's business profile score is consistent with other integrated regulated utility companies.

And by integrated, I mean a condition that offers generation, transmission and distribution service in a bundled package.

COMMISSIONER MURRAY: Thank you.

JUDGE VOSS: Commissioner Gaw?

COMMISSIONER GAW: I don't have any questions. Thank you, sir.

MR. GORMAN: Thank you.

JUDGE VOSS: Is there any recross based on questions from the Bench? Mr. Mills?

CROSS-EXAMINATION

BY MR. MILLS:

Q Mr. Gorman, I believe in response to one of Commissioner Appling's questions you mentioned the fuel adjustment clause.

If Aquila is awarded a fuel adjustment clause in -- in this case, would that change your recommendation for the appropriate return on equity?

A It would. The fuel adjust -- implementation of a fuel adjustment mechanism would reduce the operating risk of this company and I think would justify a lower return on equity.

Q And can you quantify that?

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.

MR. MILLS: Thank you.

JUDGE VOSS: Staff?

MR. THOMPSON: No questions.

JUDGE VOSS: Aquila?

MR. SWEARENGEN: Yes, please. Thank you.

RECROSS EXAMINATION

BY MR. SWEARENGEN:

Q Mr. Gorman, I think you said in response to a question from Commissioner Appling that your 10 percent recommendation for Aquila in this case was based on their regulated risk profile?

A Yes.

Q Okay. And -- and I think you followed that up by indicating that you recognize several things in that regard including their construction activities?

A Yes.

Q And what were the other factors that you looked at?

A The other factor -- well, predominately, I relied on S&P's business profile score for a utility company which considers construction risk, regulatory risk, management risk, service area economy risk.

I recognize that Aquila's current profile score from S&P now is at the high end of what's typically awarded to -- or determined appropriate for integrated utility companies.

Q And I think you said those were the reasons why your recommendation for Aquila in this case was higher than what you recommended for AmerenUE and that recently concluded case?

A In -- in particular, some of the circumstances surrounding Aquila, which deal with some financial improvement programs, its construction activities and --

Q And what was your recommendation in the AmerenUE case?

A 9.8 percent.

Q And since your 10 percent recommendation for Aquila in this case includes those risk factors that you mentioned, including construction risk --

A Yes.

Q -- I assume that if the Commission in its ROE award to Aquila in this case recognized those risk factors, that would be consistent with your thinking?

A Well, if they added it to my authorized return on equity, it would be redundant with it because they have already been built into my recommendation.

Q But if they did consider those in their decision, those risk factors, that's something that you think would be appropriate?

A Well, considering the -- the current risk of the company, as is important in determining appropriate return on equity, I think those are two factors that should be given consideration, not the only factor, but two factor that should be considered.

MR. SWEARENGEN: I understand. Thank you. That's all I have.

JUDGE VOSS: Now redirect? Does the Federal Executive Agencies have any redirect?

CAPTAIN HOLLIFIELD: No questions, your Honor.

JUDGE VOSS: Sedalia Industrial Energy Group?

MR. WOODSMALL: No, thank you, your Honor.

COMMISSIONER APPLING: No, thank you.

JUDGE VOSS: Well, then, Mr. Gorman, you're excused. And this concludes the hearing for today because, as I mentioned off the record, a couple of the Commissioners will not be back until late today or late tomorrow, and they want to be sure not to miss any of the issues related to the fuel adjustment clause.

I N D E X

E X H I B I T S

EXHIBIT	DESCRIPTION	OFFERED	ADMITTED
221	Direct Testimony of David Parcell	467	467
222	Rebuttal Testimony of David Parcell	467	467
223	Surrebuttal Testimony of David Parcell	467	467
507	Direct Testimony of Michael Gorman	518	518
508	Rebuttal Testimony of Michael Gorman	518	518
509	Surrebuttal Testimony of Michael Gorman	518	518

(Original exhibits were retained by the Public Service Commission.)