BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its Aquila Networks—MPS and Aquila Networks—L&P Missouri Service Areas.	)))))	**Case No. ER-2007-0004** Tariff No. YE-2007-0001

STAFF'S PREHEARING BRIEF

Respectfully submitted,

Kevin A. Thompson
General Counsel
Missouri Bar No. 36288

Denny Frey
Senior Counsel
Missouri Bar No. 44697

Nathan Williams
Deputy General Counsel
Missouri Bar No. 35512

Attorneys for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-8700 (Telephone)
(573) 751-9285 (Fax)

denny.frey @psc.mo.gov
nathan.williams@psc.mo.gov

NP

TABLE OF CONTENTS

REVENUE REQUIREMENT 4

Rate of Return

1. Return on Common Equity 4
2. Capital Structure 5
3. Cost of Debt 5

Rate Base Issues 8

4. Generation Resources 8
5. South Harper 12
6. Accounting Authority Orders 14

Expense Issues 17

7. Fuel and Purchased Power allocation 17
8. Fuel and Purchased Power Expense 17
9. Coal Prices 17
10. Natural Gas Prices 22
11. Off- System Sales Margins 26
12. Depreciation 26

Demand Side Management 26

13. Demand Side Management programs and costs 26

Hedging 28

14. Recovery of Aquila's hedging results 28

Fuel Cost Recovery 31

15. Fuel and purchased power recovery mechanism 31

NP

CONCLUSION 36

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its Aquila Networks—MPS and Aquila Networks—L&P Missouri Service Areas.	)))))	**Case No. ER-2007-0004** Tariff No. YE-2007-0001

STAFF'S PREHEARING BRIEF

On July 3, 2006, Aquila, Inc. filed tariff sheets to implement a general electric rate increase for service it provides to its Missouri customers in and about Kansas City and St. Joseph, Missouri under the names Aquila Networks-MPS and Aquila Networks-L&P, respectively. The Commission suspended the effective date of the tariff sheets and opened Case No. ER-2007-0004.

The Staff has organized this brief to follow the list of issues filed March 22, 2007; however, the Staff believes the most significant issues are those pertaining to Aquila's rate of return (Issues 1, 2 and 3), proposed fuel cost recovery mechanism (Issue 15), fuel and purchased power costs (Issues 8, 9 and 10) and generation capacity resources (Issues 4 and 5).

REVENUE REQUIREMENT

Rate of Return

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

Alternatively,

A. What is the appropriate proxy group to be used in calculating Aquila's return on equity?

B. What is the appropriate model (discounted cash flow, capital asset pricing model, risk premium) to be used in estimating Aquila's return on equity?

C. In the event that the Commission decides to use a DCF model for estimating return on equity, should the Commission utilize a constant growth or multistage DCF model or both?

D. For any DCF model, what is the appropriate growth rate?

E. In the event that the Commission decides to use a risk premium model for estimating return on equity, what is the appropriate premium to account for the difference in risk between equity and bondholders?

F. In the event that the Commission decides to utilize a risk premium model for estimating return on equity, what is the appropriate interest rate for utility bonds?

G. Is an equity add-on appropriate to account for Aquila's construction risk and small company nature?

Staff Position: Using traditional and accepted methodologies, Staff estimates Aquila's Cost of Common Equity as a range of 9.0 – 10.25, midpoint 9.625. Given that the average awarded ROE for electric utilities in 2006 was 10.36, Staff's recommendation of 9.625 is within the Zone of Reasonableness extending from 9.36 to 11.36. Nothing in Aquila's recent performance supports an ROE at the high end of the Zone of Reasonableness.

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

Staff Position: Although Staff does not agree with Aquila's proposed hypothetical capital structure, Staff's capital structure – derived using traditional methods and based on Aquila's actual, consolidated capital structure – coincidentally results in the same ratios as Aquila proposes.

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

Staff Position: Although Staff does not agree with Aquila's "internal assignment process," Staff accepts the embedded cost of debt proposed by Aquila because they appear to represent the actual rates supporting Aquila's Missouri electric operations.

There is no real dispute in this case about either capital structure or embedded cost of debt. The dispute of consequence is over the cost of common equity.

One of the most important and most difficult tasks facing the Commission in this and every rate case is determining the cost of common equity, or return on equity (ROE), to be used

in calculating the rate of return (ROR) that is intended to compensate Aquila's shareholders for the use of their private property committed to the public service. One way to think of ROE is as "profit." In setting ROE, the Commission will determine just how much profit Aquila's shareholders will earn.

This task is important because each "basis point" of profit is worth many thousands of dollars that Missouri working families and small business owners will have to provide to Aquila by paying their electric bills.[1] The task is difficult because it is a matter of expert analysis and the Commission will have to sift through the conflicting opinions of various expert witnesses in seeking a reliable and fair estimate of Aquila's ROE. Oddly enough, these experts will look at the same data and, using much the same methods, reach wildly differing conclusions, depending on whether they are testifying for the Company – which naturally desires a high ROE in order to maximize profits – or testifying for the other parties, who desire a low ROE in order to minimize the electric bills they will have to pay.

An expert witness is a witness that is qualified by "knowledge, skill, experience, training, or education" to assist the tribunal in understanding the evidence or determining a fact in issue.[2] Expert witnesses differ from ordinary witnesses in at least two important respects: first, they may testify as to their opinions and, second, they are paid – often very handsomely – to testify.[3] This is an important distinction because it is a crime to pay a non-expert witness for his or her testimony. Given that expert witnesses are hired by the parties to testify in support of the parties' positions, one should naturally take the experts' testimony with a grain of salt. In evaluating the expert testimony in this case regarding Aquila's ROE, Staff urges the Commission to be ever

---

[1] One basis point is worth approximately 140,000 for the MPS case and 15,000 for the L&P case.
[2] Section 490.065.1, RSMo 2000.
[3] In the recent KCP&L rate case, Case No. ER-2006-0314, expert witness Robert Camfield testified that he had been paid $160,000 for his testimony.

mindful of the bias inherent in the testimony of these hired guns. It is worth noting, in this regard, that only the Commission's Staff has no axe to grind in this case.

Staff has presented the expert testimony of David Parcell, a well-regarded and experienced expert in the field of ROE estimation. Using classic, time-tested methods applied to two comparable groups of utilities, the first including five electric utilities and the second including 24 electric utilities, Parcell proposes a range of 9.00% to 10.25%, selecting the midpoint 9.625% as his final recommendation. Parcell, Direct: 2-4, 30. Parcell relies equally on the comparative Discounted Cash Flow (DCF) method, the Capital Asset Pricing Model (CAPM), and the Comparable Earnings Method. Parcell, Direct: 21-30 (*passim*).

Method	**Result**
DCF	9.00 – 9.50
CAPM	9.75 – 10.25
CEM	10.00

Because the evaluation of expert ROE testimony is so fraught with difficulty and because the Commission rightly regards this expert testimony with some suspicion, the Commission has adopted in recent years a benchmark referred to as the "zone of reasonableness" against which the recommendations of the experts may be compared. This zone is defined as extending one hundred basis points – one percentage point – above and one hundred basis points below the recent national average of ROE awards in the appropriate regulated industry.[4] The testimony shows that the national average ROE award for electric utilities last year was 10.36%, so the "zone of reasonableness" extends from 9.36% to 11.36%. Parcell, Surrebuttal: 3. With this benchmark in mind, it is useful to compare the recommendations offered in this case:

[4] *See, e.g., In the Matter of The Empire District Electric Company,* Case No. ER-2004-0570 (*Report & Order,* issued Mar. 27, 2005) at 45: "the 'zone of reasonableness' defined by this Commission . . . (within 100 basis points above or below the industry average).

Analyst	ROE
Hadaway (Aquila) (1st)	11.50
Hadaway (Aquila) (2nd)	11.25
Gorman (SIEU-FEA-SJIG)	10.00
Parcell (Staff)	9.625

The initial estimate offered by Aquila's expert witness, Samuel Hadaway, is outside of the Commission's "zone of reasonableness." Hadaway's second, revised recommendation, as well as those of Parcell for the Staff and Gorman for the SIEUA – FEA – SJIG, are all within the zone.

For these reasons, Staff urges the Commission to adopt an ROE determined using well-accepted methods as supported by Staff's expert witness David Parcell. Parcell's recommended ROE, 9.625%, is sufficient to provide a fair return on the value of Aquila's assets devoted to the public service.

Rate Base Issues

4. Generation Resources: What are the prudent types and amounts of generation resources to include in Aquila Networks-MPS's rate base and for determining the fuel and purchased power expenses of Aquila Networks-MPS and Aquila Networks-L&P?

Staff Position: Five 105 MW combustion turbine units (525 MW total) at a site designed to accommodate up to six 105 MW combustion turbine units should be included in Aquila Networks-MPS's rate base in place of the 615 MW which Aquila has included through its South Harper facility (315 MW) and two purchased power agreements totaling 300 MW it executed in late December 2006.

The Staff has no quarrel with Aquila's capacity mix, except for its reliance on three combustion turbines capable of generating about 315 MW plus purchased power of about 300 MW to replace the capacity it had from Calpine under a purchased power agreement that ended May 31, 2005, rather than building and owning five combustion turbines for that capacity.

NP

As indicated in the prudence subpart of the statutory requirement and applicable standards section of this brief, the standard under which this issue is evaluated is whether Aquila made an informed and sensible decision (acted prudently) when it chose in 2004 to build three utility-owned combustion turbine generation units capable of generating a total of 315 MW and rely on an additional approximately 200 MW of short-term purchased power to meet its load requirements, rather than building five combustion turbine units capable of generating 525 MW. Further, Aquila continued to rely on purchased power to meet its capacity needs executing short-term purchased power agreements for 300 MW after its 200 MW purchased power agreement expired. In the Staff's view, despite the favorable impact on rates Aquila's choices would have, Aquila should have built five combustion turbines as its least cost plan identified, instead of only the three combustion turbines it did build.

The evidence the Staff anticipates will be adduced in this case which will supports Staff's position that, from the perspective of Aquila Networks-MPS, part of the Missouri utility operations of Aquila, Aquila's decision not to build and own a total of about 525 MW of combustion turbine capacity between February, 2004 and May 31, 2005, was imprudent follows.

Aquila entered into a purchased power agreement with Calpine for capacity of 320 MW during the summer of 2001, 200 MW per month from January, 2002 through May, 2005, and for an additional 300 MW per month during the months April through September in each year 2002 through 2004. The agreement expired on May 31, 2005. To serve its Aquila Networks-MPS customers, Aquila needed to have a new source of capacity in place by the time the foregoing purchased power agreement expired. In 2001 Aquila solicited proposals for replacement capacity. Because of changing market conditions, Aquila did not act on any of those proposals and solicited proposals for capacity again in 2003. In January of 2004 Aquila advised the Staff

Aquila's preferred short-term resource plan was to build and own three combustion turbines in 2005 and enter into three-to-five year purchased power agreements for the balance of Aquila Network-MPS's capacity needs. In response to a letter from the Staff questioning, among other things, the short planning horizon of Aquila's resource plan, Aquila provided to the Staff in February 2004 a resource plan designed on a twenty-year horizon where **____

____

____

____

____

_________________** In July 2004, and subsequently, Aquila's least cost and preferred plans remained the same as they were in February 2004. Aquila ultimately acquired its South Harper facility site and finished building three combustion units with a total capacity of 315 MW on it in 2005. Aquila was unable to enter into a suitable long-term capacity contract for Aquila Networks-MPS's remaining needs, and for part of 2005 Aquila met the shortfall by a short-term contract with an affiliate for 325 MW. After Aquila was unsuccessful in purchasing from Calpine the 585 MW combined cycle Aries facility in December 2006, Aquila entered into new purchased power agreements:

> **____
>
> ____
>
> ____
>
> ____
>
> ____**

NP

The Staff does not quarrel with the process Aquila employed for evaluating its capacity needs for Aquila Networks-MPS; however, the Staff does quarrel with how Aquila exercised its discretion. Until recently, Aquila had a policy of not acquiring generation capacity held by its regulated divisions, and Aquila enforced that policy, even if it's regulated division determined building and owning capacity was that division's best option. Utilities should carefully perform risk and contingency analyses of their resource options and select a plan that is robust throughout many different scenarios of possible future events. When the need for the capacity is anticipated to continue into the distant future, the case here for approximately 525 MW, the primary basis of the decision should be on the long-term impacts on rate base, not the short-term impacts. Among the long-term impacts of owning generation are (1) an overall lowest cost approach to meeting capacity needs, (2) stability to the utility's cost structure not present when the utility is continually pursuing the purchase of capacity to meet its loads, (3) a stronger negotiating position in purchasing power since it has demonstrated a willingness to build capacity, and (4) decreased vulnerability to the purchased power market.

When Aquila was planning how to meet its capacity needs at Aquila Networks-MPS for 2005 and beyond, it was imprudent for Aquila to rely on capacity contracts to meet those needs without even having a firm long-term capacity contract in hand. Further, the Staff believes Missouri consumers obtain stability when a utility meets its capacity needs by building and owning its own generation units. It is the Staff's view that the prudent course for Aquila was to own its generation and not to rely on purchased power agreements to satisfy significant portions of Aquila Networks-MPS's ongoing long-term capacity needs.

Here, Aquila should have owned and had operating for its Aquila Networks-MPS division in 2005 a total of five combustion turbine units capable of generating a total of 525

NP

MW. Instead, Aquila built three combustion turbine units at its South Harper site capable of generating a total of 315 MW and entered into a one-year purchased power agreement with ** ____**. Further, in December 2006 Aquila continued to rely on purchased power agreements for Aquila Networks-MPS, entering into agreements for 300 MW of capacity after its unsuccessful bid to acquire from Calpine the Aries Combined Cycle Unit an Aquila affiliate and Calpine built. The Commission should disregard what Aquila actually did to replace the variable capacity (200-500 MW per month) Aquila Networks-MPS lost when Aquila's contract with Calpine expired in May 2005 and, instead, treat Aquila Networks-MPS as owning five combustion turbine units capable of generating 525 MW.

The Staff has relied on the costs Aquila prudently incurred in acquiring and installing on the South Harper site three combustion turbines capable of generating a total of 315 MW as a proxy for 315 MW of the 525 MW. For the remaining 210 MW the Staff has used an estimate of for the cost of the two combustion turbines of $63.9 million.

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

Staff Position: None. However, in lieu of including the South Harper facility costs in rate base, costs based on the actual costs of the South Harper facility should be included in rate base.

As indicated in the "Used and Useful" and "Fully Operational and Used for Service" subpart of the statutory requirement and applicable standards section of this brief, the standard under which this issue would typically be evaluated is whether the South Harper facility was completed to the point where it may be included in rate base. Because construction of the South Harper facility is complete and Aquila is using the facility to provide electricity to current customers, under the foregoing standards, the costs of the plant would qualify for inclusion in

NP

Aquila Network-MPS's rate base. However, here, as discussed below, Aquila unlawfully built the South Harper facility.

On December 20, 2005, the Western District of the Missouri Court of Appeals issued its opinion affirming the January 11, 2005, judgment of the Cass County Circuit Court permanently enjoining Aquila from constructing and operating Aquila's South Harper facility in Cass County, Missouri.[5] By posting an appeal bond, Aquila was able to avoid the effects of that judgment until it became final and unappealable. Aquila publicly announced January 4, 2006, it will not seek review of the Court of Appeal's opinion and, therefore, the opinion became final fifteen days after it was entered—on January 5, 2006. As a result, there is now a final unappealable judgment that Aquila's South Harper facility is unlawful.

In the Staff's view, the unlawful facility is not properly includable in rate base; however, the Staff believes the Commission should recognize the benefit to ratepayers of the electricity Aquila Networks-MPS is obtaining from the unlawful South Harper facility. The Staff has used the costs of acquiring a site and building three combustion turbine units having a total capacity of 315 MW as a substitute for the unlawful South Harper facility. For the costs of that site and acquiring and installing those combustion turbine units, the Staff has used the actual costs, from the standpoint of its regulated division Aquila Networks-MPS, Aquila prudently incurred in building its South Harper facility.

The Staff has included in its case costs for about 315 MW of 525 MW of generation it asserts Aquila should have met with five combustion turbine units by using Aquila's South Harper facility as a proxy. This issue affects costs the Staff has included in its case.

As discussed above, the Staff believes the Commission should recognize the benefit to ratepayers of the electricity Aquila Networks-MPS is obtaining from the unlawful South Harper

[5] *StopAquila, org. v. Aquila, Inc.*, 180 S.W.2d 24 (Mo. App. 2005).

facility. The Staff has used the costs of acquiring a site and building three combustion turbine units having a total capacity of 315 MW as a substitute for the unlawful South Harper facility. For the costs of that site and acquiring and installing those combustion turbine units, the Staff has used the actual costs, from the standpoint of its regulated division Aquila Networks-MPS, Aquila prudently incurred in building its South Harper facility.

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

Staff Position: Yes. The Commission authorized these accounting authority orders in Case Nos. ER-90-101, EO-91-247 and ER-93-37. The unamortized balances the Commission authorized in those cases should continue to be included in the rate base calculations until such time as the amortization period is complete.

There are two accounting authority orders at issue in this case. The Commission granted them to authorize Aquila Networks-MPS to defer depreciation expenses, property taxes and carrying costs associated with the Capacity Life Extension (Sibley Rebuild Project) and Western Coal Conversion projects at its Sibley generating station. The Commission granted these authorizations in Case Nos. EO-90-114 and EO-91-358 and reauthorized them in Case Nos. ER-90-101 and ER-93-37.

Public Counsel witness Ted Robertson has raised the issue of whether the unamortized balance of the AAOs associated with the Sibley Rebuild Program and the Western Coal Conversion Program should be included in rate base.[6] If the Commission does include the unamortized balance in rate base, the Company will receive a return *on* that balance, as well as a return *of* the balance. All parties agree that the Company may receive a return *of* the balance. The Staff believes the unamortized deferred balances of the AAOs for the Sibley Rebuild Program and the Western Coal conversion Program authorized in Case Nos. ER-90-101 and ER-

[6] Staff witness Williams Rebuttal, p. 4, ll. 1-3.

NP

93-37 should be included in the determination of rate base to permit the Company to receive a return *on* the balance, because this treatment is consistent with the Commission's previous determination of this issue and because the policy determinations underlying the Commission's previous determination remain unchanged and are still appropriate.[7]

Staff has consistently applied the Commission's methodology in each Aquila rate case and the rate cases of its predecessor company since Case No. ER-90-101. The Commission ordered the Sibley Rebuild Program AAO and the Sibley Western Coal Conversion AAO to be amortized over a 20-year period consistent with the life extension of the generating units. The capital expenditures and the related AAO authorized by the Commission are just like any other capital expenditure in that they are given rate base treatment (return on the investment) as well as a recovery of the related costs through depreciation/amortization expense recovery.[8]

The Sibley Rebuild Program and The Sibley Western Coal Conversion Project were extraordinary construction projects undertaken by the Company to ensure it could continue to provide adequate service. These projects represent major capital additions to plant in service, rather than extraordinary maintenance expenditures resulting from an extraordinary occurrence like in an ice storm. The deferred costs included in the AAO authorized by the Commission for the life extension of Sibley should be treated the same way as the other capital costs for these projects, and afforded rate base treatment. Allowing a continuation of construction accounting of major capital projects by an AAO and including those construction costs in rate base provides an incentive for the utility to commit significant capital investment on a timely basis.[9] As Mr. Williams correctly states:

---

[7] Staff witness Williams Rebuttal, p. 4, l. 6 – p. 5, l. 2.-.
[8] Staff witness Williams Rebuttal, p. 5, ll. 10-20.
[9] Staff witness Williams Rebuttal, p. 6, l. 19 - p. 7, l. 5.

NP

> The Commission has already made a ratemaking decision on this issue. To now accept the Public Counsel's arguments would negate the Commission's orders from Case Nos. ER-90-101 and ER-93-37. The AAOs granted in those cases were the result of life extension projects and, as such, should be treated the same way as normal capital expenditures (which are classified as plant in service and not as routine maintenance costs). These amounts were included in the AAOs to provide the Company an opportunity to recover the depreciation, property taxes and carrying costs associated with the rebuilds that occurred between the completion of the projects and the Company's next rate case. Absent AAO treatment, these amounts would have been lost as a result of booking these costs directly to expense following completion of the projects.[10]

The Commission has the regulatory authority to grant a form of relief to a utility in the form of an accounting technique—an Accounting Authority Order.[11] An AAO allows the utility to defer and capitalize certain expenses until the time it files its next rate case, and it protects the utility from earnings shortfalls and softens the blow which results from extraordinary construction programs.[12]

The Commission has performed this function and should proceed accordingly.

6.a. Accounting Authority Orders (AAOs): How should the Commission treat the amortization expense associated with the Ice Storm AAO from 2002 that expires in 2007?

Staff Position: The Commission should include the recovery of the remaining unamortized expense associated with the Ice Storm AAO in the Company's expenses.

An additional issue pertaining to AAOs appears to have been omitted from the issues list. The parties disagree on the appropriate way to treat the AAO the Commission authorized in Case No. EU-2003-1053 to defer and amortize costs incurred due to an ice storm. That AAO amortization ended shortly after the update period. Accordingly, Staff recommends that the Commission place the unamortized balance of the ice storm AAO in the company's ongoing expenses to permit the Company to recover its costs. Staff recommends the Commission include

---

[10] Staff witness Williams Rebuttal, p. 5, ll. 10-20.
[11] *Missouri Gas Energy v. Public Service Commission State of Missouri,* 978 S.W.2d 434, 436 (Mo. App. 1998).
[12] Id. at 436.

NP

the unamortized expenses as of the end of the update period (December 31, 2006) as an ongoing expense, thereby upholding the long-standing matching principle between revenues (which were considered through December 31, 2006) and expenses.[13]

Expense Issues

7. Allocation of Fuel and Purchased Power between Aquila Networks-MPS and Aquila Networks-L&P: On what basis should Aquila's fuel and purchased power expense be allocated between Aquila Networks-MPS and Aquila Networks-L&P?

Staff Position: The Staff's allocation is based the results of "stand-alone" runs of its fuel model for both Aquila Networks-MPS and Aquila Networks-L&P. To the best of Staff's knowledge, the Staff's approach, which has not changed for a number of years, has not been an issue in at least the past three rate cases.

8. Fuel and Purchased Power Expense: What amount of fuel and purchased power costs should be included in expenses?

Staff Position: In the opinion of the Staff, this issue is not meant to indicate that there is an issue with respect to the Staff's modeling of fuel and purchased power costs in this proceeding. No party has filed any testimony raising an issue concerning the Staff's model runs. Furthermore, the Staff believes that the answer to the question raised depends upon the positions taken with respect to other more specific issues related to fuel and purchased power expense, such as issue 9 ("Coal Costs"), issue 10 ("Natural Gas Prices") and issue 11 ("Off-system Sales Margins") below.

9. Coal Prices: On what prices should Aquila's coal fuel expense be based in setting rates?
   a. Should they be based on Aquila's contract with Consolidated Coal Company or on Aquila's contract with C.W. Mining?

Staff Position: Considerable uncertainty still exists as to what Aquila's actual, effective, cost of high-Btu coal will be at its Sibley and Lake Road plants. This is because of the pending litigation with its former supplier, C.W. Mining, over the latter's discontinuation of the coal supply contract that was to be in effect at least through 2006, with an option at Aquila's discretion to extend supply through 2008. With this significant matter still unresolved, it remains Staff's view that it would be premature in the current rate case to charge Aquila's customers permanently for the cost of the more expensive coal with which Aquila has replaced the C.W. Mining coal. Rather, this considerably more expensive replacement coal should only be used in computing the Interim Energy Charge (IEC), thus allowing at IEC expiration a prudence review in which any outcome of the litigation process may be taken into consideration.

[13] Staff witness Williams Surrebuttal, p. 3, ll. 6-12.

The overriding issue with respect to coal prices is whether, as the Staff contends, the cost of coal as specified in the contract between Aquila and C.W. Mining, which the supplier subsequently breached, should be included in the Company's cost of service. This is the same position that the Staff took in the previous Aquila rate case. Aquila argues that the contract with C.W. Mining should not be recognized for ratemaking purposes; and, instead, the cost of replacement coal pursuant to a contract Aquila entered into with Consolidation Coal Company ("Consolidation Coal") subsequent to the breach, a cost almost double that agreed to under the contract with C.W. Mining, should be reflected in Aquila's cost of service.

Aquila witness H. Davis Rooney alleges that the Staff is proposing to establish rates using the price of coal from a supplier who is no longer supplying coal, and that the Company is properly reflecting its actual costs of coal.[14] In response Staff witness Graham Vesely reinforces the Staff's position that the lower costs should be included only in base rates, and that the higher coal rates should be included as part of the ceiling amount of an Interim Energy Charge ("IEC").[15] Indeed, the IEC mechanism is an ideal solution to a situation such as this. Because the forecast amount is subject to refund, to the extent that Aquila receives a judgment for damages due to the breach, that amount might then be refunded to customers following the true-up audit of the IEC, during which the Staff will have an opportunity to make a prudence determination.

Aquila raises a number of arguments in an attempt to rebut the Staff's position, including the following:

a) that Aquila had no policy requirement and no expectation that would prompt even a cursory review of labor relations/practices of a potential supplier.[16] Only the supplier's credit worthiness/financial stability and

[14] Rooney Rebuttal, p. 3, ll. 18-23.
[15] Staff witness Vesely Surrebuttal, p. 2 - p. 7.
[16] Herl Rebuttal, p. 5, ln. 17-18.

ability to supply the proper quantity and quality of coal need be investigated;

b) that, had it taken account of the labor dispute at C.W. mining, it likely would not have changed its decision to contract with C.W. Mining because no other bidder was able to meet the tonnage needs with coal of an acceptable quality;

c) that if Aquila prevails in its lawsuit against C.W. Mining and receives damages, the Company will allocate to its customers their rightful share thereof through the FAC mechanism it has proposed in this proceeding, or if the FAC is denied, through an alternative and appropriate refund mechanism (*i.e.*, as in Case No. ER-82-39);

d) that it is the price of the replacement coal that is known and measurable.

Regarding the first assertion, it should be kept in mind that the matter at issue relates not to a supplier of pads or pencils, but rather to a supplier of coal, arguably the life blood of most electric utilities, including Aquila.[17] Indeed, "[t]he additional costs for replacement of the C.W. Mining coal, which include SO_2 emission credits costs, are in the tens of millions of dollars."[18] Aquila witness Abby Herl suggests that the Company need not consider labor problems because "any company registered in the United States would be expected to follow State and Federal labor laws as required and as enforced by their respective agencies."[19]

Staff witness Cary Featherstone rejects that argument, asserting instead that the Company has a higher duty than merely relying on a company's willingness to adhere to labor laws or a government's ability to enforce them; and therefore, that Aquila was imprudent in failing to take note of the labor issues at C.W. Mining when such a vital commodity was at stake. Moreover, even according to Ms. Herl's own specified evaluation criteria of "the existence of suitable coal reserves, mining capacity to remove it from the ground, and the ability to transport/load out the

[17] Vesely Surrebuttal, p. 3, 5-6.
[18] Featherstone Surrebuttal, p. 25, ln. 16-17.
[19] Herl Rebuttal, p. 5, ln. 18-20.

NP

coal,"[20] it is difficult to see how C.W. Mining would have such capacity in the absence of an adequate labor supply. "Having the coal is one thing, but being able to get the coal mined, transported, loaded and prepared for shipment back to Aquila's power plants is just as important as knowing there is plenty of coal in the ground." While Aquila can assert that it was not required to look into the labor problems of its potential supplier of coal, the bottom line is that its failure to do so has, thus far, cost it many millions of dollars.[21] "A 'policy requirement, or expectation' would not have to be in place to make this review—just plain old good business practice and good old fashioned common sense would require the substantiation that the company under consideration for the contract can fulfill all the terms of the agreement."[22]

Mr. Vesely points some indicators—including the fact that it is not publicly traded and that it does not even have a web site—that, even with a cursory review early on, should have suggested to Aquila that perhaps C.W. Mining's status should be accorded greater scrutiny. This is especially so, given that Aquila had only one or two past spot market business dealings with C.W. Mining. Mr. Vesely also takes issue with the suggestion that, having seen its coal supply interrupted, Aquila could not have acted sooner to mitigate its damages. The outcome of the pending lawsuit should shed some light on this question.[23]

Mr. Featherstone discusses and presents evidence to indicate that C.W. Mining had labor issues at the time it entered into the contract with Aquila; that the labor dispute was the subject of considerable media attention, and that, with a modicum of diligence, Aquila should have been aware of the situation. Indeed,

**____

[20] *Id*. at p. 6, ln. 3-5.
[21] Featherstone Surrebuttal, p. 27.
[22] *Id.* at p. 29, ln. 8-11.
[23] Vesely Surrebuttal, p. 5, ln. 11-14.

NP

____

____.**

The Staff is not persuaded by Mr. Rooney' assertion that consideration of the labor problems would not likely have changed the Company's choice of a supplier. The Staff suggests that, in light of the potential for big problems with C.W. Mining, Aquila might have taken a closer look at the other bidders, or they should have issued another RFP.[24]

With respect to the issue of whether Aquila is proposing to use known and measurable costs, the fact is that actual eventual cost of coal to Aquila is simply not yet known.[25] Consequently, the IEC proposed by the Staff would allow Aquila to collect its current cost of coal through the IEC charge, with the C.W. Mining cost reflected in base rates. After the court has decided, the Staff would be able, in the IEC true-up audit, to assess the result in along with other information and make its determination whether Aquila acted imprudently, thus prompting a refund of some or all of Aquila's increased coal costs to its customers.

Not including Aquila's current coal costs in permanent rates also has the advantage of encouraging Aquila to continue pursuing its legal remedies in the courts.[26] Notwithstanding Aquila witness Rooney's assertion that Aquila is continuing to pursue its rights[27], Aquila may not have done so if it had received in the previous rate case the requested treatment for the higher-price replacement coal. Moreover, there is also the possibility, following the initial court

---

[24] *Id.* at p. 4, ln. 1-8.
[25] Staff witness Featherstone takes issue with Mr. Rooney's assertion that the C.W. Mining costs included by Staff are not known and measurable. Mr. Featherstone points out: "There is a contract that Aquila is pursuing in the courts that has specific terms of tons of coal to be delivered with known certain per ton prices for each year of the agreement." (Fearherstone, Surrebuttal, p. 25, ln. 4-10).
[26] *Id.* at p. 7 ln. 13 – p. 8, ln. 2.
[27] Rooney Rebuttal, p. 5, ln. 8-10.

NP

decision, that further costly legal action will be required in order for the Company to have a final favorable result.[28]

Based on the foregoing, the Staff is not persuaded by Aquila's assurance that it would return customers their rightful share of any proceeds realized from the Company's legal action. In order to better balance the risk of this unfortunate situation between Aquila and its customers, it makes more sense not to include the much higher cost of replacement coal in permanent rates and instead, following the Staff's prudence review of the entire matter in the wake of the anticipated court decision, to permit the Commission to determine how much (if anything) of the cost of the Aquila's decisions the Company should bear. The Staff remains hopeful that Aquila will prevail in its lawsuit and that it will receive full damages.

In the event that the Commission rejects the IEC mechanism in favor of a fuel adjustment clause, the Staff recommends the C.W. Mining coal costs continue to be used to determine fuel costs. Additionally, Aquila should be permitted to defer the additional costs of the replacement coal until such time as the court determines whether or not Aquila is to be faulted for its actions, along with the related matter of damages. This would permit a determination, following the court's decision, regarding rate recovery of the deferred amounts.[29]

10. Natural Gas Prices: On what prices should Aquila's natural gas expense be based in setting rates?

Staff Position: For ratemaking purposes, natural gas prices should be determined based on Aquila's actual experience. This is consistent with the Staff's normal approach. In this proceeding, gas prices should be based on Aquila's actual payments over the 24-month period of January 2005 through December 2006. Aquila's proposal to base the price on NYMEX futures prices is seriously flawed, as recognized by one of the Company's own witnesses in a recent Apulia rate case.

---

[28] Featherstone Surrebuttal, p. 5-10.
[29] Featherstone Surrebuttal, p. 4, ln. 4-12.

NP

The Staff's approach to determining a commodity price of natural gas of approximately **______** per MMBtu[30] is entirely appropriate. This price is based on Aquila's actual payments over the 24-month period of January 2005 through December 2006. In contrast to the Staff's method of reflecting a normalized level of actual gas costs incurred by the Company, Aquila recommends using the natural gas futures market of the New York Mercantile Exchange (NYMEX).

The Staff's methodology for developing its price of natural gas is clearly consistent with its practice of relying on <u>actual</u> costs to develop its cost of service recommendations. The Staff used the actual prices paid for natural gas. In the analysis leading up to its recommendation, the Staff also reviewed the price forecasts of experts in the natural gas industry.[31]

The Staff takes exception to Aquila witness H. Davis Rooney's suggestion in his surrebuttal testimony that Staff's use of Aquila's actual average incurred price paid for natural gas are not normalized prices.[32] The Staff's 24-month average indeed represents a normalized price paid by Aquila, as opposed to Mr. Rooney's three-month average price of NYMEX futures contracts, which bears absolutely no relation to Aquila natural gas purchases.

The Staff notes also that Aquila has done a complete flip-flop in recent years on its method for normalizing natural gas prices. Aquila arrived at its proposed level of natural gas prices in Case No. ER-2004-0034 by averaging price estimates made by experts in the natural gas industry.[33] However, Aquila completely abandoned that approach in its 2005 rate case and in this proceeding, and instead used an average NYMEX futures strip average. In fact, Aquila's primary witness on natural gas prices in its 2004 rate case, Mr. John Browning, very clearly told

---

[30] Hyneman Rebuttal, p. 15, ln. 17.
[31] Hyneman Direct, pp. 11-13.
[32] Rooney Surrebuttal, p. 13.
[33] Hyneman Rebuttal, p. 16, ln. 22 – p. 17, ln. 2.

NP

this Commission that NYMEX futures were in no way appropriate for ratemaking purposes. In his rebuttal testimony, Staff witness Hyneman includes the following quotes from Mr. Browning's rebuttal testimony in Case No. ER-2004-0034, concerning the use of NYMEX futures as a basis for setting rates:

> As I mentioned in my direct testimony, the use of NYMEX futures is questionable in both the near term as well as the long term for predicting future spot prices. The near term futures can be highly volatile and react to short-term events irrationally. On the other hand, futures for years such as 2005 and 2006 are illiquid and lightly traded making them potentially meaningless as far as predicting future physical prices. [rebuttal page 10]
>
> Kwang Y. Choe, a Regulatory Economist with the Commission, filed testimony in Case No. ER-2001-672 that concurs with my opinion. Mr. Choe describes in great detail why the correlation between NYMEX futures and future spot prices is very weak and not suitable for ratemaking. [rebuttal page 11]
>
> I completely agree that the most realistic and most up-to-date price information should be used for ratemaking. That would exclude the use of historical costs from 2001 or 2002 and the usage of NYMEX futures. [rebuttal page 13].[34]

Thus, just a few years ago Aquila took the position that NYMEX futures were not appropriate at all for setting rates. Now, Aquila claims that NYMEX futures are better than actual incurred prices for setting rates.

Aquila's reliance on NYMEX futures prices in this proceeding is totally misplaced for a number of reasons. First, the NYMEX futures price does not represent a transaction into which Aquila itself actually entered for purposes of purchasing its natural gas supplies. This contrasts with the Staff's use of prices Aquila actually paid for natural gas over the past 24 months, a period that includes some of the most volatile periods in recent times.

Second, the NYMEX futures market is essentially of no use as a predictor of natural gas prices for Aquila.[35] In his Rebuttal testimony, Staff witness Dr. Kwang Choe explains in some

---

[34] Hyneman Rebuttal, p. 17, ln. 8-23.
[35] Choe Rebuttal, p. 4, ln. 1-2.

NP

detail why this is the case.[36] As noted above, Aquila's own witness in a recent rate case provided testimony in support of this proposition and emphatically stated that NYMEX futures should not be used as a basis for ratemaking. Predicting future prices of natural gas is not the purpose of the NYMEX futures market. The market exists primarily to provide interested parties with some certainty regarding an otherwise volatile commodity market.[37] If one buys a future quantity of natural gas at a certain price on the NYMEX, one can be assured of his/her net price when the time comes to actually make a physical purchase of the natural gas. In rebuttal testimony, Staff witness Hyneman provides several examples of the unimpressive performance of NYMEX futures as a predictor of Aquila's actual natural gas prices in recent years.[38]

Third, the NYMEX is based on natural gas prices at the Henry Hub in Louisiana. Aquila does not even buy its natural gas there. Instead, Aquila purchases gas from the mid-continent region (Texas, Oklahoma and Kansas), where the prices are lower. The difference is called a basis differential, which is ever changing with considerable variation from NYMEX, and which itself requires Aquila to make another estimate to be stacked on top of the NYMEX estimate, thereby compounding the folly of using NYMEX estimates.[39]

Fourth, NYMEX prices are subject to manipulation. In recent years, more than 30 energy and utility companies, including Aquila, have been charged with attempting to manipulate NYMEX and other natural gas pricing markets. As a result, the Commodities Futures Trading Commission has assessed more than $300 million in fines on these companies. It now appears that the U.S. Congress will be looking into this matter.[40]

---

[36] Choe Rebuttal, pp. 4-5.
[37] Choe Rebuttal, p 3, ln. 17 – p. 4, ln. 2.
[38] Hyneman Rebuttal, pp. 7 -9.
[39] Hyneman Rebuttal, p. 3, ln. 15 – p. 7, ln. 1.
[40] Hyneman Rebuttal, p. 13, ln. 1-7.

For the reasons stated, the Commission should reject Aquila's recommended methodology for determining a price of natural gas in favor of that of the Staff.

11. Off-system Sales Margins: How should off-system sales margins be determined? What amount of off-system sales margins should be included in expenses?

Staff Position: The Staff's recommended level for off-system sales margins of approximately $12.2 million is based on a two-year average for the period ending December 31, 2006. The Staff considers a two-year average to be appropriate because the Company's margins have grown substantially over the past five years.

In her direct testimony, Aquila witness Susan K. Braun proposed a three-year average level (2003 through 2005) for off-system sales margins.[41] The Staff's recommended amount of approximately $12.2 million[42] for off-system sales margins is based on a two-year average through December 31, 2006.[43] The Staff's analysis shows that Aquila has experienced substantial growth in off-system sales margins over the past five years. In fact, through December of 2006, the level of off-system sales margins is well more than double what Aquila realized in 2002. Given this substantial growth over this period, the Staff believes that a recommended level based on a two-year average is appropriate.[44]

12. Depreciation: What depreciation rates should be used for determining Aquila's depreciation expense?

a. What average service life should be used for determining depreciation rates for Other Production Accounts (Accounts 342 to 346)?

Current average service lives for Aquila combustion turbine accounts (Accounts 342 to 346) are too short; however, until a full depreciation study is performed, no changes should be made to current depreciation rates.[45]

Demand Side Management

13. Should the Demand Side Management programs Aquila proposes be approved? If so, who should bear the costs of the programs?

[41] Braun Direct, p. 20, ln. 21 – p. 21., ln. 6.; p. 28, ln. 1-9; Sched. SKB-4.
[42] Staff Accounting Schedules, filed Feb. 27, 2007.
[43] Traxler Supplemental Direct, p. 2, ln. 15- 18; p. 3. ln. 2.
[44] Harris Direct, p. 12, ln. 20-27.
[45] Schad Direct, pp. 3-6).

As an incentive for Aquila to utilize demand-side programs to adequately meet the increasing load requirements of its customers, Staff recommends that the Commission allow [Aquila] to use a cost recovery methodology to recover current and future demand-side resource analysis and implementation costs. This would be a utilization of the same methodology approved in Kansas City Power & Light Company's and the Empire District Electric Company's regulatory plans, and that has been proposed in Union Electric Company d/b/a AmerenUE's pending rate case, Case No. ER-2007-0002. This proposed methodology would entail that "demand-side costs that were incurred in the test year other than the costs of the energy efficiency programs agreed to in Aquila's last rate case, be placed in a regulatory asset account and amortized over a ten-(10) year period." "…[U]nder this proposal Aquila would be allowed to place its future demand-side costs in the regulatory account where they would be allowed to earn a return not greater than Aquila's Allowable Funds Used During Construction (AFUDC) rate." [46]

Under this methodology, "[t]he amount in the regulatory asset account at the time of the next rate case would be reviewed by the parties in the case for a determination of the prudence of the planning and implementation of the demand-side programs." [47]

Due to the pending nature of Aquila's resource plan filing, Staff is reluctant to specify at this time a cap to the amount Aquila would be able to spend and place in the regulatory account. Staff does recommend that "[t]he costs recovered through this account should only be for those demand-side programs that are shown to be cost-effective for Aquila through an analysis that treats demand-side and supply-side resources on an equivalent basis. When a more definitive

---

[46] Mantle Direct, p. 3, ln. 7 – 12.
[47] Mantle Direct p. 4, ln. 4 – 6.

NP

estimate of cost-effective demand-side programs have been determined, parties in future cases may request a specific cap for this account." [48]

Costs suitable for placement in the proposed regulatory account include the costs of developing, implementing, and evaluation customer energy efficiency and demand response programs. The methodology would allow for a return on the costs of demand-side resources, but would not provide for a recovery of those revenues lost due to the reduction of energy consumption. (Mantle Direct, p. 4 to p. 6).

Until Aquila's integrated resource plan filed February 5, 2007, is thoroughly examined in Case No. EO-2007-0298, the Staff reserves expressing an opinion as to whether Aquila's demand-side management plans adequately fit into Aquila's overall resources portfolio. [49]

Hedging

14. Should the Commission allow rate recovery of the results of Aquila's hedging program?

Staff Position: The Company should not be permitted to recover in rates the results of its hedging program. Aquila's program is too mechanical and does not allow for the exercise of good sound business judgment that is sensitive to prevailing prices. The Company was imprudent in implementing such a program, which in turn has led to imprudent hedging decisions, with highly unfavorable results.

Aquila should not be permitted to include in rates the results of its hedging program. Staff witness Charles Hyneman's testimony lays out a clear case as to why the Company's hedging program is imprudent. The results have been disastrous and, without a dramatic change in the Aquila hedging program, are likely to continue on the current path.

The fundamental problem is that Aquila's program is too mechanical, leaving virtually no room for the application of good sound business judgment in decisions to enter into hedging contracts. The program calls for the purchase of "a set number of futures contracts each month

[48] Mantle Direct, p. 4 ln. 9 – 17.
[49] Mantle Direct p. 6, ln. 16 – 22.

on a specific date, with little or no consideration of the current natural gas futures contract price……Aquila has created a systematic no judgment hedging policy and it is sticking with it no matter how significant the hedging losses it is incurring."[50] And indeed, the losses Aquila is incurring are, to say the least, significant. Actually, in its direct case, the Company proposed to *reduce* fuel costs by **__________**. Following two subsequent updates, however, that gain turned into a **________** loss, for an unfavorable swing of **__________**.[51]

The Staff's opposition to recovery of the Company's hedging results should come as no surprise to Aquila. Although, the Company did not seek to include the results of its fledgling hedging program in the previous rate case, Case No. ER-2005-0436 (a gain in that instance), the Staff expressed its concerns about the program at that time in testimony and in discussion it had with Aquila personnel. To date, though, Aquila has not seen fit to modify its plan.[52]

Aquila witness Davis Rooney attempts to justify inclusion of the hedging losses by pointing to the Commission-approved Nonunanimous Stipulation And Agreement in the previous Aquila general rate increase case (Case No. ER-2005-0436), which authorized the Company to treat the results of its hedging program above the line. All that means, however, is that the monies are eligible for inclusion in rates, subject to a prudence review. As Mr. Hyneman states: "To receive rate recovery, a regulated utility has to be able to show that the costs it incurs are reasonable, prudent and necessary in the provision of utility service. This is the essence of rate regulation and Aquila chose to be in a business that is rate regulated."[53]

---

[50] Hyneman Rebuttal, p. 14, ln. 8-15.
[51] Hyneman Surrebuttal, p. 25, ln. 11-20.
[52] Hyneman Rebuttal, p. 14, ln. 6-21.
[53] *Id.* at p. 26, ln. 6-9.

NP

The Staff supports hedging activity on the part of electric utilities[54] and recognizes that in some years, the utility will incur losses.[55] The question, however, is whether the utility acted prudently. In Aquila's case, the Company is done in by the rigid nature of its hedging plan, with purchases being made with virtually no regard for the price. Staff witness Hyneman provides some examples of high-price purchases made by Aquila at a time when it should have held back because of the instability and jump in prices brought about by the hurricanes in 2005.[56]

Aquila explains that it has designed its hedging program to be **________**. The Company claims that any attempt to deviate from their mechanical hedging plan in order to take advantage of price opportunities would constitute market speculation. The Staff believes the goal of **_______________** to be the cause of the imprudence of the current program. And because the Company's mechanistic hedging program is imprudent, it has caused Aquila to enter into imprudent hedging transactions.[57]

A sound hedging program must be flexible enough to be sensitive to prevailing market prices, and to permit the application of judgment to decisions whether to enter into hedging contracts. In developing such a program, Aquila should seek the assistance of those who have experience in hedge program design for electric utilities. Kase and Company, Inc., which assisted KCPL in the development of its program, would be an example. Both KCPL and Empire have in place hedging programs that permit the exercise of judgment based on prevailing prices. Both utilities regard their plans as successful. Aquila does not make the same claim.[58]

---

[54] *Id.* at p. 28, ln. 20-22.
[55] *Id.* at ln. 12-13.
[56] Hyneman Surrebuttal, pp. 32-34.
[57] *Id.* at p. 29, ln. 6-9.
[58] *Id.* at p. 36, ln. 22 – p. 38, ln. 9.

NP

It is clear that the Company's heavy losses can be attributed to a badly flawed and imprudent hedging program. Accordingly, the Company's hedging losses should be disallowed just as its gains from 2005 were not reflected in rates in Aquila's last rate case.

Fuel Cost Recovery

15. Should the Commission authorize Aquila to use a fuel and purchased power recovery mechanism allowed by 4 CSR 240-20.090?

    i. What standard should the Commission use in determining whether to allow Aquila to use a fuel and purchased power adjustment mechanism?
    ii. What portion of fuel and purchased power costs should be recovered by a recovery mechanism rather than by base rates?
    iii. Should a fuel and purchased power adjustment mechanism include recovery of any demand costs?
    iv. Should a fuel and purchased power adjustment mechanism require definitive production standards for recovery of fuel and purchased power costs via the mechanism?

a. FAC: If the Commission authorizes Aquila to use a fuel adjustment clause, how should it be structured?

    i. What recovery period should be used in the FAC?
    ii. What line losses adjustment should be included in determining the fuel cost adjustment?
    iii. How often should the fuel adjustment clause be adjusted?
    iv. Should the fuel adjustment require a phase-in (cap) for sharp changes in fuel or purchased power costs?
    v. What heat rate testing of generation plants should be conducted.

b. IEC: If the Commission authorizes Aquila to use an interim energy charge, how should it be structured?

    i. What natural gas costs/prices should be included in the charge?
    ii. What coal costs/prices should be included in the charge?
    iii. What purchased power costs/prices should be included in the charge?
    iv. Should the IEC be established and trued up on a divisional basis (for MPS and L&P separately) or on a unified basis (MPS and L&P combined)?

Alternatively,

NP

Should the Commission authorize Aquila to utilize a fuel and purchased power recovery mechanism consisting of periodic rate adjustments outside of rate proceedings or an interim energy charge to reflect increases and decreases in its prudently incurred fuel and purchased power costs, including transportation as authorized by law?

Staff Position: The Staff supports implementation of an interim energy charge (or IEC). The mechanism has been used a number of times in the recent past in general rate increase cases involving Aquila and Empire. A properly designed IEC permits the sharing between the Company and its customers of the risk associated with recently experienced natural gas and purchased power price volatility. In addition, an IEC provides the utility with strong incentives to run its plants efficiently and strive to minimize the cost of its fuel and purchased power. Aquila's fuel adjustment clause (FAC) proposal, which features a total pass-through to customers of the Company's fuel and purchased power costs, should be rejected. Such a scheme severely reduces the incentives for the utility to lower its fuel and purchased power costs. If the Commission decides that a fuel adjustment mechanism should be authorized, the Staff would support the Alternative FAC, as proposed in the testimony of Donald Johnstone, a witness for Sedalia Industrial Energy Users' Association (SIEUA) and Ag Processing Inc. Among other desirable features, the mechanism calls for sharing between Company and customers of any adjustments to base rates that result from its implementation.

In light of the extreme volatility in the natural gas and purchased power markets, the Staff supports the implementation of an Interim Energy Charge ("IEC") in the instant case. In its direct filing, Aquila proposed implementation of a fuel adjustment clause pursuant to Section 386.266, which is often referred to as Senate Bill 179.[59] Aquila asserts that its proposal is consistent with Commission rule 4 CSR 240-20.090, which was proposed at the time of Aquila's direct filing and has since become effective.

The features of Aquila's proposal are set forth in the direct testimony of Company witness Dennis R. Williams. Specifically, an "FAC factor" will be calculated periodically and will be based on differences between the cost of fuel and purchased power built into base rates and that amount of such costs that Aquila actually incurs. Off-system sales margins are to be included in base rates, but deviations from the base amount are to be included in the FAC and shared with customers on a 50/50 basis. Among other items to be flowed through the proposed

[59] Aquila witness Williams Direct, Featherstone Rebuttal, p. 2, ll. 15-17.

NP

FAC are "[a]ll hedge costs, settlement costs and benefits," and Commission-approved capacity contracts that are less than one year in duration. The proposal calls for quarterly adjustments, provided that they are of a significant size, and over- and under-recoveries would accrue interest.[60]

The Staff is opposed to an FAC as proposed by Aquila. Because the FAC is designed to provide a full pass-through of Aquila's prudently incurred costs to its customers, the mechanism serves to greatly diminish the Company's incentives to reduce its costs of fuel and purchased power. Furthermore, the Staff disputes the Company's claim that the "threat" of a prudence review will provide sufficient incentive for the Company to reduce fuel and purchased power costs. For a number of reasons, it is very difficult to conduct an after-the-fact review of the prudence of an electric utility's actions in connection with the purchase of fuel and energy. A whole host of factors play into the relevant decisions, including multiple fuel types, market prices of fuel and energy, plant outages (both scheduled and forced), etc.[61] As such, prudence audits are considerably more complex than they are for the PGA/ACA process used to audit natural gas procurement costs of local distribution companies (LDCs). For this reason, the Staff does not accept the suggestion of Aquila witness Williams that because a pass-through process is already utilized in for natural gas LDCs, it should work as well in the electric industry.[62]

The Staff also opposes the Company's proposal to share in 50% of the margins from off-system sales in excess of the amount included in base rates. Such a scheme may actually reduce Aquila's incentive to engage in off-system sales. As Staff witness Cary Featherstone points out, at the present time, Aquila retains 100% of the off-system sales margins above the level included

[60] Williams Direct, p. 3, l. 16 – p. 4, l. 16.
[61] Featherstone Direct, p. 13, ln. 17-19.
[62] Williams Rebuttal, p. 7, ln. 22 – p. 8, ln. 2.

NP

in its rates. "This provides even more incentive for the Company to pursue off-system sale transactions."[63]

Instead of an FAC, the Staff recommends implementation of an Interim Energy Charge (IEC). The mechanism would be similar to that previously implemented for both Aquila and The Empire District Electric Company. A base (or floor) level of estimated variable fuel and purchased power costs would be included in permanent rates. A forecast (or ceiling) amount would be collected via the IEC. If, upon a true-up audit conducted following the expiration of the IEC, Aquila's prudently incurred costs are within the cost range defined by the ceiling and floor amount of the IEC, customers would receive a refund equal to the amount collected minus the prudently incurred actual costs. If those actual costs are below the floor amount, customers would receive a refund equal to the amount collected under the IEC down to the base amount, and Aquila would retain the difference between the base amount and the actual cost.[64] On the other hand, if actual costs exceed the amount collected, the Company would absorb the amount of the excess. Any refund amounts deemed due to customers as a result of the true-up audit would be returned with interest.[65] The IEC should be authorized for a period of two years. Although a three-year IEC was originally contemplated, the recent announcement of Aquila's intention to merge with Kansas City Power & Light Company now makes a three-year IEC inadvisable.

While the Staff envisions an IEC that would be the product of negotiations among the parties to this proceeding, the Staff would recommend as a starting point, the following floor and ceiling price levels of natural gas and purchased power[66]:

---

[63] Featherstone Rebuttal, p. 10, ln. 3-4.
[64] Featherstone Direct, p. 11, ln. 6 – p. 12, ln. 2; p.18, ln. 15-16.
[65] Featherstone Direct, p. 14, ln. 30-32.
[66] Featherstone Rebuttal, p. 6, ln. 6-9.

NP

	natural gas ($/MMBtu)	purchased power ($/kWh)
floor	$6.00	$55.00
ceiling	$9.00	$90.00

The above range of prices would generate approximately $50 million split between MPS and L&P on an approximately 80% to MPS and 20% to L&P basis.[67] As noted in the C.W. Mining discussion earlier in this brief, Staff would propose to use the lower-price coal of the C.W. Mining contract in base IEC rates, and the replacement coal in the forecast or ceiling of the IEC range. The Staff believes that the IEC is the most appropriate mechanism for addressing the issue of variable fuel and purchased power cost recovery during times when these prices are subject to the level of volatility that has characterized these markets in recent years. The IEC creates a range of variable fuel and purchased power prices within which Aquila will be assured of recovering all of its prudently incurred fuel and purchased power costs, and Aquila's customers will not be paying any more than those costs after the true-up. At the same time, the IEC provides incentives for the Company to minimize the amount it expends for fuel and purchased power, both to avoid incurring costs above the forecast level and to take advantage of opportunities to drive costs below the base level.

As noted earlier, the IEC provides a good mechanism for dealing with the current uncertainty regarding the Company's ultimate cost of coal. The Staff proposes to include the cost of coal to Aquila under the original C.W. Mining contract in base rates, and to include Aquila's current coal cost in the ceiling. Using this approach, depending on the outcome of its lawsuit against Consolidated, Aquila may eligible to recover the increased cost following a true-up audit at the expiration of the IEC.

---

[67] Featherstone Surrebuttal, p. 14, ln. 5-7.

In the event that the Commission decides to authorize an FAC for Aquila in this proceeding, the Staff would support the fuel clause proposal supported by several parties, which contains a sharing mechanism. The mechanism is sponsored in the testimony of Donald Johnstone, a witness for Sedalia Industrial Energy Users' Association (SIEUA) and Ag Processing Inc. The mechanism, referred to as the alternative fuel adjustment clause (Alternative FAC) and includes a sharing mechanism, and is therefore "a much fairer approach than what is being proposed by Aquila in this case."[68] The sharing proposal would provide the Company with incentives to operate its plants as efficiently as possible. Staff witness Featherstone cited a number of additional principles and features reflected that serve to mitigate the volatility inherent in the total pass-through mechanism proposed by Aquila, including a two-year time limit on the mechanism (owing to the impending KCPL purchase of Aquila), longer accumulation and recovery periods, and inclusion of performance standards for the production facilities to provide protection from unusual outages that may occur while the Alternative FAC is in place.[69]

In summary, the Staff continues to believe that an IEC mechanism would be the most appropriate means of addressing today's climate of fuel and purchased power price volatility. If, however, the Commission chooses to authorize a fuel adjustment clause, the Staff would support the Alternative FAC as far superior to the mechanism proposed by Aquila.

CONCLUSION

The Commission should adopt the Staff's positions on the issues in this case.

WHEREFORE the Staff submits the foregoing as its prehearing brief for this case.

[68] Featherstone Surrebuttal, p. 17, ln. 9-20.
[69] Featherstone Surrebuttal, p. 18, ln. 10 – p. 19, ln. 1.

Respectfully submitted,

/s/ Kevin A. Thompson____________
Kevin A. Thompson
General Counsel
Missouri Bar No. 36288

/s/ Denny Frey___________________
Denny Frey
Senior Counsel
Missouri Bar No. 44697

/s/ Nathan Williams______________
Nathan Williams
Deputy Counsel
Missouri Bar No. 35512

Attorneys for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-8700 (Telephone)
(573) 751-9285 (Fax)
denny.frey @psc.mo.gov
nathan.williams@psc.mo.gov

Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record this 30th day of March 2007.

/s/ Kevin A. Thompson______________

NP