Exhibit No.:
Issues: Policy
Witness: Keith G. Stamm
Sponsoring Party: Aquila Networks-MPS & L&P
Case No.: ER-

Before the Public Service Commission
of the State of Missouri

Direct Testimony

of

Keith G. Stamm

TABLE OF CONTENTS

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
DIRECT TESTIMONY OF KEITH G. STAMM
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
CASE NO. ER-__________

Q. Please state your name and business address.

A. My name is Keith Stamm, and my business address is 20 West Ninth Street, Kansas City, Missouri 64105.

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

A. I am employed by Aquila, Inc. ("Aquila" or "Company") in the position of Senior Vice President and Chief Operating Officer

Q. Please describe your qualifications and experience?

A. I have a Bachelor of Science degree in Mechanical Engineering from the University of Missouri at Columbia, an MBA with an emphasis in Finance from Rockhurst University in Kansas City and I am licensed as a Professional Engineer in the State of Missouri. I joined the Company in 1983 in the position of staff engineer at our Sibley Generating Station and held a number of operating and administrative positions within the Company through 1995. In 1996 I was promoted to Vice President and General Manager, Regulated Power; and in 1997 became Chief Executive Officer of United Energy Limited, an Australian utility company in which Aquila currently holds a 33.8% interest. From January 2000 through November 2001, I served as Chief Executive Officer of Aquila Merchant Services, Inc. and in November 2001 was appointed to the position of President and Chief Operating Officer of Aquila's Global Networks Group. In August

2002, I assumed responsibility for the sale of our assets. I assumed my current position in October 2002.

Q. Would you please describe your responsibilities as Chief Operating Officer?

A. I have responsibility for Aquila's domestic utility operations, Capacity Services and Aquila's investments in Everest Communications ("Everest") and international utilities. The domestic gas and electric utilities are held at the Aquila, Inc. parent level, grouped into seven state-based divisions.

PURPOSE AND SUMMARY OF TESTIMONY

Q. What is the purpose of your testimony in this case?

A. The purpose of my testimony in this proceeding is to explain, generally, why Aquila is seeking rate relief at this time; the efforts we have made to insure that our customer rates are not impacted by our recent financial difficulties unrelated to our utility operations; and our proposals to mitigate the impacts of the required rate increase.

Q. Please explain the reasons for your request for rate relief?

A. First, let me say that while no time is a particularly good time to request an increase in rates, this is an especially inopportune time for Aquila to make such a request. We understand that publicity associated with our recent financial difficulties will heighten regional media coverage of this rate request and exacerbate negative perceptions of our Company. Also, there is likely to be a presumption on the part of some of our constituents that this is an attempt to take advantage of our customers and restore financial viability that has been threatened as a result of our investments outside of the utility sector.

However, this is simply not the case. This request for rate relief stands on the merits of the need of Missouri regulated operations alone, isolated and insulated from the impacts of our non-regulated activities. Company witnesses Lisa Starkebaum and Susan Braun provide schedules summarizing the support for our revenue requirement determinations for the Missouri Public Service ("MPS") and Light and Power ("L&P") operating divisions. Those schedules reflect the need for a $79.0 million revenue increase in the MPS service area and a $14.6 million electric revenue increase for the L&P service area in and around St. Joseph, increases of 23.4% and 15.5% respectively. However, we have filed tariffs to limit the MPS rate area increase to $65 million, or an approximate 19.2% increase in revenues.

Q. Why did you limit your electric rate request for the MPS service area?

A. While we believe that a $79.0 million revenue increase for the MPS electric operations is fully supported and justified, we also recognize that the impact on customers from a 23.4% increase would be significant. Therefore, Aquila senior management made the decision to mitigate the impact somewhat by having the Company absorb a portion (about $14 million) of the revenue deficiency.

Q. What about the L&P rate increase?

A. With respect to L&P, at the time we acquired St. Joseph Light & Power Company, company representatives indicated that they had prepared and were ready to file a request for a $9 million electric rate increase. Although costs for L&P have continued to increase over the past two years since the acquisition, particularly in the areas of pension, fuel and capital investment, we have been able to delay the planned filing, and L&P customers have benefited accordingly. Our proposed tariffs for L&P would increase rates about 15.5%.

Q. In February 2002, Aquila's Missouri electric rates were reduced by about $4 million. How has the need for a substantial rate increase for the MPS operations arisen in such a short time?

A. The main drivers of the proposed rate increase for MPS, and also for L&P, are necessary capital investments and cost increases due to market conditions outside the control of the Company, especially increased natural gas costs. The table below summarizes our some of the major components of our revenue requirement determinations for the MPS and L&P operating divisions in comparison to levels we believe are embedded in current rates. Although I will discuss these items in more detail later in my testimony, it is noteworthy that almost half of the MPS rate request can be traced to natural gas cost increases.

Change from Embedded Rates	**Rev. Requirement** *(in millions)*		**Percent of Increase**	
	MPS	**L&P**	**MPS**	**L&P**
Increase in gas costs	$ 28.4	$ .2	44%	2%
Capital additions	$ 23.6	$ 7.3	36%	50%
Pensions	$ 6.0	$ 5.3	9%	36%
Decline in off-system margins	$ 9.0		14%	
Steam subsidy		$ 1.8		12%
All other, net	$ (2.0)		(3)%	
Total	**$ 65.0**	**$14.6**	**100%**	**100%**

Q. Should the magnitude of higher natural gas costs come as a surprise?

A. Escalating natural gas prices have been well publicized and the subject of many articles and news stories in the media. However, the general public may not be aware of the substantial impact rising natural gas prices can have on an electric utility such as Aquila.

Q. Please explain.

A. By way of background, because of the significant residential load percentage in comparison to most other utilities, Aquila's Missouri properties experience a pronounced "needle peak". That is, we must have generation capacity to meet the peak created by air conditioning load in that one hour, on that single day when summer demand is highest. Yet, during the rest of the year the base load, or the demand not impacted by weather, is relatively low.

Q. Do these circumstances impact the type of generation capacity that the Company acquires?

A. Yes. From a total cost standpoint it does not make sense to construct base load plants (typically coal or nuclear fuel plants) to meet needle peaks. Base load plants are generally less expensive to operate, but have very high construction costs. Consequently, Aquila instead relies on intermediate load, peaking plants or purchased power to serve a high proportion of its energy requirements. These sources are typically fired by natural gas or fuel oil.

Q. How has this approach worked?

A. Over time, this approach has served us well and has been the most environmentally friendly and cost effective option for our customers. However, the combination of higher natural gas costs and our fuel mix has dramatically increased our cost of service.

Q. Has the topic of increasing gas costs been disseminated to the general public?

A. Yes. Over the past several months, natural gas supply and demand issues have been the subject of newspaper and television reports, press releases from state regulatory commissions and the Federal Energy Regulatory Commission ("FERC"), utility bill inserts, and congressional hearings. For example on the 10th of June, Federal Reserve Chairman Alan Greenspan testified before the Full House Committee on Energy and Commerce concerning natural gas supply and demand issues. In part, Chairman Greenspan made the following comments:

> "In recent months, in response to very tight supplies, prices of natural gas have increased sharply. Working gas in storage is currently at very low levels relative to its seasonal norm because of a colder-than-average winter and a seeming inability of increased gas well drilling to significantly augment net marketed production.
>
> Our inability to increase imports to close a modest gap between North American demand and production (a gap we can almost always close in oil) is largely responsible for the marked rise in natural gas prices over the past year.
>
> Futures markets project further price increases through the summer cooling season to the peak of the heating season next January. Indeed, market expectations reflected in option prices imply a 25 percent probability that the peak price will exceed $7.50 per million Btu. Today's tight natural gas markets have been a long time in coming, and futures prices suggest that we are not apt to return to earlier periods of relative abundance and low prices anytime soon."

Q. Have similar reports been covered in the media?

A. Yes. On June 17th, the New York Times featured an article that, among other things, stated that the United States is facing its most severe shortage of natural gas in a quarter-century:

> "The market manipulation by companies likes Enron has been blamed... for much of the price surge. But now most analysts agree, the basic law of supply and demand is at work. With natural gas promoted as a cleaner-burning fuel than oil or coal, nearly all the electric plants built since 1998 are designed to be fired mainly by gas. So demand is up. Supplies...have not kept up."

Similar stories have appeared in numerous national media reports. Locally, the Kansas City Star on June 11th and March 13th of this year and the St. Joseph News Press on April 14th ran feature stories discussing gas price spikes that have occurred to date, the impact on consumers, and the likelihood that costs would continue to rise. Other papers in our service territory have run similar stories.

Q. Is the Missouri Public Service Commission ("Commission") aware of this issue?

A. Yes. The Commission in its April 2003 Consumer Connection publication and in press releases dated March 11 and June 10, 2003 proactively warned consumers of the likelihood of higher gas costs due to "high natural gas prices, low natural gas storage inventories, summer usage for electric generation and the possibility of tight natural gas supplies."

IMPACT OF CURRENT FINANCIAL CONDITION

Q. You indicated that none of the costs supporting the proposed rate increase for either operating division are attributable to Aquila's current financial condition. Could you please explain this statement?

A. Yes. To understand our financial situation, it is helpful to briefly consider the recent history of the Company. Prior to 1985, Aquila existed as Missouri Public Service Company, a regulated electric and gas utility operating only in this state. At that time UtiliCorp United Inc. was formed (later renamed Aquila) to pursue a growth strategy through acquisition of other domestic utility properties. Our strategy at that time was to diversify risk by product, geography and regulatory jurisdiction, and to create economies of scale and scope that would benefit both our customers and shareholders. Over the next ten years, Aquila made eight domestic utility acquisitions in seven mid-continent states. These regulated investments have generally performed well and achieved our original objective. As it became more difficult to find domestic utilities that could be acquired, Aquila also pursued the acquisition of international utilities in English speaking countries with stable governments and sound economies. The majority of these properties, situated in Canada, Australia, New Zealand, and the United Kingdom also performed equal to or better than planned.

Q. Did the Company pursue non-regulated investments as well?

A. Yes. In fact, one of the first domestic utility acquisitions made was of People's Natural Gas, a natural gas distribution company that also operated a small two-person natural gas merchant business. Over time as competitive markets emerged, this small operation became Aquila Merchant Services, one of the largest providers of wholesale energy and risk management services in North America.

Q. Did Aquila Merchant Services become involved in other undertakings?

A. Yes. In addition to the services mentioned, Aquila Merchant Services developed a diverse portfolio of investments in electric generation assets, gas pipelines, gathering systems and gas storage facilities whose operations were optimized using its energy trading capabilities. Aquila Merchant Services also traded commodities such as natural gas, power, global liquids and weather derivatives. The merchant services group grew tremendously and as late as 2001 comprised over half of Aquila's total operating income.

Q. Were there any other aspects to Aquila's growth strategy?

A. Yes. As part of its growth strategy, Aquila entered the telecommunications sector by investing in Everest Connections ("Everest"), a company that provides local and long distance telephone service, cable television, high-speed Internet and data services in Kansas City. We also made an equity investment in Quanta Services Inc. ("Quanta"), one of the largest specialized contractors in the nation, serving utilities, telecommunications and cable television operators. At the time, record investment and construction in the telecommunications and cable services industry suggested that Quanta was well positioned for growth.

Q. What happened to this strategy?

A. While there was a period of time where the energy merchant and telecommunication trategies were able to attract capital, ultimately the strategy was unsuccessful. In this regard, I want to say at the outset that Aquila's senior management accepts full responsibility for the strategic choices we made and the resultant consequences. The impact on shareholders, retirees and employees is beyond devastating. We failed to foresee a number of events including the near-simultaneous implosion of, and rapid flight of capital from, the energy merchant sector and telecommunications sector. While these events ultimately resulted in a tremendous erosion of value in our Company, even as late as the first quarter of 2002, a number of companies, including Aquila, believed they were *well-positioned for success in the wake of Enron's failure and acted accordingly.* Unfortunately, the fallout from Enron and the California energy crises was far more devastating to the entire energy sector than we had anticipated. We did not foresee the order-of-magnitude change in liquidity to be required by the credit rating agencies when they re-evaluated investment-grade guidelines for energy merchants.

At the same time, the telecommunications industry and out-sourced utility construction spending experienced a rapid decline, negating the value of our Quanta investment.

Q. *Given these circumstances, what steps did Aquila take?*

A. When in 2002 it became clear that Standard & Poor's and Moody's were raising the requirements for liquidity and balance sheet strength to levels that Aquila could not achieve, we quickly made the decision to exit the merchant industry business. Credit downgrades, along with costs associated with unwinding the merchant and related businesses, put such a strain on cash flow that we divested our "credit-dilutive" equity investment in Quanta and have stopped funding any expansion of Everest. We are also in the process of selling the remainder of our non-U.S. utility investments, and we have refocused our efforts on the preservation of cash and returning to our roots in the regulated utility business.

Q. You mentioned the "order-of-magnitude change in liquidity required by rating agencies when they re-evaluated investment grade guidelines for energy merchants. Can you provide additional background on that statement?

A. Yes. After the collapse of Enron, the rating agencies determined that the energy merchant business was much riskier than they previously thought. As a result, the participants would, in effect, need to have ready access to a lot more cash to withstand a worst-case scenario. If the companies did not have that kind of cash, they would be downgraded below investment grade. Given the size of our trading book at the time, we determined that we would need access to at least $2 billion cash in order to maintain our investment grade status. At the time, we had a $650 million revolving credit facility. There was no practical way for us to meet the new threshold so we determined that we had to exit the energy merchant business.

Q. Why couldn't Aquila simply operate as a non-investment grade energy merchant?

A. If we were downgraded, the vast majority of our counter-parties would have the right to demand that we cash-collateralize our commitments and out-of-the-money positions within three days. Given the size of our trade book at the time, the potential demand for collateral would have exceeded $1 billion. Our inability to post that collateral within a three-day time frame would have resulted in Aquila being in default. That default event would have cross-defaulted a number of other debt obligations causing those to become due within a period of days. The end result is that if we did not act to sufficiently wind down the merchant operation prior to being downgraded, we would have a number of defaults and we would have run out of cash.

Q. You mentioned that the Company failed to foresee the collapse of Enron and the reaction of the rating agencies that resulted in new liquidity hurdles that your Company was simply unable to meet. Did others, however, question your energy merchant and telecommunications strategy?

A. Yes. In fact, certain members of the Commission Staff questioned and raised concerns about our growth strategy for years. This is not really surprising, however. Different views of the future are a requirement for capitalism in a democratic society to work. Our utility acquisition strategy was and continues to be successful. Moreover, there was a period of time when the energy merchant and telecommunication strategies were able to attract a lot of capital and we briefly saw the benefit of that. However, we are now seeing the flip side, and today, there are more people that don't believe in these strategies than people that do believe in them.

Q. Has the diversification strategy involving the non-regulated sector directly or indirectly affected your domestic utility operations?

A. Yes, I believe the domestic utility operations may have been affected in three ways.

Q. Please explain.

A. First, I believe that during the period when the non-regulated side of the business was successful, we may have lost some of our financial focus in regard to our utilities. Stated another way, while our field resources continued to provide excellent utility service, the financial success of our non-regulated business enabled us to overlook earnings deterioration and future challenges faced by the regulated side of the business. In November of 2001, we instituted a program to restructure our U.S. utility operations into a more focused, more efficient, state-based organization. While this effort was well underway prior to any recognition that our non-regulated operations were in jeopardy, I believe that it was our reliance on non-regulated earnings growth that masked the deterioration in regulated earnings achievement.

Q. Please explain what you mean by a loss of financial focus.

A. At the time I assumed my current position, some of our regulated utility operations were clearly under-performing. The reported Missouri electric financial return on equity, for example, was less than three percent. Missouri cash flow performance was even more devastating. Cash flow provided from Missouri operations was only about $900,000 in 2002 compared to cash expended for plant investment of over $60 million. Yet, at least partially because of our reliance on non-regulated earnings, the Company had not developed a viable strategy to return those utility properties that were under-performing to a sound financial footing.

Q. What is the second way in which the utility operations have been impacted?

A. The demise of our non-regulated businesses has eliminated some of the synergies available to our domestic utilities.

Q. Please explain.

A. Aquila serves in general, and in Missouri in particular, a largely rural, largely residential customer base. The cost of a dispersed transmission and distribution grid spread over a smaller customer base creates a challenge to maintain customer rates comparable to those of more geographically-concentrated utilities. This has partially been achieved over the past decade through knowledge transfer and cost savings made available through non-traditional business activities. Efficiency measures that we implemented as a result of our overseas experience, live wire maintenance techniques first incorporated by our Canadian affiliate, and energy risk management concepts and techniques passed on to our utility operators are all examples of knowledge transfer that resulted in reduced costs for our customers. Likewise, our utilities benefited from economies of scale available from a larger company and non-traditional employee workforce. For example, health insurance premiums have been reduced because underwriters' risk are lowered when spread over a larger workforce, particularly since the energy marketing and communications workforce tended to be much younger and has fewer claims than the regulated utility workforce.

While I recognize the positive impacts of these examples would not have been available had Aquila not embarked on its growth strategy, they have resulted in savings upon which the utility has relied, and which may no longer be available as we return to a traditional domestic utility operation.

Q. What is the third way in which the utility operations may have been impacted?

A. Lower credit ratings and the impact of unwinding our non-regulated operations, have further strained cash resources available to Aquila. While we have implemented actions to effectively provide financial protections for our customers during this transition, Aquila must continue to work closely with creditors and regulators to responsibly manage its cash flow.

COMMITMENT TO UTILITY OPERATIONS

Q. Have the negative financial conditions impacted the service provided to your utility customers?

A. No. Aquila has developed internal service quality metrics that are reported to me on a monthly basis. These metrics include CAIDI (outage minutes divided by number of outages), SAIFI (number of outages per customer), SAIDI (outage minutes per customer), and customer satisfaction. Our customer satisfaction rating stands at approximately 94%. Our reliability measures were all better than the Southwest Power Pool Benchmark and the U.S. Average Benchmark.

Q. Have the negative financial conditions impacted the cost of service paid by your utility customers?

A. Utility customer rates have not been impacted as a result of our financial difficulties. In fact, rates in effect today are lower than they were 20 years ago. Moreover, I have asked all employees associated with the preparation of this rate request to insure, to the extent possible, that impacts of the negative financial results from our non-regulated businesses have not been included in the determination of regulated revenue requirements.

Q. What are some examples of costs that have not been included in this rate case filing?

A. We have not included costs associated with the departure of our former CEO and CFO. We have not included the higher interest costs that we are incurring because we are non-investment grade. We have not included costs associated with exiting or winding down our non-regulated businesses and investments.

Q Please explain how you intend to carry out your commitment to protect customers while restoring financial viability to the Company.

A. Aquila will maintain its focus on three key business principles: protection of customers from potential adverse financial impacts of events not directly associated with utility operations, maintenance of quality customer service, and enhancement of regulatory transparency.

Q. How can you protect customers from potential adverse financial impacts?

A. Aquila instituted a capital allocation process shortly after its formation in the mid-1980s that was specifically designed to insulate each of its utility divisions from other operations of the Company. Aquila's regulated utility operating units receive capital based upon what a comparable utility would receive. We have presented this process to state commissions in every rate case since 1988. In his direct testimony, Company witness Don Murry more fully discusses this capital allocation process and our intent not to assign debt to utility operations at a cost higher than what could be obtained by a utility that carried an investment grade credit rating.

Q. What commitments have you made to service quality?

A. Aside from those mentioned earlier, we have also established internal service quality metrics for meter reading accuracy, emergency response time, safety, generation availability, heat rates, and call center performance. These metrics are reported to me monthly and I conduct detailed reviews of service quality performance with each state Operating Vice-President quarterly. Aquila is also interested in working with this Commission to address any other areas of specific concern.

Q. What do you mean by enhancing regulatory transparency?

A. Having completed the reorganization to a state-based structure that I discussed earlier, we are now focusing on proper identification of allocated costs and creation of a more transparent structure to facilitate review of our operations. We believe that use of common corporate platforms and provision of some services at a corporate level is not only necessary from a governance perspective, but also beneficial in terms of both cost control and consistency of performance. Our new structure, however, creates a greater operational focus in each state and reduces the total dollar amount of costs that are allocated. For costs that are allocated, Aquila maintains a detailed Cost Allocation Manual that is revised annually, or more frequently if a material change takes place. The restructuring reduces the dollar volume of allocations and thus the review necessary; the cost allocation manual updates add clarity to our approach; and while it would not be prudent to burden our customers with the multi-million dollar cost to replace a functioning accounting system, we have developed a number of system enhancements and reports that will facilitate outside party reviews. Because some of these enhancements were not in place for the entire test year in this case, I requested that our financial management group make a special, internal review of all corporate costs allocated to Missouri. The results of this review are discussed in the direct testimony of Company witness Beverlee Agut, and the accompanying work papers are available for review.

In addition, Aquila maintains detailed affiliate transaction reporting, procedures and monitoring in compliance with Commission rules.

REASONS FOR RATE INCREASE

Q. If Aquila is attempting to insulate its customers from any impact of the financial downturn associated with its non-regulated activities, then why are you asking for such substantial rate relief?

A. I summarized the Company's revenue requirement determinations earlier. Unfortunately, a combination of events, some relating to the unique demographic circumstances within Aquila's service territory, some relating to the significant change in energy markets and gas commodity costs, and others relating to the cumulative impact of various regulatory policies and practices have combined to make rate relief necessary. The timing of this request is regrettable from a number of perspectives, but the necessity is unavoidable and the timing unalterable.

Q. What specific events are driving the need for this request?

A. With respect to the demographics of our service territory, Aquila has for some time now experienced limited growth opportunities in its Missouri jurisdiction, with overall increases in residential customers averaging less than two percent over the past couple of years. Cost increases due to inflation in most other areas of our operations and the need to make capital and safety-related expenditures of $60 to $70 million per year, exacerbate the negative impact on earnings and cash flow. The end result is a significant net increase in costs with little opportunity in the way of net customer growth to pay for it, absent seeking rate relief.

Q. What do you mean by the impact of commodity prices and the changing energy market?

A. The negative impact of the current energy market is the single largest factor in Aquila's need for immediate rate relief.

Q. Please explain.

A. Due to increased demand, reduced production and record low storage levels, the cost of natural gas has increased dramatically. Natural gas prices embedded in our existing electric rates are below $3 per Mcf. They were set at a level that was near the lowest point of the gas market during the past five years. In contrast, market prices at the time of the preparation of this testimony were almost $6 per Mcf and gas commodity futures prices do not fall below $4.50 over the next 18 months. Consequently, Aquila has not been able to recover its actual cost of gas incurred since our rates were reduced in the last rate proceeding in early 2002. The impact to Aquila is significant. For each $1 increase in natural gas commodity prices, the annualized cost of fuel to serve our intermediate and peaking loads increases by approximately $10.5 million.

Q. Has the changing energy market had any other impact on Aquila's Missouri regulated electric earnings?

A. Yes. While natural gas commodity costs have increased significantly, the demand from others seeking to purchase power from Aquila and the Company's ability to supply that power have eroded just as dramatically. In recent years, Aquila was able to take advantage of market demand and during the test period leading up to our last rate proceeding improved its margin by almost $9 million. Regulatory policy in Missouri has been to assume that existing off-system sales will continue at the same level in the future and to flow the full benefit of those sales to customers through reduced rates. Unfortunately, as a result of the sea-change in the wholesale energy environment, the revenue stream from off-system sales has now dried up and there is little prospect that it will return in the foreseeable future. Demand has declined, alternative sources of energy are available for what demand does exist, Aquila's transmission system is significantly constrained from reaching existing market areas, and its capacity resources are no longer capable of providing a significant level of energy should demand unexpectedly return.

Q. Please explain your reference to the cumulative impact of various regulatory policies and practices.

A. Current economic conditions have contributed to factors that in some instances make existing regulatory practices problematic. I have already discussed the impact of the past regulatory treatment of off-system sales. I have also mentioned the negative impact on Company earnings and cash flow when the base cost of gas embedded in rates is too low. While we do not expect our customers to pay more than the actual cost of gas, the fact is the methods used in the past that employed average historical prices for ratemaking purposes do not serve as good predictors of future prices of a commodity subject to such price volatility. Consequently, another approach to deal with these fuel costs must be found.

Q. Are there other regulatory policies that you question?

A. Yes. The method used in recent rate proceedings to normalize pension costs is not adequate.

Q. Please explain.

A. Due to economic conditions, the Company pension plan investments have suffered serious setbacks and it has been necessary for Aquila to make substantial new contributions to the pension fund. Market driven pension plan gains and losses are subject to volatility outside the control of the Company or our customers. When FAS 87 accounting was first adopted, our recognition of pension plan gains and losses tended to smooth out this volatility. Under the FAS 87 method, pension expenses and the related revenue requirement were less volatile while still reflecting actual market results over time. In recent years, however, this state's regulatory treatment of pension costs has had the effect of eliminating any opportunity for rate smoothing. At the same time, the prepaid pension asset included in rate base, upon which we must earn a return, has grown significantly. The impact has been to initially reduce current revenue requirements, but at the ultimate expense of future customers. To correct these problems, Aquila has reflected pension expense in this filing using the FAS 87 approach that, until recently, was followed by this Commission.

Q. Have there been any changes in Missouri regulatory policy in recent years, which you question?

A. Yes. Policy changes have resulted in depreciation rates that are not reflective of proper cost causation and place the Company at risk of non-recovery of a major and necessary cost element.

Q. Please explain.

A. Traditionally, depreciation rates were established using not only estimated lives, but also estimates for the net salvage of an asset once it was retired. This approach was sensible because the customers who were currently using an asset were charged rates that reflected the ultimate net salvage of that asset. Moreover, since this generally resulted in higher accumulated depreciation, the Company's rate base was reduced. In recent rate proceedings, however, Missouri regulatory policy has deferred recovery until the time that the asset is actually retired. With long-lived assets, this means that customers who may never have received any benefit from a plant asset are required to pay for its removal in lieu of those customers who did benefit. Similar to the prepaid pension treatment, the impact has been to increase rate base, upon which we must earn a return, but to initially reduce current revenue requirements at the expense of future customers. Company witness Davis Rooney addresses the appropriate treatment of removal costs at greater length in his direct testimony.

Q. Are there any other regulatory policies that you question?

A. Yes. With respect to authorized returns on common equity, I am advised by counsel that this Commission frequently adopts the results of a "company specific" discounted cash flow analysis that does not meet the comparable company approach mandated by the United States and Missouri Supreme Courts. Unfortunately, the resulting authorized returns put Missouri utilities and their customers at a disadvantage in the financial markets.

GAS COST RECOVERY MECHANISM

Q. You stated earlier that you were aware that a significant rate increase would impact your customers. Have you discussed the need for rate relief with your customers?

A. Yes, in recent weeks we have held meetings with community leaders, legislators, and customers to discuss our need for rate relief. Not surprisingly, the first reaction of many was one of very strong concern based on an assumption that this was a blatant attempt to penalize them for the "mis-steps" of Aquila management. After laying out the facts similar to what I have discussed in this testimony, showing that shareholders and employees have borne the impact of the non-regulated failures, and most importantly demonstrating the reasons behind the need for rate relief, many of those attending appeared to have a much better understanding of the rationale for our rate request. That is not to say they were one hundred percent supportive. Some were skeptical, and some remained concerned; but again, the vast majority, while understandably not embracing approval of a rate increase, did express understanding. Their discussion moved to the need to mitigate the impacts of such a significant request. Businesses and residential customers alike expressed concern regarding their ability to immediately absorb the impact of the increase, even after recognizing that new rates would likely not go into effect for another year.

Q. Have you attempted to address those concerns in this filing?

A. Yes, a number of proposals are being made to mitigate the impact of our request and provide customer protection from the volatile commodity markets. The first proposal is one I already discussed wherein Aquila is not requesting recovery of the full revenue requirement shortfall for the MPS electric operations at this time. The second proposal is based on instituting a gas commodity cost recovery mechanism that gives the Company some protection from spiraling gas costs, but insures that customers will pay no more than the actual cost of gas incurred. The final proposal introduces a mechanism that provides relief to low-income customers.

Q. Is the gas commodity cost recovery mechanism you are proposing what is sometimes referred to as a "fuel adjustment clause"?

A. No. It is my understanding that to employ a fuel adjustment clause through which rates are adjusted outside the context of a rate case would require a change in Missouri law, and unfortunately, legislation authorizing such a mechanism has not been enacted. What Aquila is proposing in this case, however, is not an automatic adjustment clause, but rather a mechanism that would allow the Company to recover more realistic gas costs through base rates while at the same time giving customers protection from paying rates based on commodity prices that are too high should the gas market stabilize and prices start to fall.

Q. Please explain your proposal?

A. Company Witness John Browning, in his testimony, supports a base fuel natural gas cost of $5.14 per Mcf which is the amount Aquila believes should otherwise be built into its base rates in this case. The Company's alternative proposal for natural fuel cost recovery, however, is to use instead a base cost of fuel of $5.64 per Mcf and to build this somewhat higher amount into base rates. Under this proposal, if actual average costs of gas used for fuel are lower than $5.64, the actual costs will be "trued-up" and a refund of the <u>entire</u> differential will be made to customers.

Q. If Company testimony supports only a $5.14 price, why are you recommending a base amount that is somewhat higher for ratemaking purposes?

A. The $5.14 per Mcf amount recommended by Company witness Browning for use under a "traditional" ratemaking approach is based upon a number of forecasts of what gas costs will be during the period that the rates established in this proceeding are in effect. Due to the volatility of natural gas prices; however, these forecasts might turn out to be substantially higher or lower than what is actually experienced. Absent the availability of a fuel adjustment clause in Missouri and due to the fact that natural gas costs comprise a large percentage of our total electric operating expenses, Aquila simply cannot afford to absorb the cost if natural gas prices rise higher than projected. Our $5.64 per Mcf proposal affords Aquila some limited protection from prices increasing above our forecast of $5.14 per Mcf, but, at the same time, provides the customer with protection through the refund mechanism if actual gas costs are below the $5.64 per Mcf cost of gas built into rates.

Q. Why doesn't the Company simply hedge the natural gas price?

A. Clearly, hedging is a viable strategy. However, there are a couple of issues that need to be addressed. First, a hedge provides the opportunity to lock in the current market price and/or limit volatility around the current market price. When executed, it does not provide the opportunity to buy below the current market price. Any attempt to lock in below the current market price simply increases the cost of the hedge by an offsetting amount. Second, there is a cost associated with hedging that would need to be recovered through rates. That is an alternative we would consider. Like commodity prices, hedge costs are also subject to price fluctuation. Price hedging is not a panacea for a volatile market. If rates were based upon the hedged cost, the benefit that customers would gain would be the certainty of knowing that the actual cost incurred is what will be recovered in rates. However, this would not guarantee that those rates reflected the lowest possible cost. Market timing of price hedges is just as important, and just as imprecise, as it is in any other market.

While we employ experts who analyze the gas commodity market, no analyst can consistently call the top or bottom of any market whether it is a commodity market or an equity market. If a utility expects declining commodity costs, they would likely choose not to hedge. Should prices subsequently rise, some parties will criticize the utility for having failed to lock in lower prices. On the other hand, if a utility does hedge prices and commodity prices drop, those same parties may level criticism for having locked in prices at a disadvantageous rate.

Moreover, the volatility of gas commodity and hedging premiums, coupled with regulatory lag, makes the matching of rates with the actual cost of gas difficult to achieve. By the time evidence is taken in a regulatory proceeding and an order is issued which establishes a gas cost, market conditions may have changed so that the cost to hedge at the price stated in the rate order is vastly different than what the rate order had assumed.

Q. How does your proposal address these concerns?

A. Aquila's proposal results in a higher risk to the Company than would the inclusion of actual hedged costs in rates; however, it also better insures that customers will pay no more than the actual cost of gas incurred. Allowing for a 50-cent "premium" in rates provides the Company with some protection from upward price movements. In exchange, any amounts that are recovered in excess of the actual cost of gas incurred would be reconciled annually and refunded to customers.

Q. Are you willing to consider other commodity price protection mechanisms?

A. Certainly. My proposal is only one of perhaps several that could be devised to address the problem of natural gas price volatility. For example, the mechanism could just as easily be applied to the total cost of fuel even though only the natural gas commodity is currently subject to extreme volatility.

Q. Can you provide examples of other mechanisms that could be considered?

A. Yes. My proposal is similar to a mechanism that this Commission approved for The Empire District Electric Company ("Empire"). That mechanism attempted to establish an incentive for Empire to reduce fuel costs by setting both a maximum base rate and a lower incentive rate. The base rate was included in Empire's cost of service for rate determination, subject to refund if actual costs incurred were lower than the base. The amount subject to refund, however, was limited to the incentive rate. If Empire was able to acquire fuel at an average cost lower than the incentive level, it was allowed to retain that portion. The major difference between the Empire plan and my proposal is that Aquila is not proposing to limit the refund amount. Customers would pay actual gas commodity costs incurred no matter how low the price for the acquired fuel might become.

Q. Do you have any other ideas for incentive programs?

A. Yes. A refund sharing mechanism could be employed whereby gas costs acquired below the $5.64 embedded in rates would be shared between customers and Aquila, similar to the sharing concept which we have in place in Colorado. Alternatively, the Commission could establish rates based on a specific plan for commodity purchases outlining the expected levels to be purchased under spot contracts, versus long-term purchase commitments. Rates could be established using the 24-month futures strip in existence at a true-up period shortly before issuance of a final rate order in this case. This would allow Aquila the opportunity to hedge the portion of its natural gas requirements for the agreed percentage of long-term contracts at rates approved by the Commission. Aquila would remain at risk for that portion of the gas purchase plan that was tied to the spot market.

LOW INCOME ASSISTANCE PROPOSAL

Q. Please describe the proposal to benefit low-income customers.

A. Company witness Vern Siemek, in his direct testimony, describes the synergies that Aquila was able to create as a result of the acquisition of St. Joseph Light & Power Company. Aquila is proposing a 50/50 sharing of these synergies with our customers. The customer portion of these synergy savings would be immediately flowed back to all customers through a reduction in revenue requirements in the current case. In addition, one-half of the Company's share of these savings would be set aside to establish a low-income assistance program. This program would be administered by an outside third party for the payment of past due and at risk accounts of both low-income electric and gas customers.

Q. What control would Aquila retain over administration of this program?

A. Essentially none. Aquila would continue to set aside funds for the low income-sharing program as long as the synergy savings from the acquisition are embedded in rates. An outside agency, such as the United Way or other organizations that have administered LIHEAP programs, would be selected to establish criteria for identification of low-income customers, determine the level of need and administer credits to their accounts.

Q. Does this conclude your direct testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P, for authority to file tariffs increasing electric rates for the service provided to customers in the Aquila Networks-MPS and Aquila Networks-L&P area	))))))	Case No. ER-________

County of Jackson)
) ss
State of Missouri)

AFFIDAVIT OF KEITH G. STAMM

Keith G. Stamm, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Direct Testimony of Keith G. Stamm;" that said testimony was prepared by him and under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information, and belief.

Keith G. Stamm

Subscribed and sworn to before me this 30th day of June, 2003.

Terry D. Lutes
Notary Public
Terry D. Lutes

My Commission expires:

8-20-2004

TERRY D. LUTES
Jackson County
My Commission Expires
August 20, 2004