Exhibit No.:
Issues: Policy
Witness: Keith G. Stamm
Sponsoring Party: Aquila Networks-MPS & L&P
Case No.: ER-2004-0034 & HR-2004-0024 (Consolidated)

FILED
APR 2 8 2004
Missouri Public Service Commission

Before the Public Service Commission
of the State of Missouri

Rebuttal Testimony

of

Keith G. Stamm

Exhibit No. 2
Case No(s). ER-2004-0034
Date 2/23/04 Rptr KF

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
REBUTTAL TESTIMONY OF KEITH G. STAMM
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
CASE NOS. ER-2004-0034 AND HR-2004-0024

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. Are you the same Keith Stamm who has previously filed direct testimony in this proceeding before the Missouri Public Service Commission ("Commission") on behalf of Aquila, Inc. ("Aquila" or "Company")?

A. Yes, I am.

Q. What is the purpose of this rebuttal testimony?

A. The purpose of my testimony is to respond to the recommendation of the Commission Staff ("Staff") that our MPS division receive less than one-half percent or essentially no electric rate increase, and that the electric rates for the L&P division be raised less than 2.3% above existing rates. The Staff's proposal would leave rates at approximately the same level they were over 20 years ago, even though investment and operating expenses have increased substantially during that period of time. In my direct testimony, I pointed out in some detail the most significant elements that comprise our request for rate relief. Key among these was the cost of natural gas, which accounted for well over a third of our total request.

Q. Did the Staff, in its direct testimony, recognize that gas prices have risen?

A. Yes, to some extent.

Q. Please explain.

A. Staff witness Graham Vesely used a 21-month historical average to arrive at the cost of gas used in the Staff determination of revenue requirements. His method resulted in an average cost of about $4.00 per Mcf of gas compared to a Staff recommendation of $2.80 in our most recent electric rate proceeding. That change results in an approximate $15 million dollar increase in revenue requirements over existing rates. While Mr. Vesely did not explain why he chose a 21-month period, he did indicate that he believed use of historical data was appropriate due to tradition in handling cost fluctuations.

Q. Do you agree with that approach?

A. No.

Q. Please explain.

A. One of the objectives of rate setting should be to establish rates that are reflective to the extent possible of the costs that will actually be incurred when rates are in effect. This is a well-established regulatory precept, and one founded on a principle of fairness and balance between the interests of customers and investors. While there are times when history may be a good predictor of the future, application of historical averages can be very arbitrary.

Q. How do your comments relate to the price of gas for purposes of this case?

A. Application of historical averages to the price of a commodity that is increasing over time deprives shareholders of the opportunity to earn returns that have been authorized and determined to be reasonable. For example, gas prices may be volatile but they continue to trend upward. No authority is expecting the return of $2 or even $3 gas in the foreseeable future, if ever. Therefore, the use of historical figures that give equal weight to such low prices for purposes of setting rates in this case is unreasonable. As described in the rebuttal testimonies of Company witnesses Browning and O'Donnell, as well as in the testimony of witnesses for other parties in this case, there are more appropriate methods to identify the cost of gas that is likely to be incurred by a utility company.

Q. If a mechanism was in place to "true-up" fuel prices for rate purposes, would that alleviate the concern about the level of fuel costs embedded in base rates?

A. I believe all parties would still want to establish base rates at a level most accurately predictive of actual costs that would be incurred, but a true-up mechanism, such as I discussed in my direct testimony, would provide protection to both customers and shareholders. Another witness in this proceeding, Mr. Maurice Brubaker has proposed a mechanism that would extend to all fuels. A similar approach was applied in recent years in establishing rates for The Empire District Electric Company's. Aquila has no objection to such an approach nor to a reasonable prudence review. We would want to insure a clear understanding in advance of such a mechanism and review procedure. I look forward to exploring the details of such a proposal as this proceeding moves forward.

Q. Has the Staff suggested application of a true-up mechanism in this case?

A. Yes. Staff witness Vesely noted that such a mechanism might be helpful and in the past has been used along with inclusion of fuel expense in rates higher than historical averages, presumably to provide the shareholders with needed protection. As I noted, compared to Staff's recommendation of gas costs in our last electric rate proceeding in 2001, the Staff has suggested an increase in revenue requirement associated with increasing fuel costs of over $15 million. This increase is recommended even using historical averages and without the inclusion of higher expense that would come with a true-up mechanism.

Q. If the Staff is proposing to increase rates by over $15 million to reflect increased gas costs, then why does the Staff's overall recommendation for increases in electric rates amount to only about $4 million?

A. That is what is particularly troublesome about Staff's recommendation.

Q. Please explain.

A. The Staff agrees that the cost we pay for gas has increased by over $15 million annually; the Staff agrees that over the past three years we have committed capital of over $120 million to new investment; the Staff agrees that our off-system sales have declined at least $9 million since the last rate proceeding; and the Staff agrees that pension expense has risen at least $7 million. Despite these tens of millions of dollars in increased revenue requirement, the Staff's ultimate recommendation is an electric rate increase of only $4 million.

Q. How do you explain this?

A. My own view is that over the past several years the Staff has come to assume a role of consumer advocacy instead of the role of attempting to balance the interests of consumers and investors. While the reasons for the increases I mentioned are well-known and unavoidable, Staff's objective seems to be aimed at retaining existing rate levels to the extent possible by offsetting these known increases through aggressive and what I believe to be unjust and unreasonable stances on nearly every other major issue. While political expediency may suggest maintaining rates at existing levels, the impact is to place the burden of increasing costs directly on the backs of shareholders. In the long run, this approach will harm our customers.

Q. Please explain how the Staff's approach will harm the Company's customers.

A. While maintaining low rates is a reasonable objective and one for which we strive daily, arbitrary exclusion of valid costs from rate recovery penalizes investors and over time creates a negative perception of the utility industry within the state. As the Staff has taken more unreasonable stances in rate proceedings in recent years, rating agencies and investors have begun to look askance at investment within Missouri versus opportunities elsewhere. A change in the outlook on utilities operating with a state occurs gradually, almost imperceptibly. Once reputational capital is lost, however, it is very difficult to regain from the debt and equity markets. The result is that both debt and equity capital is more difficult to obtain, and when it is obtained it is more costly. Customers eventually have to pay for this higher cost capital. Therefore, the unreasonable rate actions recommended by the Staff will ultimately impact our customers negatively.

Q. Do others share your views?

A. Yes. Company witness Susan Abbott, who has over 20 years experience in establishing credit ratings for Moody's, will provide additional testimony in this case on how a credit rating agency takes into account regulatory decisions in making its assessments; how those rating agency assessments can impact a utility and its customers; and how

Missouri utilities have already been impacted by recent regulatory trends in the state. Company witness John Reed will testify on the same matters from the equity market viewpoint.

Q. Besides higher future rates due to increased capital costs, are there other negative impacts that the Staff recommendations will have, if approved by the Commission?

A. Yes.

Q. Please explain.

A. Economic development is important to Missouri. Even though electric rates are low in our region when compared to other parts of the country, this fact did not prevent Missouri from being among the hardest hit in terms of job loss during the economic downturn of the last few years. Economic development is of particular importance in the MPS and L&P service territories. Aquila's Missouri properties are largely residential and span a rural geographic territory. We need to attract more industry to our service territory in order to create a more balanced peak demand and spread the high cost of infrastructure. The availability of high quality, technologically superior utility systems is one key element of attracting business to our area. Provision of assistance to local economic authorities and creation of informational tools such as LocationOne are other elements. Without adequate rate relief all of these efforts will suffer and economic development will be slowed.

In addition, innovation, efficiency and reliability can be negatively impacted without adequate rate relief. Staff has made its concerns well known regarding the potential impact of Aquila's corporate financial problems on the reliability and efficiency of our utility operations. Aquila from the start insulated its utility operations from non-regulated activities. Utility efficiency and reliability have not been, and will not be, harmed as a result of failures in other areas of our business. Yet, Staff's unwarranted recommendations, if accepted, will make it difficult for Aquila to invest in any new technology or innovations which could maintain and improve efficiency and reliability.

Q. Are there specific examples of areas where the Staff's recommendations are unwarranted?

A. Yes. Cost of capital determination is probably the most egregious and reflects an inconsistent approach.

Q. Please explain.

A. While Staff expresses concern about insulating the utility from its non-regulated activities, it attributes those activities as rationale for establishing extremely low rates of return. If it is appropriate to isolate the utility operations, as I believe it is, and as Staff agreed in its December 2002 "Staff Report on Aquila, Inc.", then we should isolate those operations completely. Specifically, on page 21 of that report, Staff makes the following comments:

> "To prevent or mitigate Aquila's higher cost of capital from being charged to Missouri ratepayers, the Commission can order the use of a hypothetical capital structure for ratemaking purposes to determine the appropriate mix of debt and equity that is appropriate for MPS and/or L&P. This capital structure would not be dependent on the capital structure currently in effect for Aquila. Aquila's response to the actions of rating agencies and other members of the financial community, while it may be appropriate for Aquila given its current situation, may not result in a capital structure that is appropriate and reasonable for its MPS and L&P utilities."

As indicated in the testimony of Company witness Donald Murry, it is not even necessary to apply a hypothetical capital structure to MPS or L&P in order to determine an appropriate mix of debt and equity for the utility operations, because Aquila has had in place for a number of years a tracking mechanism that appropriately assigns capital to the utility divisions and insulates them from non-utility operations.

Q. In this proceeding, has the Staff followed its own advice outlined in the Staff Report?

A. No. Staff, through its cost of capital witness David Murray, has applied a capital structure that is not appropriate for our Missouri operations and was derived as a result of the corporate financial condition from which other Staff members say those operations should be insulated; has identified comparable companies which are in no manner comparable to the operations of our Missouri utilities; and has recommended an initial return on equity of only 9.14% - a return that is among the lowest recommended by any Commission Staff in any utility proceeding in the United States over the past year. I speak of an initial return on equity because when coupled with Mr. Murray's capital structure recommendation, the effective recommended return on equity on a capital structure more appropriate to Missouri utility operations is only about 8 percent.

Q. What would be the result if the Staff recommendation is approved?

A. It will harm our ability to raise capital.

Q. Please explain.

A. As further discussed in Mr. Reed's testimony, it is doubtful that any rational investor would invest funds in a Missouri utility at an authorized return of 8%, (knowing that other disallowances will reduce the actual return substantially) when they could be investing in an Iowa, Illinois or some other state utility that pays over 11% returns.

Furthermore, as Ms. Abbottt will testify, the ultimate result of Staff's cost of capital recommendations would make the stand-alone utility operations, absent any impact of other Aquila operations, to be below investment grade. If this Commission accepts the Staff's cost of capital proposal, it will be sending a clear signal to the financial community that this Commission no longer endorses the notion of maintaining healthy and viable utilities within this state.

Q. How does the Staff's recommendation in this case compare to what it recommended in the last case?

A. In our last rate case in 2001, the same Staff witness recommended a common and preferred equity ratio of 55.03% to be applied in setting utility rates. One is left to wonder how the utility operations have deteriorated in just three years to result in a Staff recommended equity ratio in this case of only 35.65%. Staff offers no testimony indicating that utility earnings have deteriorated by such a dramatic percentage nor has the Staff offered any suggestion that rates were set too low in our last rate case. The only plausible conclusion then is that the Staff method is seriously flawed. Mr. Murry, on behalf of the Company, will provide greater detail regarding the clearly inappropriate cost of money recommendation that has been advanced by the Staff.

Q. Are there other examples of unwarranted Staff adjustments?

A. Yes. In 1999 our MPS division entered into a purchased power agreement with MEP Pleasant Hill ("MEPPH"), a partnership that was formed to operate the Aries power plant located in our Missouri service territory. Aquila is one of the partners in this plant. MPS purchases 500 Mw of capacity in the summer months when our peak requirements are highest and the cost of capacity is great, and purchases 200 Mw of power the remainder of the year. This arrangement is unique, is beneficial to MPS because it better matches our purchases to our load requirements, and it is likely that such an arrangement could not be obtained in today's market. As will be explained by Aquila witnesses Frank DeBacker and Max Sherman, the purchased power agreement with MEPPH was an arm's length transaction, and was the lowest cost available among a number of sources that bid on serving the MPS load. It was entered into only after extensive negotiations and, in fact, the agreement was ultimately approved by this Commission as being in the public interest.

Q. How does the Staff propose to treat the agreement for rate purposes?

A. Even though this was the low cost bid, during our last rate case Staff raised concerns about the dollar amount of the purchased power payments. The Staff, in that case, proposed a reduction in revenue requirements that, I believe, was based on errors both in fact and in logic. It is perhaps understandable that these errors were made as the issue presented itself late in the development of our last rate case and the Staff in testimony admitted it did not have complete information and might revise its adjustment. Ultimately that case settled and there was no need to resolve that individual issue.

Q. Has Staff raised the same issue in this case?

A. Yes. The Staff did raise the issue again. In fact, it is my opinion that the Staff set out in this case not to objectively look at additional facts and come to a logical conclusion, but instead to support a wrong conclusion that was raised in the last case regardless of the facts. Not only does the Staff propose a reduction in revenue requirements as a result of the purchased power agreement, but Staff witness Mark Oligschaleger also labeled this transaction "an excellent example of affiliate abuse".

Q. How do you respond?

A. Such an allegation is not only wrong, it conveniently ignores pertinent facts, and is reflective of the Staff's bias. While Staff may have been hampered in its 2001 investigation due to having raised the issue late in the proceedings, in this case the issue was present from the outset and the Staff was provided every document and every piece of information available that was requested during its investigation. Over the objections of the plant's operating partner Calpine, a data room was established by Aquila to provide even extremely confidential and market sensitive information for review. Apparently the Staff either ignored or did not understand this additional data, essentially proposed the same adjustment as in the previous proceeding, made the same errors in fact and logic, and, I suppose, assumed that labeling the transaction as an excellent example of "affiliate abuse" was all it needed to do to justify a disallowance.

Q. What errors in fact and logic did the Staff make?

A. There are a number. First, Mr. Oligschlaeger asserts incorrectly that the purchased power contract was priced to charge our MPS division costs higher than if the utility division had built its own generation. He also indicates that the Company followed a strategy of selling power at higher prices to its native load customers in Missouri, and that the purchased power agreement resulted in charges to MPS far in excess of costs to supply power.

Q. How do you respond?

A. These statements are simply not true. As noted by Mr. Sherman and supported by data reviewed by Mr. Oligschlaeger, operating and capital costs for self-generation would have substantially exceeded the payments made under the purchased power agreement.

Q. Are there other errors in logic?

A. Yes. Mr. Oligschlaeger states that because MEPPH receives purchase power payments from MPS that approximate its capacity payments, all other proceeds fall directly to the bottom line as profit.

Q. Is that true?

A. No. For that statement to be correct, Mr. Oligschlaeger would have had to assume that fixed capacity payments are the only costs incurred by MEPPH - that the plant has no operating or financing costs. Such an assumption is illogical and clearly ignores data that was readily available and reviewed by Staff.

Q. Do you have other examples?

A. Yes. Mr. Oligschlaeger leaves the impression that the plant was able to retain substantial profits by selling power on the interchange market. Data reviewed by Mr. Oligschlaeger does not support this assertion. In fact, MEPPH bore the risk of incurring substantial losses when it was not able to sell on the open market.

Q. Regarding risk, is it true as stated by Mr. Oligschlaeger that by 1998 Aquila was operating under a policy of not investing in regulated generating units?

A. Yes. Aquila adopted that policy based on market conditions and the utility environment at the time. I believe the decision made was appropriate, and Staff's conclusion that a five year purchased power agreement was not in the best interests of customers and was made in order to exact unfair profits from MPS customers is simply revisionist history.

Q. Please explain.

A. The fact is that during the timeframe in question, electric restructuring was well underway. Over thirty states had adopted some form of electric market competition and plans were in place to expand competition in a number of states. The Federal Energy Regulatory Commission ("FERC") had ordered all utilities under its jurisdiction to provide open access to their transmission lines to all third parties at comparable rates, terms and conditions. FERC was clear in its desire to expand the wholesale, bulk power market and provided discussion on the recoverability of stranded costs. Given this restructuring, a serious concern raised by commissions and utilities alike was the risk of stranded generation investment. In addition to the involvement of the Missouri Public Service Commission in restructuring discussions within Missouri, many associations of commissioners such as the National Association of Regulatory Utility Commissioners and the Mid America Regulatory Conference held a number of sessions to discuss efforts to mitigate stranded investment through divestiture of generation assets, early retirement, more rapid depreciation and other means. Certainly, direction was not being given, and it would likely have been considered imprudent, for a regulated utility to risk hundreds of millions of dollars investing in new generation assets. As noted in the rebuttal testimony of Company witness Jon Empson, this Commission and it's Staff, in particular, supported the assumption that restructuring would occur, that utilities should seek to divest assets in order to avoid stranded investment, and that short-term purchased power contracts would be the norm. With hindsight, the Staff is now alleging that Aquila's decisions were made to take unfair advantage of customers and maximize profits. However, in the context of the time in which those decisions were made, it is clear that Aquila was following the prudent and recommended course of action.

Q. Given the fact that market restructuring subsequently faltered, did MPS customers suffer any harm from the 1998 decision?

A. No. As I noted before, the purchased power agreement that was developed contained many favorable provisions, was the lowest cost among a number of competitive bids, and was, in fact, more economical than MPS building the plant itself. Moreover, plant construction costs have not escalated over the past five years and therefore MPS has maintained supply option flexibility.

Q. What do you conclude from this?

A. There are clearly no facts even to suggest, much less to prove, affiliate abuse. What is especially disappointing is that if we had entered into a purchased power arrangement in 1998 with another party, even though it would have been more costly to our customers, there would have been no claim of affiliate abuse and likely no disallowance. Not only is this purchased power arrangement cost effective, but as noted in the testimonies of Company witnesses DeBacker and Sherman, it contained operational agreements that benefited our customers and which were not obtainable from any other party.

Q. Are there other examples of proposed Staff adjustments that may ultimately harm Aquila's customers?

A. Yes. The establishment of depreciation rates, particularly calculation of net salvage on a pay as you go basis and exclusion from the determination of depreciation rates, is harmful to our customers in a number of ways.

Q. Please explain.

A. The purpose of establishing a reserve is so that earnings are not impacted at the time of a significant financial event. In the event of the retirement of a generation plant, for example, costs of removal will be extremely high. If no reserve is established for net salvage to provide for this eventuality, the impact on earnings when a major retirement occurs could be so negative as to create a financial crisis.

Q. In addition to creating a potential financial crisis, what other impact on the utility will result from this depreciation proposal?

A. This approach denies a source of cash flow to the utility. In this regard, prudent utility management generally attempts to maintain capital expenditures at levels approximating depreciation so as to minimize the necessity for accessing capital markets. Reduction in cash flow means either that technology, reliability improvement, and economic development type investments must be reduced or that access to the capital markets must be increased – either event can have negative impacts on customers.

Q. Do you have other comments on this issue?

A. Yes. Perhaps, most important is the simple fact that the current approach to cost of removal recovery is unfair to our customers, a matter of intergenerational inequity. As I stated earlier, under the current approach of allowing recovery based solely on historical removal cost, no provision is being made for major retirements such as power plants.

Current customers who are consuming the energy generated by those plants are paying not one penny towards their ultimate removal. When the time comes to remove a major plant, there will be a generation of customers who have received very little or no benefit from the plant but who will be asked to pay for it. It is possible, I suppose, that when faced with the multi-million dollar cost of such a retirement the Staff may recommend amortization of that extraordinary amount into the future. Such a solution, however, would only increase the inequity – customers who have never received one kwh of benefit from the plant would be paying for its removal years into the future.

Q. Are there other concerns about the manner in which net salvage is treated for ratemaking purposes?

A. Company witness Davis Rooney provides greater detail regarding problems with the Staff's current approach. I would point out that, as acknowledged in the direct testimony of Staff witness Cary Featherstone, the current rate treatment of net salvage has arisen only over the past four years. In my opinion it is not sound ratemaking policy and, to my knowledge, this approach is followed by only one other state in the nation.

Q. Please summarize your rebuttal testimony.

A. As I noted in earlier testimony, Aquila has made errors in judgment that have contributed to serious financial consequences for the Company. At the same time, we have taken aggressive steps to insulate our utility divisions from those consequences. We have moved to return to our core utility business focus, restructure our utility operations, and manage our costs while maintaining service metrics. Substantial cost increases have occurred, however, which even the Staff admits are outside our control and unrelated to any non-regulated activities. Still, the Staff has attempted to offset these legitimate increases through introduction of unreasonable and unwarranted measures. If their recommendations are accepted by the Commission, MPS and L&P, on a stand-alone basis, would not meet investment grade criteria. This result would have damaging impacts on Aquila's customers as well as on economic development and potential technological advances. This result would also send a very negative message to the investment community regarding not only Aquila prospects, but those of every other utility operating in Missouri.

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-2004-0034
In the matter of Aquila, Inc. d/b/a Aquila Networks-L&P, for authority to file tariffs Increasing steam rates for the service provided To customers in the Aquila Networks-L&P area	)	Case No. HR-2004-0024

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 "Rebuttal 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

Keith G. Stamm

Subscribed and sworn to before me this 26th day of January, 2004.

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