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Exhibit No.:
Issues: Fuel Adjustment Clause
Witness: Dennis R. Williams
Sponsoring Party: Aquila Networks-MPS & L&P
Case No.: ER-2007-0004

Before the Public Service Commission
of the State of Missouri

Surrebuttal Testimony

of

Dennis R. Williams

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Q. Please state your name and business address.

A. My name is Dennis R. Williams. My business address is 20 West 9^{th} Street, Kansas City, MO, 64105.

Q. Are you the same Dennis Williams who previously filed direct and rebuttal testimony in this case?

A. Yes.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of this testimony is to address the rebuttal testimonies of Staff witnesses Cary G. Featherstone and Michael Taylor; Public Counsel witness Russell W. Trippensee; and SEIUA and Ag Processing witness Donald Johnstone – all on various matters pertaining to Aquila's proposal for implementation of a fuel adjustment clause ("FAC") mechanism. I will also respond to Public Counsel witness Ryan Kind on recovery of demand side management ("DSM") costs, and to Public Counsel witness Ted Robertson regarding executive compensation.

EXECUTIVE SUMMARY

Q. Please briefly summarize your conclusions.

A. In response to the FAC rebuttal testimony of the above identified witnesses, my primary conclusions are as follows:

- Aquila believes that its recommendation for a FAC is the most demonstrably fair approach to recovery of fuel costs. The Alternative FAC proposed by Mr. Johnstone operates so that Aquila is inherently penalized by design.
- The IEC mechanism proposed by Mr. Featherstone results in excessive risk that Aquila will be unable to recover its prudently incurred fuel costs.
- Although Aquila still believes that quarterly periods for accumulating fuel costs for inclusion within the FAC are appropriate, the Company is willing to modify its initial proposal to utilize an annual recovery period as recommended by Mr. Trippensee and Mr. Johnstone. This should serve to reduce the potential for rate volatility within the Company's original proposal. Annual Recovery Periods also eliminate any concern with seasonal disparity.
- Aquila understands that there may be some customer benefit to a "soft cap" type volatility mitigation mechanism in the FAC as recommended by Mr. Johnstone. However, there are offsetting disadvantages. In particular, setting the cap too low has the potential for large deferrals that increase carrying costs and could ultimately be passed on to customers in one exceptionally large increase.
- Aquila believes that existing heat rate efficiency testing at its production facilities, following the operating guidelines outlined by Southwest Power Pool ("SPP"), is sufficient. While documentation procedures can be improved, Aquila does not believe that additional testing is needed. To

the extent that additional testing is ordered, additional revenues should be provided in this rate proceeding to cover the large cost.

- The Company agrees with the rebuttal testimony of Mr. Trippensee where he points out that off-system sales are not currently significant to Aquila's overall operations. Accordingly, Aquila is agreeable to removing the proposed sharing mechanism for off-system sales through the FAC, although recognizing that at some future point in time an incentive mechanism could be warranted.
- Mr. Trippensee's recommendation to exclude certain fuel-related costs and revenues from the FAC is not appropriate. These costs and revenues are properly recoverable fuel costs; their exclusion would provide no significant benefit and would be administratively difficult to accomplish.
- It is appropriate to include capacity costs for purchased power contracts with a term under a year within the FAC.

In response to other rebuttal issues:

- Aquila agrees with the Staff Demand Side Management ("DSM") cost recovery proposal.
- Aquila previously agreed with Staff to reflect a downward adjustment for management compensation costs in updated revenue requirement schedules. The adjustment proposed by Public Counsel is redundant and unnecessary.

<u>SIGNIFICANCE OF FUEL ADJUSTMENT MECHANISMS</u>

Q. What is your understanding of the purpose of a fuel adjustment mechanism?

A. Fuel adjustment clauses are used by almost all regulatory jurisdictions that, like Missouri, have not been restructured – that is, where electric utilities still own their generation facilities used for delivery to their regulated customers. They are intended to address the issue of volatility for a significant utility operating expense.

Fuel and purchased power costs make up a very large portion of the typical utility's operating costs, and due to changes in national and international market conditions, fuel and energy costs are subject to wide fluctuations. It is also very difficult to accurately predict what fuel and purchased power costs will be in the future. As Aquila witness Trent Cozad discusses in his surrebuttal testimony, electricity and natural gas are currently the two most price volatile commodities. Because these costs are so volatile and difficult to predict, and because fuel and energy costs make up such a large portion of total operating expenses, it is inappropriate to treat them in the same manner as other costs. Typical ratemaking involves identification of actual costs during a historical test year, and adjusting those costs to reflect an estimate of the level of expenditures that will be in place when new rates go into effect. If rates are based on estimates that are incorrect, utility companies have to file numerous, perhaps ongoing, rate cases. A FAC allows for the recovery of prudently incurred fuel and energy costs without having to go through the lengthy, labor-intensive procedural steps of a rate case. Utility companies benefit through timely recovery of the largest component of their operating costs; customers benefit from not having to wait for extended periods of time for rate reductions; and, both utilities and their customers benefit from this timely matching of expense and revenue and the savings of avoiding rate cases.

Q. Are Aquila's fuel and energy costs significant?

A. Yes. The table below reflects that on-system fuel and energy costs were about $204 million and comprise 46% of Aquila's total operation and maintenance expense:

	MPS	L&P	Total
Fuel & Energy	$164,714,022	$39,013,170	$203,727,192
Total O & M	$352,141,854	$91,255,754	$443,397,608
Percentage	47%	43%	46%

(Source: Updated Revenue Requirement Model – Schedule 7)

Q. Have Aquila's fuel and energy costs been volatile in recent years?

A. Yes. Fuel and energy costs have reflected significant upward and downward variations in recent years. The overall trend, however, reflects large increases in fuel costs.

Q. Why is that?

A. Some coal contracts have been renewed and renewal prices are significantly higher than what was embedded in existing contract prices. Rail transportation rates have increased significantly. Natural gas and purchased power prices have each risen significantly. Aquila has a large residential, summer peaking air conditioning load resulting in low load factors. Summer peaks are economically more efficiently met with natural gas fired peaking plants, so Aquila has a relatively high dependence on natural gas in comparison to some other utilities in the state that have higher load factors. Because of this, increases in natural gas and purchased energy can have a significant impact on Aquila's fuel and energy costs.

Q. Can you provide any data on the level of increases Aquila has experienced in recent years?

A. Yes. Aquila's fuel and energy costs for delivery on our system, exclusive of growth, have increased between 13% and 20% per year in each of the past three years. That means we have averaged annual increases in fuel and energy costs of more than $30 million per year.

AQUILA FAC MODIFICATIONS

Q. Has Aquila made any modifications to its FAC proposal outlined in your direct testimony?

A. Except for a formulaic error that requires correction, Aquila supports its original recommendation. However, after considering the comments included in various parties rebuttal testimonies, Aquila is willing to accept a number of modifications. I will discuss each of these modifications in my testimony and I have included a sample tariff that includes these modifications in the event the Commission wants to see how they would fit into an FAC for Aquila.

Q. Please summarize Aquila's FAC with those modifications.

A. As modified, Aquila's FAC factor would be based upon historical differences between the cost of fuel and energy recorded in FERC accounts 501, 509, 547, and 555 that are built into base rates and the costs of fuel and energy that the Company actually incurs. All off-system sales margins above or below what are in base rates would be included in the FAC. Hedge costs, settlement costs and revenues, and insurance proceeds from generation outages would also flow through the FAC. However, purchased power capacity contracts greater than one year would be excluded. FAC costs would be accumulated quarterly and recovered over twelve months. Under-collected or over-collected amounts recorded in tracking accounts would accrue interest at Aquila's weighted average short-term cost of debt.

Q. How has this proposal changed from what Aquila recommended earlier in this proceeding?

A. This proposal reflects four modifications from the original proposal that was described in my direct testimony. First, Aquila is not currently proposing a sharing of off-system sales margins. Second, the annual collection period (Recovery Period) was originally defined as three months but has been changed to twelve months. Third, the tariff sheet included in my direct testimony as Schedule DRW-1 inadvertently excluded a necessary factor. Mr. Trippensee proposed a correction to eliminate the problem and I agree with that solution. Finally, Mr. Johnstone recommends the incorporation of separate loss factors by rate class and voltage level of service. Aquila's original proposal made no distinction among voltage levels for energy costs, but Aquila agrees with the approach described by Mr. Maurice Brubaker in his direct testimony on rate design.

Q. Have you provided a new tariff sheet reflecting the modifications discussed above?

A. Yes. Specimen FAC tariff sheets for MPS and L&P are attached as Schedule DRW-1 to this surrebuttal testimony.

Q. Can you briefly explain how the FAC would work in practice?

A. Yes. Very simply, during a quarter (Accumulation Period), Aquila will accumulate in a deferral account the actual fuel and energy costs incurred above or below a base rate set in this rate proceeding. In the succeeding three months, this difference will be calculated on a kWh basis spread over twelve months of estimated usage to develop a FAC factor. This is a fairly simple mathematical procedure and the results would be provided to Staff and other parties for review and to the Commission for approval. After this three month preparation and review period, the kWh factor would be added or credited to customers' bills over a twelve month period (Recovery Period). Annually, there would be a true-up of actual FAC revenues recovered and a prudence review of fuel and energy procurement practices. The prudence review would include a Staff audit and additional review by Staff and other parties of the full spectrum of Aquila's fuel and energy procurement in the prior year. That review could be followed by a prudence hearing before this Commission.

Q. You mentioned some modifications to Aquila's original proposal. Why has Aquila agreed to change its recommendation in regard to off-system sales?

A. Off-system sales relate to the sale of electricity made by Aquila when it has excess energy to sell after meeting its native load obligations. Our original recommendation recognized a base level of off-system sales in rates, and a sharing between the Company and its customers of margin variances. In his rebuttal testimony, Mr. Trippensee asserted that off-system sales margins do not currently "constitute a major driver of earnings for Aquila". He believes, therefore, that incentives derived from a sharing of off-system sales margins would be minimal, and suggests that all off-system sales margins flow through a FAC. In retrospect, Aquila agrees with Mr. Trippensee's position. In recognition of the fact that Aquila does not view off-system sales as a significant opportunity, Aquila agrees that a sharing of off-system sales is not appropriate at this time and is proposing that all off-system margins should flow through the FAC mechanism. If it should become the intent of this Commission to encourage Aquila to develop an energy sales business outside its core market, then sharing of off-system sales margins may be appropriate.

Q. Why did the Company modify its position in regard to an annual recovery period?

A. Aquila's original proposal was to accumulate fuel and energy costs for a three-month period and then recover or refund the difference from the base six-months later. The intent was to pass on differences from one high usage quarter to another high usage quarter. Since the over/under recoveries would be spread over similar kWh, the resulting FAC factor would be mitigated. Both Mr. Trippensee and Mr. Johnstone have objected to this approach. While I do not agree with some of their rationale, the Company does not object to an annual Recovery Period. The Commission should recognize, however, that the potential for larger deferral balances, and therefore greater customer interest charges, exists under this method.

<u>OTHER "CONCERNS" RAISED IN REGARD TO AQUILA'S FAC PROPOSAL</u>

Q. Mr. Trippensee also recommended annual Accumulation Periods. Do you agree that costs should only be accumulated on an annual basis?

A. No. Most of Mr. Trippensee's comments seem to be directed toward an annual Recovery Period. However, he suggests that because base rates are set on an annualized basis, that the accumulation period should also be based on a twelve-month period. Despite the fact that rate cases utilize twelve-month historical test years, the establishment of a FAC reflects the determination that fuel and energy costs should be treated differently than they are in the normal rate case process. The PGA that has operated in Missouri for forty years is not restricted to an annual Accumulation Period. A twelve-month Accumulation Period accomplishes little other than to put off recovery under the FAC mechanism for well over a year. This would result in significant cost recovery lags, larger deferrals, and higher interest charges. Mr. Trippensee's rationale for spreading the Recovery Period over a twelve month period is appropriate, and Aquila has adopted that recommendation. However, his recommendation for a 12-month Accumulation Period before FAC charges or credits can be made is not appropriate.

Q. What is your reaction to Mr. Johnstone's concern regarding seasonal pattern variations?

A. Adoption of an annual Recovery Period should adequately address those concerns.

Q. What is your response to Mr. Trippensee's statement that the Commission rules provide for only one mandatory adjustment per year and that, therefore, "Aquila's proposal fails to meet this basic test of reasonableness?"

A. Mr. Trippensee misinterprets the rules because those rules specifically allow for an FAC with up to four adjustments per year. 4 CSR 240-20.090(4)(A) requires one mandatory filing, but provides that an electric utility may file "up to three (3) additional adjustments to its FAC within a true-up year…"

Q. Do you agree with Mr. Trippensee's statement that more than one filing per year would "overwhelm the regulatory resources of the Commission and definitely effectively exclude all interveners from the prudence review process"?

A. No. The rules contemplated one prudence review at least every eighteen months and Aquila's proposal meets that requirement by requesting an annual prudence review. An annual prudence review also appears to be what Mr. Trippensee is proposing. Accumulation Period filings will require neither more nor less resources whether filed annually, quarterly or even monthly because the same total amount of review time would be necessary under any of those scenarios. It is simply a matter of whether the parties review twelve months of data all at one time or review that data in smaller increments. From a resource planning standpoint, quarterly reviews would appear to me to be advantageous.

Q. Mr. Trippensee indicates that Aquila violated the Commission rules by proposing to start its Accumulation Period on June 1 rather than July 1. Do you agree?

A. No. Mr. Trippensee quotes the rule that states that the True-up year is to begin on the first day of the first calendar month following the effective date of the

Commission order approving the fuel adjustment clause. He assumes that the effective date of the order in this case will be after June 1, 2007. However, Aquila's case was filed July 3, 2006, so the operation of law date is May 30, 2007. On August 22, 2006 the Commission issued an Order Adopting Procedural Schedule and Modifying Previously Ordered Test Year and on page two of that order states:

> Aquila tariffs have been suspended until May 30, 2007, which is the maximum suspension period allowed by the controlling statute.

Therefore, beginning the Accumulation Period on June 1, 2007 is in compliance with the Commission rules.

Q. Mr. Trippensee opposes inclusion of certain fuel related costs and revenues from the FAC. How do you characterize his recommendations?

A. They are not appropriate. Mr. Trippensee lists a host of costs that he believes should not be included in a FAC including repair costs to railcars, repair costs to company-owned coal handling or other facilities, depreciation on railcars, disposal of ash net of ash revenues, fuel handling expense, fuel disposal costs, labor related to fuel, insurance, maintenance and hedging costs and revenues. He believes that only costs that are materially impacting the utility's financial health, are volatile, and are beyond management control should be included in a FAC. First of all, the Company has no fuel disposal costs other than ash disposal, which Mr. Trippensee addresses separately. Similarly, boiler maintenance and insurance costs, as Mr. Trippensee surmises, are not recorded in any of the FERC accounts that Aquila has proposed for consideration in a FAC.

Secondly, divided into small enough segments, some of the remaining items might individually not have a material impact on the utility's financial health, but, in combination they could. For example, in total these items amounted to almost $17 million of expense in 2006.

Finally, Mr. Trippensee's proposal raises the level of complexity and increases administrative effort for no good reason. The FERC Uniform System of Accounts establishes the definition for what costs are properly included in fuel-related accounts, and is therefore, a good independent source that can be used to avoid expenditure of time and resources arguing whether a particular item is appropriate for inclusion or not. Likewise, it does not seem beneficial to expend the additional time and cost necessary to separately account for these items, while still effectuating compliance with FERC requirements.

Q. Would excluding these costs from a FAC have a significant impact?

A. Yes, I believe that the impact of excluding these items from the FAC would be significant. Moreover, I believe the costs more appropriately belong in the FAC. If the effect is in fact de minimus as Mr. Trippensee contends, treating them in the FAC should not really matter and is certainly not worth the administrative effort that would be required to treat them apart from the FAC.

Q. Do you have any comments in regard to some of the specific examples of costs that Mr. Trippensee believes should be excluded?

A. Yes. Mr. Trippensee proposes to exclude railcar maintenance and depreciation costs. These costs are directly related to fuel transportation and their exclusion from other fuel and energy costs does not seem sensible. When coal is transported in leased rail cars, the costs of those cars and their associated repairs are included in the lease rate and thus fuel expense. Likewise, the cost of owned railroad cars and their repair should be included therein. These costs are appropriate expenditures necessary for the delivery of coal and appropriate for FAC inclusion.

Mr. Trippensee also wants to exclude ash disposal costs and revenues from a FAC. However, ash disposal quantities and costs bear a direct relation to the amount of fuel burned and are therefore properly associated with other fuel costs. Moreover, revenues from the sale of ash are volatile due to changes in demand. Finally, hedge costs and revenues, which Mr. Trippensee also proposes to exclude, are necessarily as volatile as the underlying commodity to which they are related. Natural gas hedging costs are included for pass-through in the Missouri PGA mechanism because the Commission recognizes that they are appropriate to control gas price volatility. Similar hedging costs utilized for sound electric fuel management should likewise be allowed for inclusion in a FAC.

Q. Mr. Featherstone indicates that it is Staff's position that not only should demand charges for purchased power agreements over a year be excluded from the FAC, but that they should likewise be excluded for short term purchase power agreements. How do you respond?

A. Mr. Featherstone's rationale is that demand charges are fixed costs to reserve capacity of another company's production facilities, and therefore are like plant investment costs and should not be included in a FAC. I agree with that reasoning for long-term agreements (over a year) because for long-term agreements, capacity charges, like the depreciation of plant investment, can be spread or amortized over the life of those agreements. With short-term agreements, however, the demand costs cannot be spread over a longer period, but must be completely expensed in the initial year of contract. Moreover, due to their short-term nature, purchased power contracts of less than one year are not included in base rates; therefore, the only opportunity to recover the related demand charges is to recognize them as a fuel expense item.

Q. Staff witness Michael Taylor, in rebuttal testimony regarding the Commission's FAC rules for heat rate and/or efficiency tests, stated that "a number of adequate testing procedures are provided in The American Society of Mechanical Engineers' Performance Test Codes ("ASME-PTC")". Does Aquila believe that it is necessary that all testing procedures from ASME-PTC should be followed?

A. No. As Mr. Taylor pointed out, there are approximately fifty (50) Performance Test Codes and Staff does not expect written procedures to duplicate the ASME-PTC. Aquila believes it is unnecessary and certainly not cost effective, to do all of the ASME-PTC tests on a continuing basis. Indicative results can be sufficiently obtained through Aquila's current testing program. Aquila currently uses SPP operating guideline testing to monitor its generating plants' efficiency. To bring current testing into full compliance with the ASME-PTC would cost approximately $2.5 million annually. If the Commission believes this additional testing is required, the revenue requirement in this proceeding needs to be increased accordingly.

Q. What specific testing procedures does Aquila recommend?

A. Aquila believes SPP operating guidelines are sufficient but agrees that written documentation of its process could be improved. Aquila is currently working with Staff to develop mutually agreed upon written testing procedures to ensure that Aquila power plant heat rates are being properly monitored.

Q. Why is heat rate testing important and why is it being addressed in the context of the FAC discussion?

A. Heat rate testing insures that power plants are running efficiently and the plants are getting the most out of the fuel put into the units to create electricity. Changes in output data are used to indicate if there are possible problems with the unit and/or the operation of the plant that need to be addressed.

MR. JOHNSTONE'S FAC SUBSIDIZATION PROPOSAL

Q. Please briefly describe the major differences between Mr. Johnstone's Alternative FAC proposal and that of Aquila?

A. The major differences between Mr. Johnstone's proposal and that of Aquila include:

- Mr. Johnstone utilizes a six-month Accumulation Period compared to Aquila's three month Accumulation Period;
- Mr. Johnstone proposes a twelve-month Recovery Period to which Aquila has acquiesced;
- Mr. Johnstone proposes a two-year limit on the FAC;
- Mr. Johnstone proposes a cap that, in any six-month period, limits any increase in the average residential rate to no more than 1.5%;

- Mr. Johnstone proposes that certain quantities of coal-fired generation and capacity purchases from Nebraska Public Power District ("NPPD") be achieved or that penalties would be assessed; and
- Mr. Johnstone proposes that there would be a "sharing" of 50% of the difference between fuel and energy costs actually incurred and the amount of fuel and energy costs included in base rates.

Q. How would you characterize Mr. Johnstone's proposal?

A. Under the guise of "consumer protection" and "sharing", Mr. Johnstone has devised a FAC mechanism that is punitive and will make it highly unlikely, if not impossible, for Aquila to recover its prudently incurred fuel and energy costs. What Mr. Johnstone calls "sharing" is more accurately described as cost subsidies.

Q. Are Mr. Johnstone's recommended coal-fired generation standards punitive?

A. Yes. First and foremost, his recommendation is not balanced. The Company is penalized if it does not achieve his proposed standard, but is not rewarded if it exceeds that standard. Mr. Johnstone's proposed standard requires the utility to achieve at least 96 percent of the coal-fired output that is included in Staff's case in this proceeding. As an illustration of my concern, assume that in one period Aquila achieves only 95% of its established standard but in the following period achieves 105% of the standard, an average of 100%. Applying Mr. Johnstone's proposal would result in a net penalty to Aquila, which is in contrast to what would occur absent a FAC mechanism.

Q. Is such an event as described in your simple example likely to occur?

A. Yes. Maintenance schedules vary greatly by season and by year. If Staff's fuel run is truly indicative of normal or average levels of outages, then in periods of high maintenance, Aquila will likely not achieve its prescribed standard and will be penalized. However, in periods of low maintenance and achievement in excess of standards there would be no reward.

Q. Does Staff's fuel run reflect coal fired output levels that are representative of levels that likely will be achieved in the future?

A. No, they likely do not. As a generating plant ages, its heat rate declines. More importantly, federal mandates require the addition of environmental controls on most of Aquila's base load generating facilities, which will further drive down mWh output. Therefore, basing standards on historical, normalized output creates a measure that Aquila is not likely capable of achieving in the future.

Q. To what coal-fired generation facilities does Mr. Johnstone's proposal apply?

A. Mr. Johnstone proposes to apply his recommendation to Aquila's "entire fleet of coal-fired generation".

Q. Does that suggestion make sense?

A. No. Aquila has plant investment in the Sibley, Lake Road, Jeffrey, and Iatan generating stations. However, only Sibley and Lake Road are operated by Aquila. The Company is only a part owner in the Jeffrey Energy Center and Iatan and does not manage or operate either of those plants. Therefore, Aquila has no control over maintenance schedules or other operational matters that may impact their availability.

Q. Has Mr. Johnstone also proposed standards for capacity purchase contracts?

A. Yes. His proposal extends to capacity purchases with NPPD. Those contracts are for capacity from NPPD's Gentleman and Cooper generation plants. Aquila has no control over maintenance schedules or other operational matters at those plants that may impact the availability of capacity through those contracts. Consequently, the application of his standards to these contracts is not appropriate.

Q. Are there other operational factors that may impact fuel and energy prices that are outside of the Company's control?

A. Yes. System transmission constraints, transmission outages, maintenance of generation facilities by others, and unplanned outages on other utilities' systems are all examples of issues outside Aquila's control that can impact supply availability. Weather-related incidents, such as ice storms, can, and have, impaired transmission capacity and minimized the availability of power from our NPPD contract. These are all examples of operational issues outside of the Company's control which are inexorably linked to power prices.

Q. Do you have equal concerns in regard to what Mr. Johnstone's calls "sharing"?

A. Yes. My concerns in regard to his "sharing" proposal are even greater. As explained in the surrebuttal testimony of Steven Fetter, the word "sharing" is a misnomer, because what Mr. Johnstone is proposing is rate or cost subsidization. If actual fuel and energy costs are greater than the amount included in base rates, Aquila's customers would be required to pay only half that difference. The balance would be made up by Aquila's shareholders, who would be required to, in effect, provide a rate subsidy to the Company's customers. Conversely, if actual fuel and energy costs are less than the amount included in base rates, the subsidy would flow the other way. As Mr. Fetter stated in his surrebuttal testimony, such subsidization is contrary to good regulatory policy and contrary to the purposes of a fuel adjustment mechanism.

Moreover, any mechanism that proposes a "sharing" in comparison to a base level must necessarily assume that the established base level is a valid starting point. In this case, the base that will be used is the level of fuel and energy costs estimated to be incurred at the time rates will go into effect. One of the main justifications for implementation of a FAC, however, is fuel and energy cost volatility. In other words, it is difficult to impossible to accurately predict an appropriate starting point. Providing a 50 percent subsidy above or below an estimated starting point, that is at best a guess, is problematic.

Q. Why did Mr. Johnstone select 50% as an appropriate "sharing" percentage?

A. I do not believe he indicated why that level was appropriate. It appears to be an arbitrary number, and implies that a utility can control half of the variations in its fuel and energy costs. By far the greatest factors causing fuel cost volatility are weather, market conditions, and operational issues outside a utility's control. It is nonsense for Mr. Johnstone to suggest that Aquila has the ability to control 50% of the variations in its fuel and energy costs.

Q. Although you indicate that most fuel cost volatility is outside the utility's control, Mr. Johnstone suggests that with a FAC the utility has no incentive to manage fuel costs. Do you agree?

A. No, I do not. Nor do I agree with Mr. Featherstone's contention that a FAC results in a utility losing its incentive to operate efficiently and negotiate contracts stringently. First, it should be noted that the rules adopted by this Commission to establish a framework for a FAC permit a utility to recover only its actual fuel and fuel related costs that are prudently incurred. The requirement that utilities that have FACs undergo periodic prudence reviews is a powerful incentive because costs that are determined to have been imprudently incurred will have to be refunded with interest. Other consumer protections included in the Missouri rules include:

- A utility can only initiate a FAC in a general rate proceeding where all relevant factors can be examined;
- A utility requesting a FAC mechanism has to file extensive reporting requirements in connection with its request;
- A utility using a FAC mechanism has to provide extensive monthly surveillance data for review to all parties;
- A utility with a FAC must submit to approximately annual true-up proceedings and prudence review where its decisions are subject to hindsight evaluation;
- The utility FAC must be based upon historical, not projected, fuel costs;
- The Missouri FAC rules limit adjustments to four times annually; and
- A utility utilizing a FAC must file a new rate case every 37 months.

Q. Given that a number of consumer protections are already in place, is there any other reason why a customer group might propose a fuel cost subsidization mechanism, like Mr. Johnstone's?

A. Yes. If the customer believes that fuel costs will increase over time, forcing the utility to absorb half of that increase will insure that the customer will pay less than the cost of fuel the utility is incurring to serve them. A mechanism that prevents the utility from recovering all of its fuel and energy costs means that customers will pay lower rates. Customers would be subsidized because Aquila's shareholders would be forced to bear a portion of the true cost of service. This is not a fair or reasonable approach to ratemaking.

Q. Does Mr. Johnstone believe that fuel and energy costs are increasing over time?

A. His testimony reflects that belief. On page 10 of his rebuttal testimony, Mr. Johnstone states. "The introduction of a tracking mechanism to recover fuel costs removes some or all of the fuel costs from the traditional approach. It will thereby increase the likelihood of the utility realizing improved and even excess earnings." In other words, Mr. Johnstone says a FAC will benefit a utility because prices are going up. It is understandable, therefore, why he would make a "sharing" proposal.

Q. Since the subsidies Mr. Johnstone recommends will result in Aquila being unable to recover its full cost of fuel and energy in a rising market, it seems important to verify the likelihood that fuel and energy prices will rise. Is there a scientific method to support whether the belief that fuel costs are on an upward path is true?

A. Yes. Statistical graphs such as a distribution curve can be used to show the frequency of price distributions. Aquila witness Trent Cozad has applied a distribution curve to the cost of gas. His testimony illustrates the effect of the curve on sharing risk.

Q. Do you agree with Mr. Johnstone that his proposed subsidies do not deny Aquila the opportunity to recover all its costs?

A. No. In a period of rising fuel and energy costs, Mr. Johnstone's proposal will result in Aquila recovering less than its prudently incurred costs.

Q. Do you have any other concerns with Mr. Johnstone's proposal?

A. Yes. Mr. Johnstone has proposed what he refers to as a "soft cap" on the recovery of fuel costs. Specifically, he proposes that fuel adjustment increases should be limited to no more than a 1.5% increase in a customer's bill every six months. Any under-recovered fuel costs would be deferred, accrue interest during the deferral periods, and be collected at some unspecified time in the future. Although it can easily be argued that a proposal of this type sends inappropriate price signals, Aquila does not object to some type of volatility mitigation cap. However, the cap must be balanced and reasonable, in light of recent market activity.

Q. Please explain.

A. The purpose of a volatility mitigation cap should not be to postpone recovery indefinitely or to some future period, but to smooth the impact of price changes that result from the FAC. If the soft cap is set too low, large deferrals could be created and customers could be forced to pay not only the deferred amount but also unnecessary interest costs. Any deferral existing at the end of the four-year FAC cycle would be rolled into base rates at the time of the mandatory four-year rate case filing. Recovery of an extremely large deferred balance could result in significant rate shock – the very thing the cap was supposed to prevent - and also could result in inter-generational inequities. In other words, new customers might end up paying for a large amount of the fuel costs used to serve former customers.

Q. Do you believe that Mr. Johnstone's soft cap is set too low?

A. Yes. The maximum annual increase that could be reflected, according to Mr. Johnstone's proposal would be approximately 3% of current rates. Based upon recent market trends, restricting annual increases to 3% would result in significant deferrals.

Q. Can you estimate the magnitude?

A. I can make a rough estimate. If fuel and energy costs increase 15% in a given year, for example, Mr. Johnstone's proposal would result in a deferral of millions of dollars as reflected in the below calculation:

Base Fuel and Energy Cost	$200,000,000
Percentage Increase	15%
Fuel and Energy Cost Increase	$ 30,000,000
Average Residential Rate per kWh	$ .076969
Annual Cap Percentage Limit	3%
Per kWh Limit	$ .00230907
Annual kWh sales	7,785,854,000
FAC Annual Cap	$ 17,978,082
Deferral at End of Year	$ 12,021,918

The deferral shown in the example above would accrue interest throughout the deferral period, so by the time it was recovered from customers the amount would be even greater. Therefore, if the Commission determines that a cap should be applied, a more reasonable level would be 1.5% for each quarterly accumulation period, and this cap should be applied to both increases and decreases in the FAC rate.

Q. Does Mr. Johnstone discuss how a deferral of this type should be amortized?

A. No. I assume it would be maintained in the deferred fuel recovery account and reflected in subsequent FAC collections to the extent the ongoing cap would allow. At some point the balance would have to be eliminated by increasing base rates through a potentially large rate adjustment.

Q. Mr. Johnstone indicates that Aquila's FAC should be limited to two years due to the proposed merger between Aquila and Great Plains Energy. Do you agree with his recommendation?

A. Not at all. The merger is not the subject of this proceeding and, in fact, we do not know with certainty that it will take place. The extent to which the proposed merger should impact on Aquila's FAC mechanism is a matter that can more easily and more appropriately be addressed in the Commission's review of that transaction. Restricting Aquila's FAC in this proceeding as a result of an event that has not taken place is inappropriate.

Q. Do you have any other comments in regard to Mr. Johnstone's testimony?

A. Yes. On page 9 of his rebuttal testimony, Mr. Johnstone supports the notion that a fuel tracking mechanism is unnecessary for Aquila because "all fuel costs are not highly volatile and inexorably increasing". Mr. Johnstone supports his contention by suggesting that Aquila witness Davis Rooney supports that same concept.

Q. How do you respond?

A. Mr. Rooney, in the testimony reproduced on page 8 of Mr. Johnstone's rebuttal, identifies nuclear fuel, coal, hydro, natural gas, and fuel oil as fuels that have a material impact on power market prices. Mr. Rooney indicated that compared to other fuels, natural gas is the least stable, but that coal prices have recently become more volatile and are increasing. Thus, only nuclear and hydro energy sources are relatively stable in cost. Mr. Johnstone may not be aware that Aquila has no nuclear or hydro generating facilities. Thus, his conclusion that a tracking mechanism is unnecessary because these costs are not volatile or increasing is unfounded.

Q. Do you wish to comment on Mr. Johnstone's concern regarding prudence reviews?

A. Yes. Mr. Johnstone's concern may be strictly limited to the possibility that customers have paid currently for fuel or energy procurement decisions that are later determined by the Commission to be imprudent. If so, that situation is easily remedied through appropriate refunds or reductions in future fuel adjustment charges – a similar approach to how imprudent actions are adjusted out of a test year to reflect lower going forward rates under "traditional regulation".

Q. What if Mr. Johnstone's concern is that FAC prudence reviews are ineffective?

A. If that is the case, I believe his concern is ill-founded for a number of reasons. First, as I noted previously, current ratemaking is based on estimates of future costs. If a FAC is adopted, more facts will be known and the impact of identified imprudence can be identified and quantified with more certainty. Eliminating as much guesswork as possible is a superior approach.

Second, it has been my experience that prudence reviews that concentrate on fuel procurement costs and practices are much more diligent and focused than the broader reviews that parties are able to pursue in the context of a more traditional rate case.

Third, Mr. Johnstone is concerned that, "the benefits of the prudence review are diminished as compared to traditional regulation, because the prudence review in the context of the FAC is after the fact". However, I would point out that all prudence reviews, even those performed in conjunction with what Mr. Johnstone calls "traditional regulation" are after the fact. In Missouri, rates are established looking forward but utilizing a historical test year. Use of a historical test year necessarily requires an assessment of a utility's actions after the fact.

Q. Mr. Johnstone complains that Aquila was unable to provide analyses of the historical impact of the proposed fuel adjustment clause on customer rates. Is that correct?

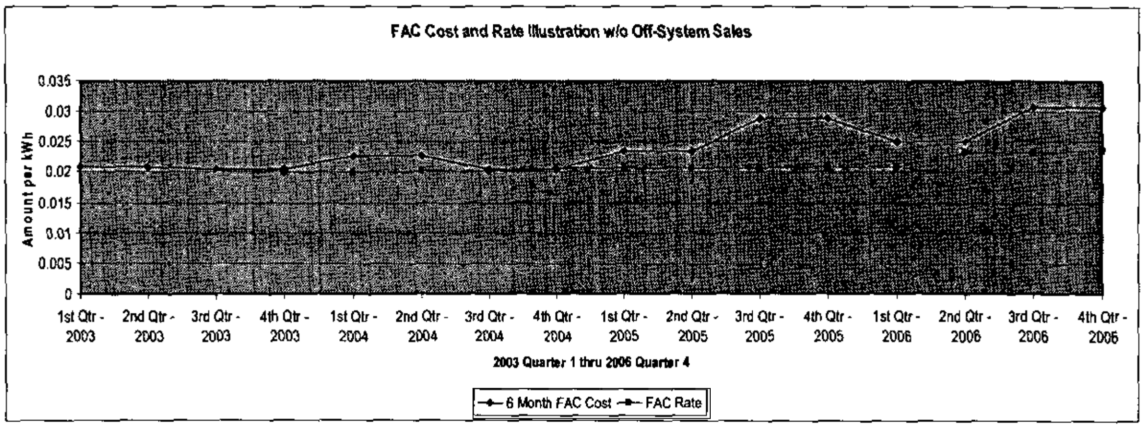
A. Aquila responded to Mr. Johnstone's inquiry by noting that it was impossible to assess the impact of the FAC mechanism without having knowledge of what level of fuel was in base rates. The last two Aquila rate cases in Missouri resulted in "blackbox" settlements and therefore it is impossible to know with certainty the level of base fuel costs that are in rates that resulted from those cases. It is impossible to ascertain the dollar impact of an adjustment above or below a base, without knowing at what level that base was set. That is one important reason that the Commission determined that a rate case was required prior to FAC implementation. As a courtesy, however, Aquila provided Mr. Johnstone a summary of the historical wholesale FAC impact for the period requested. This was the best information available for Mr. Johnstone's purposes, and he has utilized that information in the preparation of a number of graphs in his rebuttal testimony.

Q. Do you have any comments in regard to Mr. Johnstone's graphical presentations?

A. Yes. Mr. Johnstone's graphs are primarily utilized to convey the level of volatility in relation to Aquila's proposed recovery mechanism versus his own. Three primary causes contribute to these volatility differences. First, Mr. Johnstone proposes to pass on only 50% of any costs over or under the cost of fuel in base rates. Obviously, recognizing only half of an adjustment mitigates the size of that adjustment by half. Secondly, there is a substantial variation because of Mr. Johnstone's proposal for an annual Recovery Period versus Aquila's original quarterly Recovery Period. As I previously indicated, Aquila has modified its proposal to adopt an annual Recovery Period so that difference no longer exists. The remaining difference in volatility is less significant and is due to Aquila's use of a quarterly accumulation period, while Mr. Johnstone utilizes a six-month accumulation period.

Q. Please comment on Mr. Johnstone's Chart 5 included on page 29 of his rebuttal testimony.

A. Chart 5 is a graphical illustration of the impact of Mr. Johnstone's proposed FAC mechanism on Aquila's recovery of prudently incurred fuel and energy costs. The graph takes into consideration Mr. Johnstone's recommended six-month Accumulation Periods, twelve-month Recovery Periods and 50% "sharing" proposal. The graph is reproduced below. It is very telling of the impact and intent of Mr. Johnstone's proposed fuel adjustment mechanism.



Q. What do you conclude from the above graph.

A. It is noteworthy that according to Mr. Johnstone's own depiction of the impact of his proposal on historical information that Aquila never recovers the full cost of its fuel and energy cost incurred, even though Mr. Johnstone has assumed that all of these costs were prudently incurred. If Aquila is prohibited from recovering all of its prudently incurred fuel and energy costs, it will not have a reasonable opportunity to earn its authorized rate of return.

INTERIM ENERGY CHARGE

Q. Staff witness Featherstone discusses in his rebuttal testimony the concept of an interim energy charge ("IEC") in lieu of the FAC Aquila has proposed. What is your reaction to an IEC?

A. I addressed this topic in my direct testimony and pointed out that the IEC has previously been utilized by Aquila but was not successful. The IEC has certain advantages over the way fuel and energy costs have generally been treated in Missouri for the past 28 years. An IEC recognizes that the establishment of base fuel costs in rates includes conjecture and is not precise. For example, establishing the base cost of gas requires consideration of a number of complex issues identified by Mr. Featherstone including: weather normalized system load requirements, annualized system load requirements, fuel and freight prices, energy prices, normalized generation levels, normalized maintenance outage schedules for each production facility, normal purchased power levels, normal heat rates for production facilities, and abnormal events. The IEC sets a band range around the base cost of fuel. Mr. Featherstone points to the advantage of an IEC by stating, "Within the band range, both Aquila and customers are protected as to increases and decreases to fuel and energy costs."

Q. Does the IEC suffer from any shortcomings?

A. There is one great shortcoming of the IEC that makes it unacceptable. The IEC recovers fuel costs only within a limited range of costs incurred, and if costs go above that range, the utility is denied the opportunity to recover its prudently incurred fuel and energy costs. An illustration of this can be found in the Report and Order the Commission issued in the recent rate case of The Empire District Electric Company, Case No. ER-2006-0315. In that order the Commission noted that during a period of less than two years when an IEC was in effect, Empire under-recovered its prudently-incurred fuel and purchased power costs by almost

$27 million. In addition, if costs fall below a pre-established level, the customer is required to pay more than the cost of fuel and energy actually incurred. Volatility of fuel and power markets and substantial price increases that have occurred in recent years create an intolerable risk that is viewed negatively by credit analysts.

Q. Can you provide an example of how this risk is created?

A. Yes. Staff's IEC recommendation carries a band range of approximately $6 to $9. That is, on a stand-alone basis if natural gas and related purchase power prices actually incurred fall within a range of $6 to $9, the Company will recover its fuel and energy costs. If prices over the period are under $6, the Company will over-recover its actual costs and if they are over $9, the Company will under-recover its actual costs. In discussing price risk, Aquila witness Cozad provided a gas cost price distribution risk curve. Modifying this bell curve diagram, as I have done on Schedule DRW-2 to highlight the Staff's recommended IEC range, shows that natural gas prices are statistically expected to fall within the $6 to $9 band range only 42% of the time.

Q. Mr. Featherstone identified a list of issues that he characterized as inherent to the ratemaking process. He also stated that Aquila's FAC proposal does not contemplate these factors and ignores the normalization and annualization process of a rate case. Do you agree?

A. Not at all. As required by Commission rules, Aquila filed a rate request prior to its proposed implementation of a FAC, and all elements of the Company's cost of service, including fuel and energy costs, are reflected in that filing and will be considered in the establishment of base rates in this case. The FAC will be implemented at the same time as base rates. The FAC will operate as a tracking mechanism of actual fuel and energy costs incurred compared to fuel and energy costs that are included in base rates. Since the FAC utilizes actual costs, no further normalization, annualization or other estimation techniques are required.

FAC SUMMARY

Q. Please summarize your position in regard to the various fuel recovery mechanism proposals.

A. Proposals from the various parties seem intent on undoing the purpose for which fuel cost recovery legislation was intended. First, parties have proposed to eliminate a number of costs that other jurisdictions and accounting authorities, particularly the FERC, define as fuel or energy costs. Parties also have tried to reduce the likelihood of full recovery of fuel and energy costs by proposing non-balanced "performance standards" that, if implemented, penalize but never reward, the utility. In some proposals, a cap is set that limits recovery to a specified percentage. However, these proposals may end up increasing rate hikes that they were designed to mitigate. And, finally, there are proposals that would allow Aquila to recover only a fraction of its actual, prudently-incurred fuel and energy costs.

The utility is entitled to recover the full cost of the fuel and energy related cost it prudently incurs to provide service to its customers. Only the Company's proposal ultimately achieves this objective.

DSM COST RECOVERY

Q. OPC witness Ryan Kind indicates that the Public Counsel is not in agreement on all DSM funding points but supports the DSM cost recovery proposal made by Staff witness Lena Mantle. Have you reviewed Ms. Mantle's DSM cost recovery proposal?

A. Yes. Aquila also supports the Staff proposal.

MANAGEMENT COMPENSATION ADJUSTMENT

Q. Please describe the Public Counsel's proposed adjustment to management compensation.

A. Mr. Robertson has proposed a reduction of $132,704 and $34,840 in Missouri jurisdictional operating expenses for MPS and L&P, respectively to reflect the OPC contention that Aquila executive management payroll costs are too high.

Q. How do you respond?

A. When Aquila filed its updated case, management compensation expense was reduced in the amounts of $158,132 and $41,516 for MPS and L&P, respectively. Mr. Robertson's proposed adjustment is duplicative and unnecessary.

Q. Does this conclude your prefiled surrebuttal testimony?

A. Yes.

FUEL ADJUSTMENT CLAUSE
ELECTRIC

DEFINITIONS

ACCUMULATION PERIOD:

The four three-month accumulation periods, the four twelve-month recovery periods and filing dates will be as follows:

Accumulation Period	**Filing Date**	**Recovery Period**
December – February	By April 1	June – May
March – May	By July 1	September – August
June – August	By October 1	December – November
September – November	By January 1	March – February

RECOVERY PERIOD:

The billing months during which the Cost Adjustment Factor (CAF) is applied to retail customer billings on a per kilowatt-hour (kWh) basis.

COSTS:

Costs eligible for Fuel Adjustment Clause (FAC) will be the Company's allocated Missouri Jurisdictional costs for fuel consumed in Company generating units, purchased power charges and emission allowance costs. Eligible costs do not include the purchased power demand costs associated with purchased power contracts with a term in excess of one (1) year.

APPLICATION

The price per kWh of electricity sold will be adjusted subject to application of the FAC mechanism and approval by the Missouri Public Service Commission. The price will reflect accumulation period Missouri Jurisdictional costs above or below base costs specified on Sheet No. 126 for:

1. fuel consumed in Company electric generating plants, plus
2. purchased power (excluding demand contracts, the term of which exceed one (1) year), and all hedge costs, settlement costs and benefits, plus
3. emission allowance costs, plus or minus
4. an adjustment for recovery period sales variation. This is based on the difference between the values of the FAC as adjusted minus actual FAC revenue during the recovery period. This amount will be collected during a succeeding recovery period.
5. Interest on deferred electric energy costs shall be determined monthly. Interest shall be calculated at a rate equal to the weighted average interest rate paid on short-term debt, applied to the month-end balance of deferred electric energy costs. The accumulated interest shall be included in the determination of the CAF.

FUEL ADJUSTMENT CLAUSE (CONTINUED)
ELECTRIC

The FAC will be the sum of (1), (2), (3), (4) and (5), above. The Cost Adjustment Factor is the result of dividing the FAC by estimated kWh sales during the recovery period, rounded to the nearest $.0000, adjusting for voltage level losses, and accumulating over four quarters. The formula and components are displayed below.

$$FAC = F + P + E + X - B + C + I$$

The Cost Adjustment Factor (CAF) is as follows:

$$CAF = \Sigma_{Q=1\text{ to }4}\,(FAC / S_R) * L_{VL}$$

Where:

- F = Actual cost of fuel – FERC Accounts 501 & 547
- P = Actual cost of purchased energy – FERC Account 555
- E = Actual emission allowance cost – FERC Account 509
- X = Base off system sales margins – accumulation period off system sales margins
- B = Base cost of fuel and purchased power energy = S_A x $0.0215 for Aquila Networks – L&P, or S_A x $0.0287 for Aquila Networks – MPS
- C = Under / Over recovery from prior recovery period, and modifications due to annual prudence reviews
- S_A = Actual sales (kWh) for the accumulation period
  - S_{ASec} = Lower than Primary Voltage Rates
  - S_{APrim} = Primary and Higher Voltage Rates
- S_R = Estimated sales (kWh) for the recovery period
  - S_{RSec} = Lower than Primary Voltage Rates
  - S_{RPrim} = Primary and Higher Voltage Rates
- I = Interest
- L_{VL} = Loss factor by voltage level
- Q = Previous sequential three-month periods

The FAC will be calculated separately for Aquila Networks – L&P and Aquila Networks – MPS and by voltage level, and the resultant CAF's will be applied to customers in the respective divisions and voltage levels.

APPLICABLE BASE COST

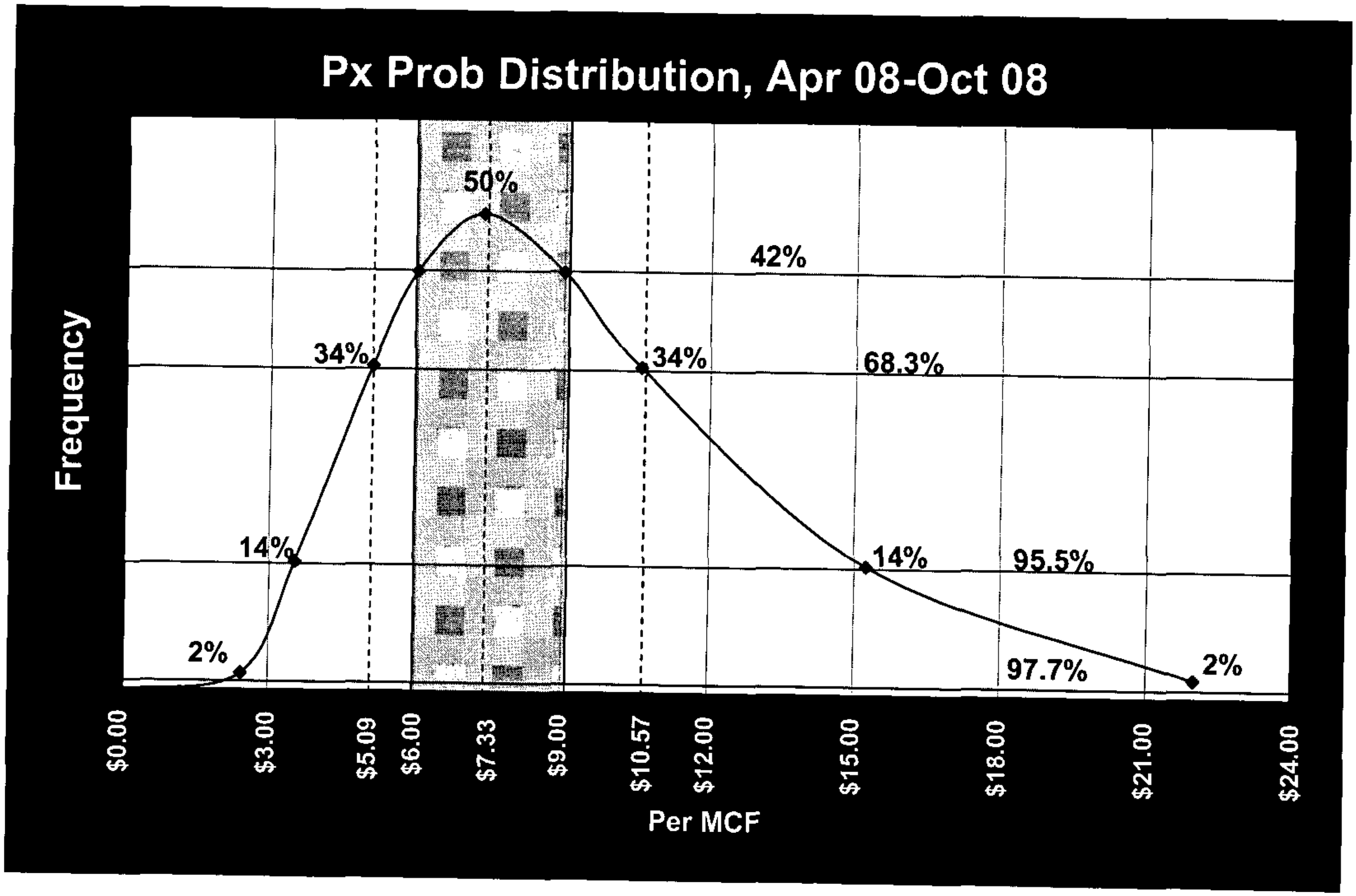
Company generated energy and purchased energy per kWh sold, $0.0215 for Aquila Networks – L&P, and $0.0287 for Aquila Networks – MPS. (Or the amounts approved in the rate case.)

FUEL ADJUSTMENT CLAUSE (CONTINUED)
ELECTRIC

COST ADJUSTMENT FACTOR

Aquila Networks – L&P		Total		Secondary		Primary
Accumulation Period Ending		mm/dd/yy				
1. Total energy cost (F, P, E and X)		$xxx,xxx,xxx				
2. Base energy cost (B)	-	$xxx,xxx,xxx		$xxx,xxx,xxx		$xxx,xxx,xxx
2.1 Loss factors			*	1.00114	*	0.98330
2.2 B adjusted for losses				$xxx,xxx,xxx		$xxx,xxx,xxx
2.3 Loss factor weights				xx.xxx%		xx.xxx%
3. Fuel Adjustment Clause		$xxx,xxx,xxx		$xxx,xxx,xxx		$xxx,xxx,xxx
4. Adjustment for Under / Over recovery for prior periods				$xxx,xxx,xxx		$xxx,xxx,xxx
5. Estimated recovery period sales kWh				x,xxx,xxx,xxx		x,xxx,xxx,xxx
6. Current quarter cost adjustment factor				$x.xxxx		$x.xxxx
7. Previous quarter cost adjustment factor				$x.xxxx		$x.xxxx
8. Previous quarter cost adjustment factor				$x.xxxx		$x.xxxx
9. Previous quarter cost adjustment factor				$x.xxxx		$x.xxxx
10. Current annual cost adjustment factor				$x.xxxx		$x.xxxx

Aquila Networks – MPS		Total		Secondary		Primary
Accumulation Period Ending		mm/dd/yy				
1. Total energy cost (F, P, E and X)		$xxx,xxx,xxx				
2. Base energy cost (B)	-	$xxx,xxx,xxx		$xxx,xxx,xxx		$xxx,xxx,xxx
2.1 Loss factors			*	1.00402	*	0.97679
2.2 B adjusted for losses				$xxx,xxx,xxx		$xxx,xxx,xxx
2.3 Loss factor weights				xx.xxx%		xx.xxx%
3. Fuel Adjustment Clause		$xxx,xxx,xxx		$xxx,xxx,xxx		$xxx,xxx,xxx
4. Adjustment for Under / Over recovery for prior periods				$xxx,xxx,xxx		$xxx,xxx,xxx
5. Estimated recovery period sales kWh				x,xxx,xxx,xxx		x,xxx,xxx,xxx
6. Current quarter cost adjustment factor				$x.xxxx		$x.xxxx
7. Previous quarter cost adjustment factor				$x.xxxx		$x.xxxx
8. Previous quarter cost adjustment factor				$x.xxxx		$x.xxxx
9. Previous quarter cost adjustment factor				$x.xxxx		$x.xxxx
10. Current annual cost adjustment factor				$x.xxxx		$x.xxxx



Schedule DRW-2

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-2007-0004

County of Jackson)
) ss
State of Missouri)

AFFIDAVIT OF DENNIS R. WILLIAMS

Dennis R. Williams, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of Dennis R. Williams;" 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.

Dennis R. Williams

Dennis R. Williams

Subscribed and sworn to before me this 20th day of March, 2007.

Terry D. Lutes

Notary Public
Terry D. Lutes

My Commission expires:

8-20-2008

Notary Public Notary Seal State of Missouri

TERRY D. LUTES
Jackson County
My Commission Expires
August 20, 2008