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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

GRAHAM A. VESELY

AQUILA, INC. d/b/a AQUILA NETWORKS-MPS (Electric)

CASE NO. ER-2004-0034

Jefferson City, Missouri
February 2004

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila Networks-L&P and Aquila Networks-MPS to implement a general rate increase in electricity.	))))	Case No. ER-2004-0034

AFFIDAVIT OF GRAHAM A. VESELY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Graham A. Vesely, of lawful age, on his oath states: that he has participated in the preparation of the following surrebuttal testimony as modified on February 27, 2004, in question and answer form, consisting of 8 pages to be presented in the above case; that the answers in the following surrebuttal testimony as modified on February 27, 2004, were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Graham A. Vesely

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

D SUZIE MANKIN
Notary Public - Notary Seal
STATE OF MISSOURI
COLE COUNTY
MY COMMISSION EXP. JUNE 21,2004

D Suzie Mankin

TABLE OF CONTENTS OF

SURREBUTTAL TESTIMONY OF

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AQUILA, INC. d/b/a AQUILA NETWORKS-MPS (Electric)

CASE NO. ER-2004-0034

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GRAHAM A. VESELY

AQUILA, INC., d/b/a AQUILA NETWORKS-MPS (Electric)

CASE NO. ER-2004-0034

Q. Please state your name and business address.

A. Graham A. Vesely, Noland Plaza Office Building, 3675 Noland Road, Suite 110, Independence, MO 64055.

Q. Are you the same Graham A. Vesely who has previously filed direct and rebuttal testimony in this case?

A. Yes, I am. On December 9, 2003, I filed direct testimony and on January 22, 2004 I filed rebuttal testimony on the topic of fuel prices.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Aquila (Aquila or Company) witnesses John C. Browning, Jerry G. Boehm, Joseph M. O'Donnell, and James W. Okenfuss, related to fuel prices.

Jerry G. Boehm Testimony

Q. On page 2 of his testimony, Mr. Boehm states that he disagrees with the coal prices you provided for use in the Staff's fuel model. How do you respond?

A. The coal and freight prices I provided are the ones the Company stated were in effect at the end of the update period for this case. To the results of the Staff's fuel model I added the fixed costs related to the handling of coal, in accordance with Aquila's response to

Staff data requests. I provided the Company a copy of all my work papers at the time of my direct filing.

Q. Did Aquila use coal prices based on the September 30, 2003 update period for this case?

A. No. In my rebuttal filing, I took issue with Aquila's recommendation to use coal contract increases that go into effect in 2004, well past the update period ordered by the Commission. Apparently, Mr. Boehm is continuing to press this position, a fact that could explain in large part why Aquila's resulting coal costs are higher than those of the Staff.

Q. On page 3 of his rebuttal, Mr. Boehm states that a flaw in the way you selected the Staff's natural gas price was in "assuming that historical costs (cost-based) are no different than the market's prices (price-based)". Please respond.

A. It is difficult to say exactly what point Mr. Boehm is trying to make here. He goes on to state "Cost-based analysis identifies the results of production. It can be useful for reviewing the historical operation of the plant, but it does not reflect the input to the actual operations and so it should not be used to represent the input to the production [fuel] model". The natural gas prices that I reviewed in preparing Staff's recommendation in this case were prices <u>actually</u> paid by the Company for natural gas used in its <u>actual</u> generation operations. I can only assume Mr. Boehm is re-stating the view that certain past (historical) prices, specifically the lower past prices paid during the test year, should not be used in this rate case. Mr. Boehm's reference to "costs," then, serves only to cloud the issue.

Q. What is the Staff's view on this matter?

A. In order to determine the normal amount of fuel expense to include in this case, it is necessary to make a decision, among other things, about what each unit of natural gas will cost. Neither the Staff, nor Aquila knows for sure what the price of natural gas will be in the future; therefore both have been required to make an estimate. The Staff has reviewed the history of natural gas prices and attempted to estimate the normal cost of natural gas to Aquila based on market prices actually paid by the Company. Aquila has made different assumptions and arrived at a different result, but its position is nonetheless also simply an estimate of what it will have to pay for each unit of natural gas.

Q. Mr. Boehm further states, beginning on line 1, page 4 of his rebuttal testimony, that the Staff's use of a yearly average price, instead of a separate price for each month of the year, "...appears to ignore the month-to-month fluctuation of ...prices...[and] oversimplifies the fuel input costs in the model". How do you respond?

A. The Staff's approach averages all of the actual prices paid for natural gas for generation during the test year and update period. No months were excluded, and every month was given weight according to how much natural gas Aquila actually bought at that price. The Staff does not believe this approach makes any material impact compared to using a different price in the fuel model for each month of the year, nor has the Company presented any evidence to the contrary.

James W. Okenfuss Testimony

Q. On page 3 of his rebuttal testimony, Mr. Okenfuss disagrees with you sponsoring in the Staff's fuel model a natural gas price that is the same for each of the 8,760 hours of the year. How do you respond?

A. The Company inputs monthly, not hourly, gas prices into its own fuel model so the reason he raises this concern is not clear. Given the volatility of gas prices, the Staff questions both the feasibility of trying to precisely predict monthly prices, let alone hourly prices, and the reliability of the results. The mere act of inputting twelve different gas prices to the fuel model should not be assumed to yield better results. I believe that the real difficulty Mr. Okenfuss has with the Staff's natural gas prices I am sponsoring is that they are lower than those recommended by Aquila.

Joseph M. O'Donnell Testimony

Q. What is your understanding of Aquila witness Joseph M. O'Donnell's rebuttal to your direct testimony?

A. Though he cites many factors in support of his opinion, it appears that his view overall is summarized on page 2 of his rebuttal testimony, where he states that " [natural gas] Costs from 2002 are not representative of what Aquila has paid in 2003 or what it expects to pay in the future." As a result of this, Mr. O'Donnell concludes at the end of his testimony that Aquila' s originally filed price of $5.14 should be preserved.

Q. How do you respond to these points?

A. The disputed issue, of course, is not about 2002 costs being different from 2003 costs. Instead, it is about deciding which natural gas prices represent the normal level that should be used for setting rates in this case. The Staff's overall view is that, given the volatility of natural gas prices in recent years, it is very risky to try to settle on any one single price, be it for a year or for a month, as being normal for purposes of this case.

Q. In spite of distancing himself from 2002 prices, does Mr. O'Donnell agree, in effect, that a review of pre-2003 natural gas prices is nonetheless relevant for understanding the current situation?

A. It would appear so, since on page 5 of his rebuttal testimony he uses the great jump in prices from the year 1999 to 2000 to start making his case for the limited responsiveness of natural gas supply. The Staff also sees the year 2000 as the beginning of the period of very volatile natural gas prices that we are still experiencing. The Staff finds it noteworthy that during this period the price of natural gas, after rising sharply through early 2001, then began a long decline and actually dropped 25% in 2002 before rising steeply again in 2003. It is because of this market's demonstrated ability to both rise and fall significantly, that the Staff decided to average the lower prices of 2002 in with the higher prices of 2003.

Q. Does Mr. O'Donnell base his support for using 2003 prices and not using 2002 prices, on a forecast of future natural gas prices?

A. Yes. He presents a view of the current state of the U.S. natural gas market and cites numerous sources on how the outlook for prices is influenced by the various factors affecting supply and demand.

Q. Can you provide an example of gas prices turning out to be significantly different than forecasted?

A. Yes. On page 2 of its January 2001 Short-Term Energy Outlook (Outlook), the U.S. Department of Energy's Energy Information Administration (EIA) forecasted 2001 average natural gas wellhead prices of $5.20 per thousand cubic feet (MCF). Later, in Table 4. U.S. Energy Prices: Base Case contained in its December 2002 Outlook, EIA published information indicating that the actual average wellhead price for 2001 turned out to be $4.13 per MCF. This is a good example of a forecast that underestimated by a full $1 per MCF a major decline in prices in this volatile natural gas market.

Q. Could actual natural gas prices for a future year turn out again to be significantly lower than forecasted?

A. Yes, I don't see how that can be ruled out. The Staff believes that in a volatile market, forecasting is necessarily more difficult.

Q. What would be the result, in the absence of some flexible pricing mechanism, of natural gas prices over a one-year period averaging $1 per MCF less than the price incorporated in electric rates?

A. If all other elements that contribute to earnings stayed the same, and based on the natural gas quantities (10,420,168 MCFs) currently estimated by Staff witness David Elliott's joint dispatch fuel model run, Aquila could potentially over-collect from its customers by more than $10 Million in a year.

Q. Is there some way to lessen the concern of this happening?

A. Yes. The flexible fuel and purchased power pricing mechanism, as described in Staff witness James R. Watkins' surrebuttal testimony, would mitigate this concern, and would also reduce Aquila's risk of not collecting sufficient funds to cover its prudent costs. The Staff recommends that the Commission adopt this pricing mechanism as the best solution in this difficult natural gas environment.

Q. Do you have any final comments on Mr. O'Donnell's testimony?

A. Yes. Staff witness Kwang Y. Choe explains in his surrebuttal testimony the reasons for the Staff's opposition to using natural gas futures prices in setting rates for this case. The Staff concurs with Company witness John C. Browning's statement on page 7 of his direct testimony in this case that "...futures are not good indicators of actual future prices."

John C. Browning Testimony

Q. Please summarize your understanding of Mr. Browning's rebuttal to your direct testimony.

A. On page 2 of his rebuttal testimony, Mr. Browning makes clear that he intends to press the point that, with regard to natural gas for generation, "Costs from 2002 are not representative of what we have paid in 2003 or what we will expect to pay in the future." He then cites various sources as support for his contention that the low prices of 2002 were due to circumstances applicable only to that time period, and why the high prices of 2003 can be traced to a new set of conditions that threatens to persist into the future.

Q. What type of evidence does Mr. Browning provide to support his recommended natural gas price?

A. In his rebuttal testimony, Mr. Browning provides excerpts of many articles and other information releases published throughout 2003. The sources of this information vary in nature and degree of technical orientation, from newspapers, to governmental agencies, to energy industry specialists.

Q. Do these sources attempt both to explain the high natural gas prices of 2003 and, in some cases, to make predictions for the price in the future?

A. Yes. To the extent that the sources Mr. Browning cites make forecasts regarding the future of natural gas prices, the Staff's position is the same as that expressed above in response to Mr. O'Donnell. Though forecasters attempt to consider all known factors that affect supply and demand in the natural gas market, the results cannot always be counted on to be accurate. Earlier in my testimony, I provided a recent example of results that differed substantially from the forecast.

Q. On page 8 of his rebuttal testimony, Mr. Browning states "The use of Mr. Vesely's cost of gas will guarantee gross under-recovery of the Company's actual costs going forward". Do you agree with this?

A. No, because no one knows what Aquila will actually pay for natural gas when it comes time to make actual purchases in the future. For 2004, Aquila has indicated only having purchased in advanced 30% of its estimated natural gas needs for March ($4.977) and April ($4.694).

Q. Please summarize your surrebuttal testimony.

A. The Staff recommends the Commission continue the practice of setting rates by matching, on a single specified date, the known and measurable historical elements of revenue, expense, rate base, and capital structure. The Staff acknowledges, though, the impossibility in this volatile natural gas market, of determining one price that can reliably be termed "normal" for this rate case, and that does not bring with it the risk of being, in hindsight, significantly too high or too low. The Staff has attempted to reflect both the ups and downs of prices, as well as the general up-trend of recent years, a point at least partially acknowledged by Aquila witness Keith G. Stamm on pages 1 and 2 of his rebuttal testimony. However, the Staff believes that in the existing natural gas market no single price, regardless of how it is arrived at, provides the opportunity for equitable results offered by the flexible pricing mechanism described in Staff witness James R. Watkins' testimony.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.