Exhibit No.:
Issues: Rate Design for Fuel Adjustment Clause
Witness: Donald Johnstone
Type of Exhibit: Direct Testimony
Sponsoring Party: Sedalia Industrial Energy Users' Association and Ag Processing Inc a Cooperative [with St. Joseph Industrial Group]
Case Number: ER-2007-0004
Date Testimony Prepared: January 25, 2007

Aquila Networks-MPS and Aquila Networks-L&P

Case No. ER-2007-0004

FILED
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Missouri Public Service Commission

Prepared Direct Testimony of

Donald Johnstone

On behalf of

Sedalia Industrial Energy Users' Association
and
Ag Processing Inc a Cooperative
[with St. Joseph Industrial Group]

January 2007

Exhibit No. 504
Case No(s). ER-2007-0004
Date 4/10/07 Rptr MU

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 service areas	)	Case No. ER-2007-0004

Affidavit of Donald Johnstone

State of Missouri)
) ss
County of Camden)

Donald Johnstone, of lawful age, on his oath states: that he has reviewed the attached written testimony in question and answer form, all to be presented in the above case, that the answers in the attached written testimony were given by him; that he has knowledge of the matters set forth in such answers; that such matters are true to the best of his knowledge, information and belief.

Donald Johnstone

Donald Johnstone

Subscribed and sworn before me this 15 th day of January, 2007

Carolyn Neporadny

Notary Public

CAROLYN NEPORADNY
Notary Public - Notary Seal
STATE OF MISSOURI
Commissioned for Camden County
My Commission Expires: August 30, 2009
Commission Number 05452654

My Commission expires:__________

Before the
Missouri Public Service Commission

Aquila Networks-MPS and Aquila Networks-L&P

Case No. ER-2007-0004

Prepared Direct Testimony of Donald Johnstone

Q **PLEASE STATE YOUR NAME AND ADDRESS.**

A My name is Donald Johnstone and my address is 384 Black Hawk Drive, Lake Ozark, Missouri, 65049.

Q **ARE YOU THE SAME DONALD JOHNSTONE THAT PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?**

A Yes, I am. My qualifications and experience are set forth in Appendix A to my testimony that was filed on January 18, 2007.

Q **CAN YOU PROVIDE A SUMMARY OF YOUR TESTIMONY?**

A My clients are opposed to the implementation of a FAC. Nevertheless, they are mindful of the possibility that the Commission, after due consideration of the record, may approve a FAC in some form and have therefore asked me to comment. First, Aquila must comply with the recently enacted rules, the extent of the need, if any, must be proven, and the impacts of any proposal must be illustrated for all to see. That said,

- **THE KEY GOAL IS THE ALIGNMENT OF INTERESTS**
    - Partial base rate treatment of FAC costs should be retained
    - Share costs and benefits - 50 / 50
    - Relatively lower costs should be better for Aquila and customers
    - "Skin in the Game" leads to
    - Alignment of Interests
    - Incentive by Design
- **CONSUMER PROTECTIONS ARE NECESSARY**
    - Sharing 50/50 between base and FAC rates retains incentive
    - The FAC should not provide replacement power cost insurance
    - A fixed generation mix should be considered
    - Performance standards can also minimize FAC increases unrelated to fuel prices
    - Prudence reviews alone are of limited value as a protection if the design does not otherwise align interests
- **MITIGATION OF RATE VOLATILITY**
    - Sharing 50/50 mutes rate impact by 50%
    - Extend collection periods to soften impact and add some predictability
    - Continued hedging program may be beneficial

Q **WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

A I have been engaged to address the appropriate design and structure of a Fuel Adjustment Clause ("FAC"), the specific FAC proposal of Aquila, and any alternatives or modifications thereto which may arise. All of this is within the context of the Commission's new fuel adjustment rules. The rules address the possibility of a Rate Adjustment Mechanism ("RAM"), which may take the form of either an IEC or a FAC. Although Aquila has put forward a specific proposal, this being the intervener opportunity for direct testimony, I will in due course respond more directly to the Aquila proposal in the rebuttal round of testimony. At this point my references to the Aquila proposal are only in the context of the broader discussion of the appropriate characteristics of a FAC, and as points of reference in that discussion rather than as a rebuttal to Aquila's FAC.

Q **IN ORDER TO PROVIDE CONTEXT FOR YOUR COMMENTS, PLEASE DESCRIBE THE AQUILA FAC PROPOSAL.**

A Aquila proposes a new rate schedule that is captioned "FUEL ADJUSTMENT CLAUSE ELECTRIC" The proposed rate generally provides for the collection of the Missouri jurisdictional share (the native load share) of Aquila's actual "fuel consumed in Company generating units, purchased power charges and emission allowance costs." The FAC rate is proposed to be adjusted quarterly. Among other things the proposed rate schedule also provides for recovery of all hedge costs, settlement costs and benefits, emission allowance costs, interest on the deferred amounts, and a 50/50 sharing of the margin on off-system sales. The rate schedule further provides for the costs incurred in each three-month "accumulation period" to be collected in a subsequent three-month "recovery period". The effect is a six month lag in the collection. 100% of the variations in the tracked costs would flow through to ratepayers. Finally, the rate schedule provides for additional collections or refunds, as the case may be, pursuant to any under or over collections and pursuant to annual prudence reviews.

Q **DO YOU SUPPORT ADOPTION OF A FAC?**

A No. My clients are opposed to the implementation of a FAC. Nevertheless, they are mindful of the possibility that the Commission, after due consideration of the record, may approve a FAC in some modified form. My purpose in this testimony is to identify the policies and procedures that would make a FAC, if one is to be approved, greatly superior to the proposal of Aquila. A complete rebuttal to the Aquila proposal will come in due course.

Q **ARE THERE ASPECTS OF SB 179 AND THE RULE ON WHICH YOU WOULD LIKE TO COMMENT?**

A Yes. From my understanding as a non-lawyer, SB 179, among other things, constitutes the enabling legislation for two forms of an electric RAM, either an IEC or a FAC. Electric utilities may apply for one or the other, an IEC or a FAC, and the Commission is given the discretion to approve, modify or reject the application. I see neither a "right" to a RAM for a utility, nor any indication that a RAM is to be given preference to any other rate mechanism available to the Commission, including but not limited to base rates.

Q WHY WOULD A UTILITY SUCH AS AQUILA WANT A FAC?

A A FAC is primarily intended to provide more timely recovery of some or all of the changes in fuel costs. If fuel prices are spiraling up, the combination of the price increase and the lag typically associated with changes in base rates can contribute to a decrease in utility earnings. If on the other hand, fuel costs are going both up and down due to volatility in fuel prices, the variations in fuel costs under various circumstances can contribute to periods of either over earnings or under earnings for the utility. Earnings stability is preferred. Thus, a fuel rider is a device that is primarily for benefit of Aquila in maintaining higher and/or more stable earnings. In the situation of decreasing prices it can also protect ratepayers if the base rates would have otherwise remained higher than would be consistent with the return appropriate for a regulated business. Of course, for an investor owned utility, the opportunity to earn a fair return is a part of the regulatory paradigm.

Q WHAT ARE THE INTERESTS OF CUSTOMERS IF A FUEL ADJUSTMENT MECHANISM IS TO BE CONSIDERED?

A As a general rule customers value low and stable prices[1]. A fuel rider typically moves in the opposite direction, it will not foster low and stable prices. Hence, a tension is created between the interests of ratepayers in low and

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[1] Customers certainly also have other important interests including but not limited to a supply of electricity that is in all respects adequate and reliable.

stable rates and the interests of the utility in stable earnings at or near the approved level. The source of the tension is highlighted by Aquila Vice President Dennis Williams. He states: "**Fuel costs**, particularly the cost of gas used for generation - but also coal and other fuels - **are extremely volatile and, in whole, during recent years have been increasing dramatically.**"[2][emphasis supplied] In this case Aquila simply proposes to pass through the **dramatic increases** and the **extreme volatility** it experiences in its fuel costs. Obviously, its hedging activities have not solved the problem from its perspective so Aquila would simply have the Commission approve its proposal to pass its "dramatic" and "extreme" fuel price experiences to consumers, unmitigated and without limitation. In fact, the proposal is even more expansive than fuel price inasmuch as it will also pass to customers the effect of the cost of replacement power due to any and all generator outages and even costs due to equipment performance changes. As I will explain, the Aquila proposal is not based on good regulatory policy for consumers.

Q ARE THE INTERESTS OF AQUILA AND ITS CUSTOMERS NECESSARILY IN ABSOLUTE CONFLICT OVER THE PROVISIONS OF A FUEL CLAUSE?

A To some extent the answer must be yes, but certainly not in all respects and the degree of conflict will depend greatly on the design. Indeed, any fuel clause should be designed with due consideration of the competing interests. And to a significant extent modifications to the proposed FAC can certainly better align the interests of Aquila with the interests of their customers.

[2] See Mr. Williams' direct testimony at page 2.

Q PLEASE EXPLAIN HOW THE INTERESTS OF AQUILA AND ITS CUSTOMERS CAN BE ALIGNED?

A The approach that I recommend would maintain for consumers as many of the advantages of bases rates as is possible. I begin with this premise: if it is found to be necessary to move to a different form of regulation, then the inherent advantages of the traditional approach to ratemaking should be continued to the maximum practical extent while addressing some, not necessarily all, of the dramatic and extreme costs in a RAM.

Before the decision to go forward with a FAC can be made, many relevant facts must be considered. Commission rule 4 CSR 240-3.161 defines filing and submission requirements which are also in and of themselves instructive as well as important to any decision by the Commission. The breadth of the filing and submission requirements stretches from simple but important matters such as customer notice and bill information to matters such as current and expected future generation mix. Among the provisions is a requirement to explain any feature designed into the proposed RAM that can be relied upon to ensure that only prudent costs shall be eligible for recovery. My point here is simply that much information is to be brought to the record for consideration in the matter of a FAC proposal. In my opinion, all of the required information ought to be provided as a threshold requirement before any proposal is even given consideration for approval, modification or rejection.

Q WHAT ARE SOME OF THE ADVANTAGES OF TRADITIONAL REGULATION THAT COULD BE LOST WITH A FAC?

A Some the important advantages of traditional regulation that may be lost are the following:

- ✘ Rates are predictable from month to month
- ✘ Rates often do not change for extended periods
- ✘ Rate cases provide for the consideration of all relevant factors and a thorough review of claimed costs before rates are changed,
- ✘ There is a continuing financial incentive to minimize total costs since a change in any cost will impact earnings. And consistent with this notion, by minimizing total costs the Company is able to maximize and keep earnings realized between rate cases.

Q PLEASE EXPLAIN THE IMPORTANCE OF UNPREDICTABLE RATE CHANGES.

A Any customer that needs to operate on a budget will be frustrated by the quarterly changes under the FAC proposal of Aquila. Business customers will find it difficult if not impossible to accurately budget costs and likewise anyone on a fixed budget would have a problem. Thus the "extreme" and "dramatic" costs changes, as so characterized by Aquila, will certainly also be difficult for customers. Any unlimited and unmitigated 100% pass through of fuel and purchased power costs, such as proposed by Aquila is simply a wholesale shift of the burden from Aquila to ratepayers and is not good policy.

Q **PLEASE EXPLAIN THE IMPORTANCE OF THE LOSS OF EXTENDED PERIODS OF TIME BETWEEN RATE CASES.**

A Ideally customers would like rates to stay the same or decrease. Periods of rate stability certainly promote a healthy business climate while the benefits to anyone on a fixed income are practically self evident. If the circumstances are right, periods of rate stability can be equally good for utility investors -- as long as a reasonable return can be earned at the same time.

Q **PLEASE EXPLAIN WHY IT IS BENEFICIAL TO EXPLORE ALL RELEVANT FACTORS BEFORE RATES ARE CHANGED.**

A This enables the Commission to ascertain that only reasonable and prudent costs form the basis for rates. The importance of this point is emphasized by the rule I already mentioned above that requires Aquila, as a part of its application, to describe any features in its proposed FAC that will ensure that only prudent costs shall be eligible for recovery. Of course a rate case type review is fundamentally at odds with the conceptual basis of a FAC, so features that will tend to ensure or at least promote the elimination of imprudent costs from the process are in order.

Q **IS THERE A CONTINUING FINANCIAL INCENTIVE TO MINIMIZE TOTAL COSTS UNDER TRADITIONAL REGULATION THAT MIGHT BE LOST WITH A FAC?**

A Yes. There is a continuing financial incentive under traditional regulation because once the rates are set by the Commission, Aquila's earnings will be better if all costs are minimized. This incentive to hold costs to a minimum inures to the benefit of ratepayers over time. In other words, under base rates the interests of rate payers and Aquila are aligned in an important sense because the lower costs that are inherently incented under traditional regulation are good both for Aquila and for ratepayers.

In the context of a fuel adjustment clause, an important policy goal should be to maintain an alignment of interests in low costs. But a fuel rider will create fundamental tension with this goal if 100% of any cost increases or decreases are passed thru to ratepayers under the more or less automatic operation of the clause. Instead the FAC should, by design, maintain an incentive to control costs.

The simplest way to maintain an incentive is to continue the base rate treatment for a portion of the fuel costs. Perhaps the most straight-forward example is a design that provides a FAC for 50% of the fuel costs and continues base rate treatment for the other 50%. The mechanism has the same simplicity of a FAC that would pass through all fuel costs, but simply and elegantly ameliorates the incentive problem by retaining half of the fuel costs in base rates with the effect of changes to accrue to the Aquila between rate cases. In other words, an important measure of interest alignment will continue because both Aquila and its ratepayers will continue to be better off if costs are minimized.

Q **HAS THIS PHENOMENA ALSO BEEN CHARACTERIZED AS "SKIN IN THE GAME?"**

A Yes. This is another way of saying that it will continue to be financially important to Aquila to minimize its fuel costs.

Q **CAN YOU SUMMARIZE YOUR ANSWERS TO THE SEVERAL QUESTIONS RELATING TO INCENTIVES UNDER A FAC AS COMPARED TO TRADITIONAL REGULATION?**

A Yes. I have explained how traditional regulation in an important sense provides incentives by the inherent design of the regulatory process - by relying on fixed rates for a period of time during which efficiencies are incented simply because the impact of every cost falls to the bottom line - equity return.

I recommend two policies. First, the alignment of Aquila's interest with the interests of customers should be pursued as a policy goal. This leads to a second policy. The incentives that are inherent in base rates simply due to the design of the traditional regulatory process should be preserved. In other words, incentive by design should be a second policy goal

Q **HOW CAN THESE TWO POLICY GOALS BE GIVEN FORM IN A FAC?**

A The form is that already suggested earlier. A significant measure of eligible costs should continue to be a part of base rates. I recommend 50/50 as the starting point for consideration.

Q **IS IT POSSIBLE TO PROVIDE CONSUMER PROTECTIONS ALONG WITH AN INCENTIVE BY DESIGN RECOMMENDATION?**

A Yes. The first protection is to simply ensure that every one of the Commission's filing and submission requirements is completely fulfilled by Aquila. This will ensure that the parties and the Commission will have access to important information that can then be among the factors to be considered by the Commission. Office of Public Counsel witness Ryan Kind has noted some apparent deficiencies that need to be addressed. He discusses fundamentally important matters such as present and future generation mix, and resource planning. I would think Aquila would willingly, even eagerly, meet the requirements of the rule and any deficiency ought to weigh heavily against moving forward with a FAC. Simply put, it would be difficult to be assured of an appropriate result if factors relevant to the decision can not be considered because Aquila has not met its responsibility under the rules. Certainly, it should not be the responsibility of parties that would suffer under the proposed FAC to spend resources to develop the information for the record for the benefit of Aquila.

Q **ARE OTHER CONSUMER PROTECTIONS POSSIBLE?**

A Yes. In an important sense incentive by design is a consumer protection. But additional protections are also appropriate. In my earlier direct testimony I discussed performance standards for Aquila's generation. Again it is helpful to consider the structure of traditional regulation. Once rates are set, customers are not held responsible for the efficient use of generation equipment. If there is an outage, the cost accrues to Aquila. If there is superior performance, the benefits accrue to Aquila. However, the FAC proposed by Aquila would pass through all fuel costs variations, not just those due to the proclaimed dramatic and extreme fuel price changes. The prudence review process would be only after the costs have been paid and would not in any event address the ongoing and routine incentives that would have been lost due to the change from traditional regulation.

Q **CAN THE INCENTIVE BY DESIGN POLICY PROVIDE DIRECTION FOR AN ADDITIONAL CONSUMER PROTECTION POLICY?**

A Yes. As a matter of policy the performance incentives inherent in base rates should be preserved with an extension of the incentive by design concept. More specifically, a design that incorporated a fixed generation mix would preserve negative and positive generation performance incentives similar to those in base rates. But the expected changes in generation mix would need to be provided for review even under this approach. As an alternative, a threshold level of output could be established for the low cost production sources. This mechanism would reduce the possibility of imprudent costs passing through due to any substantial equipment failure while allowing variation within a normal range.

Since it is fuel prices and not generator outages that have created the alleged need, there does not seem to be good cause to venture far from the result that would obtain from traditional regulation in regard to any other cost item. By this logic a fixed generation mix is preferred.

Q AS A CONSUMER PROTECTION, IS IT POSSIBLE TO MITIGATE RATE VOLATILITY UNDER A FAC, EVEN IN THE FACE OF FUEL PRICE VOLATILITY?

A Yes. I recommend at least two approaches. The first is the 50/50 split between base rates and FAC rates. Between rate cases this would mitigate price volatility by 50% so long as additional volatility is not introduced due to the lack of either a fixed generation mix or performance standards.

The second approach is to extend the recovery period for the accumulated cost variations to twelve months. This will mitigate the effect of cost variations from an extreme quarter. If the high or low costs persist there would be a twelve month phase in period. If the high or low costs do not persist, the large impact of a temporary price spike or dip would be mitigated by the reductions in subsequent quarters.

Q SHOULD AQUILA ILLUSTRATE THE EFFECT OF ITS PROPOSED FAC BASED ON PAST HISTORY?

A Yes. To the AGP and Sedalia intervention groups this represents an important issue. While there is no enthusiasm for a FAC, the groups believe it is essential that the potential month by month rate impact be illustrated for their review. This review will be important to my final recommendations on behalf of the groups, which will of course be presented to the Commission in due course.

Q SHOULD AQUILA'S GAS COST HEDGING PROGRAM BE REVIEWED IN CONJUNCTION WITH THE EFFECT OF THE PROPOSED FUEL RIDER?

A Yes. The above suggested review of the proposed FAC based on historical costs will also provide a format for the review of the impact of the gas cost hedging program. Thus, for several reasons the analysis of the potential impact will be important to any FAC decisions.

Q **DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?**

A Yes it does. As I noted earlier, I will reserve until the rebuttal testimony any evaluation of the specific Aquila FAC proposal and compare it to those standards.