**BEFORE THE PUBLIC SERVICE COMMISSION**
**OF THE STATE OF MISSOURI**

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| In the Matter of the Tariffs of Aquila, Inc, d/b/a Aquila Networks–MPS and Aquila Networks– L& P 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** Tariff No. YE-2007-0001 |

## AARP's Prehearing Brief

COMES NOW AARP, by and through counsel, and pursuant to the Public Service Commission's (Commission's) Order Adopting Procedural Schedule, hereby submits its Prehearing Brief.

Just and reasonable electric rates are essential to AARP's over 755,000 members in Missouri. Access to affordable electricity service for air conditioning in the summer and heat during the winter is absolutely necessary for many older consumers.

However, Aquila, Inc. d/b/a Aquila Networks—MPS and L&P (Aquila) is proceeding to request an overall 24.6% increase in residential electric rates in this case, despite the fact that it received large rate increases from the residential class (13.49% MPS; 8.72% L&P) effective just one year ago. With regard to the proper overall revenue requirement that Aquila should be authorized in this case, AARP supports the positions of the Office of the Public Counsel. In addition, Aquila is proposing a Fuel Adjustment Clause (FAC) in this case—a fluctuating mechanism that would be extremely unfair to small electric consumers.

This prehearing brief is limited to summarizing the rate design issues regarding what AARP believes to be the proper method of recognizing fuel and purchased power costs in rates. AARP is strongly opposed to the adoption of an FAC or any pass-through fuel adjustment mechanism. If however, the Commission believes that an FAC should be adopted, despite all of the compelling evidentiary and policy reasons put forth in testimony, AARP urges the Commission to adopt significant modifications to any FAC. Such modifications should be designed to mitigate the harms to consumers of such a mechanism as well as designed to retain, to the maximum extent possible, the current built-in incentive to efficiently manage fuel costs.

If the Commission is indeed going to move towards a pass-through regime for fuel cost recovery, AARP believes that the best way to preserve the incentive for the utility to be cost efficient is to ensure that a significant percentage of these fuel costs continue to be recovered through base rates. That is, at a minimum, a significant fraction of Aquila's energy costs must remain at risk (e.g., **50%**), as opposed to Aquila's proposal that would dump **100%** of its fuel cost risk onto the backs of ratepayers. Aquila must have significant "skin in the game" in order to protect ratepayers.

A. <u>The proposed FAC is unreasonable because it is generally unfair to consumers.</u>

There are several reasons why cost adjustment mechanisms for regulated monopoly electric companies are not recommended. While there are valid arguments for and against their use, the balance of policy arguments weighs against cost adjustment mechanisms in most cases. Binz/Brockway Direct Testimony, pp. 9-11.

The most important thing to remember when considering whether to adopt a cost adjustment mechanism is that moving away from traditional regulatory treatment comes with a potentially large cost. Id., p. 10. Cost adjustment mechanisms are often adopted by regulators not because of the incentives they provide, but in spite of them. Id., p. 10.

First, a cost adjustment mechanism tends to dull the incentives to efficiency that cost of service regulation provides to utilities. To see why, the Commission should consider that a firm operating in a competitive market is not able to change prices to accommodate changes in costs, at least not unilaterally – not until the market price changes. Pressure from cost increases requires a competitive firm to become more productive in order to maintain its profitability. Id., p. 9. It has long been recognized that "regulatory lag" in cost of service regulation mimics this process in a competitive market. It can benefit customers and the utility alike by supplying the incentives that competition provides in other industries.

The second argument against cost adjustment mechanisms is that they tend to skew choices the regulated company must make by rearranging its economic incentives. A utility is continuously faced with short-term and long-term decisions about fuel and power purchases, whether to "build or buy," etc. To the extent that an adjustment mechanism is a "thumb on the scale" for some choices in preference to others, it may induce an electric company to make choices it might not otherwise make, to the detriment of its customers. Id., pp 10-11.

Despite Aquila's assurances that the Commission should rely solely on prudence reviews to provide incentives, regulatory experience has shown that after-the-fact prudence reviews are a crude and considerably-less-than-perfect way to catch inefficiency. Brockway Surrebuttal, p. 6-7. The standard for finding imprudence is in practice, if not in law, higher than the standard for identifying inefficiency. Inefficiency itself is often not enough to justify a prudence disallowance. Id., p. 6. Costly after-the-fact reviews of a management's activities are no substitute for before-the-fact alignment of management motives and consumer interests. Id., p. 7. Imprudence is often difficult to prove, as the resources of the Commission's Staff and the Office of the Public Counsel are much less than those of the utility when attempting to mount a case requiring extensive expert testimony. Id., p. 7.

The third argument against the use of cost adjustment mechanisms relates to their fairness. Cost adjustment mechanisms shift the balance of risk between utilities and their customers; more generally, they change the balance of equities embodied in cost of service regulation. Binz/Brockway Direct, p.10. It would be a rare utility that would propose a cost mechanism to track decreasing costs. Id., p. 11. By removing an upward-trending cost and tracking it with a cost adjustment mechanism, the balance of fairness in ratemaking is changed and the probability that a utility will be able to exceed its authorized return is heightened, without any compensating change to benefit consumers. Id., pp. 11-12.

It is a common misconception that utility regulation is a "cost-plus" exercise and that a regulator's duty is to ensure that companies "recover" their costs. This is factually incorrect. Id., p. 14. Under cost of service regulation, past costs are not "recovered;"

they are simply used as a guide to the future costs that new rates attempt to match. In fact, "recovering" past costs, absent a specific exception, is retroactive ratemaking. Id., p. 14. An FAC distorts the traditional ratemaking equation and essentially inoculates a future rate request of a utility from a claim of retroactive ratemaking with respect to the subject costs. Id., p. 15. *Adjustment clauses such as the FAC significantly reduce the pressure on a utility to be efficient, in its fuel and purchased power operations, but more generally in all its operations. Simply put, the "cure" offered by an FAC can be worse than the "disease".* Id., p. 17-18.

An FAC should only apply to an electric company that has fuel costs which fluctuate significantly and which are also outside the utility's control. Id., p. 14. Aquila has not offered any evidence in support of the FAC proposal that shows the Company's power costs are expected to change rapidly in Missouri. Id., p. 12. While it has shown some evidence that fuel costs may increase over time, this does not necessarily indicate that the Commission should institute a "recovery mechanism." To the extent that increases in cost cannot be offset by productivity gains, increased sales, etc., the utility always has the alternative to request an increase in rates. This type of pressure on a utility to become progressively more efficient is actually a *good thing*: good for customers and companies alike. Id., p. 12.

An FAC is also an unreasonable option for a utility like Aquila which has significant ability to control variations in fuel and purchased power costs in the short term and in the long term. Here is a partial list of drivers for fuel and purchased power over which Aquila exercises control or significant influence:

- Basic choices in the utility's resource plan
- The ratio of owned generation and purchased power
- Terms of wholesale contracts
- Efficiency of system operations
- Transmission system design and operation
- Degree and type of fuel risk in purchase decisions
- Hedging activities
- Demand side choices
- Advocacy for beneficial rate design proposals

Id., p. 13. None of Aquila's witnesses have presented any analysis of these factors, all of which factor significantly to the impact of volatility in indexed input prices on the ultimate cost to consumers. Despite its protestations to the contrary, Aquila is neither passive nor powerless in the face of changing fuel and power costs. Brockway Surrebuttal, p. 7-9. Aquila shapes its own power cost future by the numerous choices it makes in these areas. Accordingly, AARP opposes the adoption of any FAC for Aquila because of the damage that it will do to resource planning decision-making. Binz/Brockway Direct, p. 13.

The Commission should tread carefully when changing the way it regulates these activities and the basic incentives provided to Aquila. Brockway Surrebuttal, p. 8. To the extent the fuel adjustment clause moves the risk of substandard performance in these areas effectively to the customer, away from the utility (i.e. further down the line from 0% reconciliation of fuel costs and rates to 100%, as would be the case in the company's proposed FAC), the company has fewer incentives to manage its operations and planning in a fuel-prudent

way. Only if it were true that Aquila had zero influence over its fuel costs would it make any sense to grant it a 100% reconciling FAC. Id., 9-10.

The presence of regulation in a market shapes the behavior of the market participants. While utility regulators might want to limit their role to being a substitute for the competition that is missing in these industries, it is rarely possible to limit regulation's effects that way. Binz/Brockway Direct Testimony, p. 14. Aquila has operated in Missouri without a power cost adjustment mechanism since 1979. This has created a desirable risk/reward proposition for consumers *and* for the Company. Id.

Under the current regulatory regime for Aquila, fundamental decisions such as whether to "build or buy," whether and how to hedge power costs, choices of fuel acquisition strategies, and even rate design choices are shaped by the fact that differences between projected and actual power costs accrue to the benefit or detriment of shareholders between rate cases. Id. An FAC mechanism would fundamentally alter the risk analysis that Aquila executives consider when making those decisions, seriously damaging the fairness of the regulatory bargain. Id., p. 15-16.

Aquila witness Fetter claims that greater use of *purchased power* is a benefit of FACs. This point simply highlights one of the main problems with such fuel mechanisms. Instead of treating all power options neutrally, an FAC skews the investment/expenditure decisions of the utility in favor of purchased power. Brockway Surrebuttal, p. 11.

Interestingly, Aquila proposes that the differences between the assumed base level of off-system sales margins and actual results (positive or negative) will be split

50-50 with rate payers and will be included in the FAC calculation. AARP opposes this "margin-sharing proposal" for treating off system sales as unfair; off-system sales should simply be set at a fixed level in base rates and fully credited to consumers. Id., p. 17, 26. It should be noted that on this particular piece of its proposal, Aquila is arguing for a sharing structure that it claims would promote incentives for efficiency. The exact same arguments can be made to argue *against* the FAC proposal itself, because as Aquila has proposed the FAC itself, it would simply track expense levels *without any sharing*. Id., p. 23.

However, if the Commission decides to consider a margin-sharing proposal for off-system sales, it can build incentives into the structure, similar to AARP's alternative FAC proposal. Id., 26. One way to do this is simply to include the best estimate of future sales margins in base rates, and then credit or debit the FAC balance with any difference between base margins and actual margins. The sharing percentages for the FAC, discussed above, would then apply to the FAC balance including off-system sales. Id. In its proposal, Aquila has done something similar, except that the sharing applied to **off-system sales is 50/50**, while the "sharing" applied to the **FAC is 100/0**, with the Company collecting or absorbing the entire amount. This is fundamentally unfair. If the Commission allows Aquila to adopt a FAC with no sharing, then the same principle should definitely apply to margins.

Without any quantification whatsoever, Aquila continues to chant that "Wall Street" prefers utilities with an FAC because of the way that such mechanisms shift risk away from shareholders and onto ratepayers. But Aquila makes no attempt to (a) isolate the effect of the presence or absence of an FAC on Aquila in Missouri, nor (b)

quantify the effect of the presence or absence of an FAC on Aquila in Missouri. The rebuttal testimony of Aquila witness Hadaway does state that only 6 of the 24 utilities in his reference group for purposes of running a DCF model do not have an FAC, arguing that the cost of capital should be raised if Aquila is denied an FAC. See Schedule SCH-15 to Hadaway's Rebuttal. To explore this proposition, AARP witness Brockway recomputed the group average DCF model results, removing the 6 utilities that were identified as having no FAC. See Brockway Surrebuttal, p. 13. Only in the case of traditional constant growth DCF model did the removal of non-FAC utilities make any appreciable difference. Id. In the case of the more up-to-date methods, removal of the non-FAC utilities lowered the average DCF by 4 basis points in one instance and increased the average DCF by 13 basis points in the other. Id. Thus there is no appreciable impact on a utility's cost of capital for the two DCF models that Mr. Hadaway actually prefers. Id., pp. 13-14.

B. If the Commission chooses to consider an FAC, despite all of the testimony and policy concerns to the contrary, modifications should be added to mitigate the harms of such a mechanism.

Current regulation incorporates an estimate of fuel and purchased power costs in base rates. If actual costs are lower, the utility earns more money; if actual costs are higher than the base rate increment, the utility earns less. None of the variation from the base is added to or subtracted from base rates. Thus, current regulation is the ***0% Pass-Through Case***, retaining a strong incentive for Aquila to act prudently.

Binz/Brockway Direct Testimony, p. 19. In contrast, the FAC proposed by Aquila would track every penny of differences between base rates and actual power costs. Whether over or under, the entire variation and risk would be passed through to customers in the form of an increment on the monthly bill. The Aquila proposal is the ***100% Pass-Through Case***. Id., p. 19.

Between these extremes are infinitely many middle-ground cases. If the Commission chooses to adopt some version of an FAC for this utility, against all of the serious objections raised, it is perfectly reasonable for the Commission to apply the FAC to 50% of the over/under deviation from base rates. Id., p. 19. If the Commission approves a ***50% Pass-Through FAC***, the vast majority of Aquila's power costs will still be collected in base rates. It is important to understand that the 50% fraction applies only to the variation from that base amount. And since the fraction applies symmetrically to cost differences, the utility will sometimes over recover, sometimes under recover, at half the rate that happens today. Id., p. 19.

By using the 50% rule, the Commission would strike an exact middle ground between the type of regulation that has existed since 1979 in Missouri and the type of regulation proposed by Aquila in this case. Id., p. 20. This is what the Missouri Legislature had in mind when it granted the Commission the ability to "approve, *modify* or reject" any FAC proposal. Subsection 386.266.4 RSMo. Supp. 2006. (Emphasis added). This 50% approach would retain half of the incentives for efficiency that traditional cost of service regulation provides to utilities. When faced with the choice of acting to lower its expenses, Aquila would know that it will be allowed to "keep" half of the costs savings in this approach. In contrast, under Aquila's proposed 100% pass-

through FAC, any efficiency gains are taken away from Aquila at its next FAC filing. Id., p. 20.

The same logic applies in reverse. Unless a utility's bad behavior is found to be imprudent (a very high standard) it faces *no consequence for incurring excess costs* under the FAC. Excess costs will simply be passed through in the next FAC filing. Id., p. 20. On the other hand, if the utility is sharing its over/under power cost results, the utility faces a disincentive for bad behavior that results in higher costs because only half of such higher costs are passed through the FAC, with the balance absorbed by the Company. Id., p. 20.

A 50/50 sharing of risks is a fair way to graduate the risks and benefits of an FAC between ratepayers and shareholders. Brockway Surrebuttal, p. 11. Aquila itself promotes a graduated or shared-risk/reward type mechanism (in its proposal for handling off-system sales discussed above), although it does not explain why sharing in this way is appropriate but not for other components of an FAC.

There are other examples of fuel adjustment mechanisms in other states that are more sophisticated than Aquila's proposal, such as the Wyoming tariff of Rocky Mountain Power, approved by the Wyoming PSC in May 2006. See Binz/Brockway Direct Testimony, pp. 21-25; Attachment RJB-7. Given the weak incentive that prudence reviews provide, the Commission should retain some at least some of the strong incentive that current regulation provides, in any FAC that is adopted.

WHEREFORE, AARP respectfully requests that the Commission reject Aquila's proposed FAC, or if it chooses to adopt some pass-through FAC mechanism despite all

of the testimony and policy concerns to the contrary, then it design it consistent with AARP's recommendations.

Respectfully submitted,

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## CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been emailed to counsel for each of the parties on the service list for this matter on this 29th day of March 2007.

/s/ John B. Coffman