

STATE OF IOWA
DEPARTMENT OF COMMERCE
UTILITIES BOARD

IN RE: AQUILA, INC., d/b/a AQUILA NETWORKS	DOCKET NOS. RPU-05-2 WRU-06-16-225
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FINAL ORDER ON REHEARING AND GRANTING WAIVER

(Issued September 12, 2006)

On March 1, 2006, the Utilities Board (Board) issued an "Order Approving Revenue Requirement Settlement, Rejecting Capital Additions Tracker Settlement, and Final Decision and Order" (Final Order) in Docket No. RPU-05-2, approving a general rate increase for Aquila, Inc., d/b/a Aquila Networks (Aquila), and rejecting a proposed settlement that would have established a capital additions tracker (CAT) surcharge. On March 17, 2006, Aquila filed an application for rehearing of the rejection of the CAT settlement. On April 5, 2006, the Board issued an order granting rehearing and establishing a procedural schedule.

In the April 5, 2006, order, the Board stated that the CAT as originally proposed had several fundamental flaws and even with the modifications made in the settlement, was not reasonable in light of the record and was not in the public interest. Among other issues, the Board questioned whether the Board's decision to apply the rate increase to the customer charge would provide enough rate stability for Aquila to remove some or all of the justification for the CAT. The Board stated that

an evidentiary hearing would allow the parties to address this issue and all other issues concerning the CAT proposal.

On May 8, 2006, Aquila filed a request for waiver of 199 IAC 26.4(1), which limits recovery of rate case expense to the expenses incurred as of the date of a company's reply brief in the initial case. Aquila requested that it be allowed to recover rate case expense through the date of the Board's final order on rehearing and to include the expense in the CAT calculation or have it recovered in the next rate case. On May 10, 2006, the Consumer Advocate Division of the Department of Justice (Consumer Advocate) filed a response opposing the waiver and on May 19, 2006, Aquila filed a reply to Consumer Advocate's response. On June 1, 2006, the Board issued an order in which it stated it would take the waiver request with the record of the rehearing of the CAT proposal. In the order, the Board stated that if Aquila was allowed to recover the rate case expense through the date of the order on rehearing, it could only be recovered in this case and not in the CAT, if the CAT is approved, and could not be held for a future rate case.

REHEARING OF CAT PROPOSAL

On rehearing, Aquila proposes the Board adopt the CAT as presented in the CAT settlement in the initial case. The CAT applies to capital investments that do not directly or significantly increase revenues, have not been included in Aquila's rate base, and are projects that replace, relocate, upgrade, protect, or otherwise extend the useful life of existing infrastructure. The surcharge will be based upon actual

amounts invested in plant that is both in service and used and useful, and there will be no lapse in the timing of recovery. The investment is capped at \$6 million and includes both a return of the investment through depreciation rates and a return on the investment with a return on equity of 10.4 percent. The CAT surcharge would only be in effect for three years and a reconciliation and true-up will be filed each year. Aquila proposes to file an investment plan and true-up report each year beginning in January 2007.

1. Regulatory lag

On rehearing, Aquila argues that regulatory lag prevents it from earning its authorized rate of return and it needs the CAT mechanism to provide a reasonable opportunity to earn its authorized rate of return since it is increasing its investment in "integrity" projects to repair or replace a significant portion of its natural gas system that is reaching the end of its useful life. In addition, Aquila states that several of the cities it serves are experiencing growing economies and receiving federal assistance which is increasing the number and scope of highway and street relocation projects, leading to additional system investment.

When capital investments are made between rate cases, the utility generally does not earn a return on or return of the new investment until it is included in rate base in the next rate case. This lag in recovery of the investment, Aquila argues, is unreasonable when applied to integrity projects that are designed to provide safe and adequate service or respond to government mandates. Aquila argues that in the past the lag in recovery was not a make-or-break issue, but under current conditions

of slow or no growth, reduced consumption, and increases in replacement and operating costs, the financial impact of regulatory lag has been significantly magnified.

In the initial case, Aquila witness Joseph M. Bahr testified that "integrity projects" were only regulatory capital projects involving Aquila's natural gas system, such as relocation and replacement, state and federal safety compliance, and homeland security implementation. Mr. Bahr then testified that integrity projects could also be those that did not otherwise produce significant revenue and on rehearing he testified that this category could include general plant.

As proposed on rehearing, investments to be recovered through the CAT would include expenditures of over \$1,000 that: (a) are not growth projects that directly and significantly increase revenues; (b) have not been included in Aquila's rate base; and (c) will replace, relocate, upgrade, protect, or otherwise extend the useful life of existing infrastructure. Aquila explains, for example, that the cost of computer equipment used to support Aquila's field personnel in providing safe and reliable service would be eligible for recovery under the CAT. This type of equipment would include meter-reading devices and computer-aided dispatch equipment, but not computer plant associated with central support services such as billing systems or call centers. On rehearing, Mr. Bahr testified that Aquila was proposing to include general plant for recovery in the CAT surcharge that would include other items that cost over \$1,000, such as desks, chairs, other furniture, small tools, line locators, and

gas sniffers. In its initial rehearing brief, Aquila states if the Board objects to the inclusion of furniture in the CAT, Aquila is willing to exclude those expenditures.

Consumer Advocate opposes the adoption of the CAT mechanism and argues that regulatory lag serves an important function in a regulated setting by providing the regulated utility an incentive to operate efficiently and to minimize costs. More specifically, regulatory lag provides the utility the incentive to contain or reduce costs, find other cost efficiencies to offset the cost increase, and find ways to increase revenues to offset the cost increase. Regulatory lag also operates as a substitute for competition in a regulated market by forcing a utility to keep costs from increasing unnecessarily.

Consumer Advocate argues that more frequent rate cases may not be a negative consequence if utility costs are going up. More frequent rate cases would allow ratepayers the opportunity to review management decisions and utility costs and would allow the matching principle to offset increases in costs with cost reductions and other efficiencies.

Consumer Advocate's primary argument against the CAT is that it violates the matching principle and allows piecemeal ratemaking without consideration of increased revenues or reduced costs. Matching of revenues and costs is a fundamental regulatory concept. Consumer Advocate points out that the matching principle has been recognized by the Board and Iowa courts for many years and was quoted with approval by the Iowa Supreme Court in Davenport Water Co. v. Iowa State Commerce Commission, 190 N.W.2d 583, 605 (Iowa 1971).

Board Discussion

Regulatory lag, the "delay between the time when reported rates of profit are above or below standard and the time when an offsetting rate decrease or rate increase may be put into effect" has been viewed under the prevailing methods of rate regulation as an incentive for utilities to operate efficiently. J. Bonbright, Danielson, and Kamershen, Principles of Public Utility Rates, (2d ed. 1988) p. 96. The Board considers it an important part of traditional regulation and a utility should show that extraordinary circumstances exist to justify developing an automatic adjustment mechanism that removes the effect of regulatory lag.

This is true especially under current statutes that have been recently amended to reduce the effect of regulatory lag. Utility concerns about regulatory lag have been recently addressed by adoption of Iowa Code § 476.33(5), which allows for updates of infrastructure investment nine months beyond the test year, and Iowa Code § 476.6(10), which allows utilities to place temporary rates into effect without Board approval within ten days of the date of filing for a general increase in rates. The combined effect of these two recent changes significantly reduces the effect of regulatory lag on a utility.

Iowa Code § 476.8 provides the Board authority to allow for the automatic adjustment of rates and charges. The Board has approved automatic adjustment mechanisms where it is shown that there are costs over which the utility management has little or no control, that are volatile (i.e., subject to sudden and important changes in level), and the costs are an important factor in determining the total cost of service

to customers. The Board has approved recovery through the purchased gas adjustment (PGA) for commodity costs of natural gas and through the energy adjustment clause (EAC) for fuel costs for electricity generation. Pursuant to the requirements of Iowa Code § 476.6(16), the Board has also approved an automatic adjustment mechanism for the recovery of energy efficiency costs and in the past approved a tracker mechanism for costs associated with the Cooper Nuclear Station (the Cooper Tracker). The Board found that these automatic adjustment mechanisms met the criteria described above.

Aquila argues on rehearing that the proposed CAT is very similar to the Cooper Tracker. The Board addressed this issue in the Final Order in the initial case and the evidence on this issue is similar to the evidence presented in the initial case.

In the Final Order, the Board reviewed the Cooper Tracker and discussed how it differed from the CAT proposed by Aquila. The Board pointed out that the costs incurred by MidAmerican Energy Company and recovered through the Cooper Tracker were the result of a contract between MidAmerican and Nebraska Public Power District whereby MidAmerican would receive 50 percent of the electricity generated by the Cooper Nuclear Station; however, MidAmerican was not the Cooper Nuclear Station owner and did not have control over capital expenditures. The Board approved the Cooper Tracker because it determined that MidAmerican's capital expenses associated with the Cooper Nuclear Station varied significantly, often driven by requirements of the Nuclear Regulatory Commission, and

MidAmerican had little or no control over those expenditures even though they could be significant.

Based upon the evidence presented on rehearing, the Board still does not consider the recovery of the integrity projects as proposed by Aquila to be sufficiently similar to the costs associated with the Cooper Nuclear Station or the costs recovered through the other automatic adjustment mechanisms to support adoption of an automatic adjustment mechanism. The evidence presented by Aquila does not satisfy the criteria for adoption of a mechanism for recovery of costs outside of the normal regulatory process.

In addition to not meeting the criteria for an automatic adjustment mechanism, the evidence presented concerning integrity investments does not show that these costs are other than traditional operating costs incurred by each utility. Aquila has control over the timing and amount of these investments. The only credible evidence of the need for additional investment in integrity projects is the testimony concerning the need to replace aging mains. Aquila provided some evidence of the number of main replacements and service line replacements in Exhibit 205. However, replacement of aging infrastructure is a traditional operating cost that is largely within management's control.

Aquila provided no specific evidence about any increased state and federal compliance requirements except for a general indication that a new federal distribution integrity rule was being discussed. Aquila indicated it could not provide an estimate of the cost of any new rule since it had not been proposed at the time of

the hearing. In addition, Mr. Bahr testified that Aquila had made no expenditures for homeland security.

Aquila is now proposing to include general plant investment as part of the \$6 million integrity investments that would be recovered through the CAT. General plant, as described by Aquila, includes items that cost more than \$1,000, such as furniture, meter-reading devices, and computer-aided dispatch equipment. General plant costs are not the type of costs that should be recovered through an automatic adjustment mechanism. These items are not extraordinary and are part of the day-to-day costs of operating a utility. Including them in the CAT raises serious questions about the need for the CAT and is not reasonable.

2. Public interest

Aquila argues that the CAT recognizes important public policy interests since it may be less expensive and more efficient than the filing of frequent rate cases. Aquila states that there is little advantage to requiring the utility to wait until the next rate case for approval of recovery of integrity capital investments. Aquila asserts that a CAT mechanism would stabilize rates and reduce the size of increases that could occur when the investments are placed into rates in the next rate case. Rate increases can be substantial when they are the result of less frequent rate case filings and Aquila asserts that ratepayers would benefit since a CAT would reduce the potential for rate shock that could result from accumulating and deferring the recovery of integrity investments to a general rate case. The CAT would provide

steady and predictable recovery of investment costs and these investments are suitable for routine adjustments in rates.

Consumer Advocate argues that there are benefits to more frequent rate cases since more frequent review of Aquila's operations would allow customers the opportunity to review management and operating practices. Consumer Advocate also contends that only in rate cases can reduced expenses, such as a reduction in the number of employees, be offset against an increase in investments or other costs.

Board Discussion

The Board is not persuaded that there are important public interest considerations that support the adoption of the CAT in this case. Historically, Aquila has only filed cases on average every five years and the last two rate cases were filed three years apart. Aquila asserts it could file yearly rate cases to recover integrity investments and this would be a significant cost to ratepayers. The evidence does not support the idea that Aquila will file yearly rate cases if the CAT is not approved. Filing yearly rate cases would be a major undertaking and Aquila would have to be reasonably certain that it could support recovery of integrity investments without having them offset by decreases in other costs. In testimony at the hearing, Aquila stated it would be reducing costs by the elimination of 220 positions and overhead costs of \$30 million companywide. If Aquila reduces expenses by reducing the number of employees and lowering overhead costs, it is less likely to file yearly

rate cases since its overall operating costs will be lower and these reductions could offset any increase in capital investments for integrity projects.

In addition, the Board is not sure that the annual true-up filings for the proposed CAT surcharge would be significantly less expensive than annual rate case filings. Aquila might not have to file prepared testimony, but it would have to respond to data requests from Consumer Advocate and requests for information from the Board. Since the integrity investments, as proposed, would include general plant as well as main and service line replacements, the review of each true-up filing would be more involved than the review done for annual PGA reconciliations. Annual PGA reconciliation reviews take at least a month for Board staff to complete, so the CAT review process could reasonably be expected to take multiple months.

There is also the concern that if the Board approved a CAT surcharge, all of the integrity investments that flowed through the CAT arguably would have been found to be prudent and therefore not subject to complaint or investigation in a later rate case. This would require Board staff and Consumer Advocate to do more than just check the numbers in any true-up filing. Each investment would have to be reviewed to ensure it was needed and is used and useful and should be recovered through the CAT. Again, this would make the annual CAT process lengthy and expensive, reducing the savings from any hypothetical reduction in rate case filings.

3. Effect of rate increase recovered through customer charge

In the Final Order, the Board indicated that recovery of the allowed rate increase through the customer charge (rather than through volumetric rates) might

provide sufficient rate stability for Aquila to mitigate the need for the CAT. On rehearing, Aquila argues that the modest increase in the customer charge has absolutely no effect on the regulatory lag problem the CAT is designed to address. Allowing costs to be recovered by means of fixed charges rather than volumetric charges increases the likelihood of full recovery but does not address the delay in recovery of integrity investments.

Aquila also points out that even with the additional increase in the customer charge, it only changes the percentage of non-gas-cost revenue recovery from 49 percent to 53 percent. That means that 47 percent of Aquila's non-gas cost revenue is still subject to the variability of the weather and to declining customer usage.

The Board agrees that the tension between rates based upon usage and the pressures on customers to use less gas should be considered separately from the CAT. The Board has opened an inquiry, Docket No. NOI-06-1, to consider whether it should propose and adopt alternative regulatory mechanisms to address the effect of having a significant portion of a utility's revenue requirement tied to usage, since average usage per customer is declining and increased emphasis is being placed on energy efficiency. To the extent the CAT is proposed to reduce regulatory lag, approval of the CAT should rest on the evidence presented by Aquila to support the need for the tracker and should not be based upon the decoupling issues being addressed in Docket No. NOI-06-1.

4. Board decision

In the Final Order denying the CAT settlement presented in the initial part of this case, the Board stated that it did not consider the traditional regulatory process to be broken, as argued by Aquila. The Board stated that traditional regulation is sufficiently flexible to allow for adjustments if circumstances unreasonably limit a utility's opportunity to earn its authorized rate of return. The Board recognized that Aquila has legitimate concerns about its opportunity to earn its authorized rate of return, since per customer usage of natural gas has declined in recent years for all Iowa natural gas utilities and Aquila provides natural gas service in areas of low customer growth. The Board pointed out that rates established in a general rate proceeding are designed to allow Aquila, and any rate-regulated public utility, the opportunity to earn the return on equity found to be reasonable. However, a public utility is not guaranteed recovery of the return on equity and must operate the utility in an efficient and prudent manner to earn the return on equity used to calculate the rates. The Board found that the CAT would allow Aquila to sidestep this traditional regulatory framework and would virtually guarantee Aquila a return on these investments, as well as a guaranteed depreciation rate, for the duration of the CAT.

The Board pointed out that even as modified by the settlement, the CAT had significant flaws. One flaw specifically mentioned was the absence of an adjustment in the return on equity to reflect the reduced risk that would accompany the approval of the CAT. The Board pointed out that the CAT settlement did not contain an agreed-upon return on equity; however, at the hearing Aquila's witnesses testified

that a return on equity of 10.4 percent would be used in the calculation of the surcharge. The Board found there was no support for the 10.4 percent return on equity to be used in the CAT and it did not reflect any consideration of what an appropriate return on equity should be for a low-risk revenue recovery mechanism such as the CAT.

The Board indicated that it had addressed one of Aquila's major concerns, revenue stability, by applying all of the approved revenue increase in this docket to the General Service customer charge. The increase in the customer charge reduced the portion of revenue that is subject to the variable use of gas. The Board stated that without further evidentiary support to show that this shift of revenue recovery to the customer charge is inadequate to address Aquila's cash flow concerns, or some recognition of the reduced risk to Aquila from adoption of a CAT-type mechanism, guaranteeing additional cash flow with a CAT is not warranted.

After reviewing the evidence presented on rehearing, the Board finds that the evidence does not support approval of the CAT mechanism as proposed by Aquila. The additional evidence presented by Aquila does not show that there are extraordinary circumstances that require the Board to adopt an alternative approach for recovery of integrity investments and the CAT does not meet the criteria for an automatic adjustment mechanism. The evidence is not convincing that Aquila will be subject to increased integrity investments due to federal safety regulations or homeland security requirements and recovery of general plant as part of the CAT is not reasonable.

Moreover, the Board is not convinced that the adoption of a CAT (with its annual filings) will result in significant cost savings even if it delays general rate case proceedings. These true-up filings could become small rate cases, since approval of recovery in a CAT surcharge could preclude any prudence review of an investment in a later docket and each expenditure would have to be reviewed to make sure it should be recovered. Additionally, the Board is not convinced that Aquila will need to file annual rate cases if the CAT is not approved, so any savings from the true-up filings would likely be less than Aquila has asserted. Finally, with the reduction in regulatory lag provided by Iowa Code §§ 476.33(5) and 476.6(10), Aquila is provided with new protections against the adverse effects of a delay in the recovery of a return on and a return of integrity investments.

The argument that adoption of the CAT will reduce the potential for ratepayer hardship and public controversy that could result from accumulating and deferring recovery to general rate cases is not credible. The Board's experience with customer reaction to Aquila's general rate case filings has not demonstrated that ratepayers have unduly complained about the general rate increases requested by Aquila. Customer meetings held by the Board regarding Aquila general rate case filings have been lightly attended and the Board has received relatively few customer complaints about the increases. The public does not like rate increases, but based upon the number of customers who have appeared at the consumer comment hearings, customers do not appear to be overly concerned about increases in the rates for non-gas costs that occur every three or more years.

As discussed above, the CAT does not meet the criteria for an automatic adjustment mechanism. Integrity investments are not beyond the control of management since Aquila can reduce the amount of investment or accelerate investment (within reason). This can be seen by the increase to \$6 million annually in integrity investments that Aquila is projecting, which is almost twice as much as Aquila has invested historically. Integrity investments are not subject to sudden changes since they are largely related to replacement of aging pipe and can be forecasted and repairs can be scheduled. Integrity investments may be considered an important part of overall costs, however, they are not as significant as gas costs.

Evidence about the lower customer usage or weather-related reductions in revenue recovery should not be considered in deciding whether to approve a CAT mechanism. Mr. Bahr testified that reduced customer usage is not relevant to whether the CAT should be adopted. The Board is addressing this issue in Docket No. NOI-06-1. Whether the Board should adopt a CAT mechanism for recovery of integrity investments is a stand-alone issue and should not be influenced by the matters considered in Docket No. NOI-06-1.

There still remains some concern that Aquila's current financial circumstances may be one of the reasons that Aquila has proposed the CAT as a way of increasing revenues. None of the other rate-regulated utilities have indicated that integrity investments have increased so dramatically that they need an automatic adjustment mechanism to recover the additional costs. Consumer Advocate considers Aquila's financial situation as one of the primary reasons that Aquila is proposing the CAT;

however, Aquila contends there is no connection. Since the Board is not approving the CAT, for the reasons described above, it need not address whether Aquila is pursuing the CAT because of financial pressures related to its unregulated activities. Protection of Iowa ratepayers from the adverse effects of Aquila's prior unregulated activities is still a priority with the Board.

Even though the Board has denied the CAT proposal in this docket, it still recognizes that circumstances may change and Aquila may be required to expend significant amounts on integrity investments for homeland security and federal regulations at some point in the future. The Board therefore requests that Aquila, in its next rate case filing, separately identify those capital investments that Aquila believes would have qualified for the CAT tracker. These capital investments should be for (1) projects that are not growth projects that directly and significantly increase revenues, (2) projects that have not previously been included in Aquila's rate base, and (3) projects to replace, relocate, upgrade, protect, or otherwise extend the useful life of existing infrastructure. The investments would include any capital investments made to comply with federal mandates or homeland security, but would not include general plant.

REQUEST FOR WAIVER RELATING TO RATE CASE EXPENSE

On June 1, 2006, the Board issued an order denying Consumer Advocate's motion to dismiss Aquila's waiver request and taking the request to waive the limitation on rate case expense recovery in 199 IAC 26.4(1) with the record of the

rehearing of the CAT proposal. In the June 1, 2006, order, the Board stated that Iowa Code § 476.6(5) authorizes the Board to allow recovery of rate case expense, including the expenses incurred by the utility, up through a decision on rehearing, however, subrule 26.4(1) places a limit on that recovery. The Board directed Aquila and Consumer Advocate to file additional rate case expense information through the date of reply briefs on rehearing.

To grant a waiver of a Board rule, the Board must find that there is clear and convincing evidence that the four criteria in rule 1.3 are met. Those four criteria are: 1) the application of the rule would pose an undue hardship on the person for whom the waiver is requested, 2) the waiver would not prejudice the substantial legal rights of any person, 3) the provisions of the rule subject to the waiver are not specifically mandated by statute or another provision of law, and 4) substantially equal protection of health, safety, and welfare will be afforded by a means other than that prescribed in the rule for which the waiver is requested.

The Board finds that it would be an undue burden on Aquila for it to be required to forgo the recovery of rate case expense for the rehearing of the CAT issue. The Board granted rehearing to allow for a full consideration of the issues raised, because those issues had not been fully litigated in the initial case since the Board was presented with a settlement. On rehearing, Aquila and Consumer Advocate were therefore required to address all of the issues raised concerning the CAT. It would be unreasonable to deny Aquila the recovery of the expenses

associated with presenting the evidence necessary for a comprehensive review of the issue.

The Board finds that the waiver would not prejudice the substantial legal rights of any person since Iowa Code § 476.6(5) requires that the Board allow recovery of costs of the litigation. The limitation on rate case recovery to reply briefs in the initial case is not mandated by statute or other provision of law and substantially equal protection of health, safety, and welfare will be afforded by a means other than that prescribed in the rule for which the waiver is requested.

Aquila and Consumer Advocate have filed their additional expenses. Aquila has indicated it has expenses of \$117,174 for the rehearing, and Consumer Advocate has billed approximately \$38,847. Board expenses billed to Aquila through September 1, 2006, are approximately \$27,000. Aquila may file for recovery of rate case expenses through the date of the issuance of this order by filing a revised tariff and supporting documentation consistent with the tariff approved for the general rate increase in this docket. Rehearing rate expense is to be recovered over the same amortization period as the rate case expense in the initial case.

ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. The proposal to adopt a capital additions tracker for recovery of integrity capital investments is denied.

2. The request for waiver of 199 IAC 26.4(1) filed by Aquila, Inc., d/b/a Aquila Networks, on June 1, 2006, is granted. Proposed tariffs including the additional rate case expense shall be filed within 30 days of the date of this order.

UTILITIES BOARD

/s/ John R. Norris

/s/ Diane Munns

ATTEST:

/s/ Judi K. Cooper
Executive Secretary

/s/ Curtis W. Stamp

Dated at Des Moines, Iowa, this 12th day of September, 2006.