BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of The Empire District Electric Company to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its Missouri Service Area.	)))))	Case No. ER-2006-0315

PREHEARING BRIEF OF STAFF OF PUBLIC SERVICE COMMISSION

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STAFF'S PREHEARING BRIEF

OFF-SYSTEM SALES

What amount should be included in Empire's revenue requirement for off-system sales?

It is the Staff's position that the annual level of off-system sales margin the Commission should use when setting rates in this case should be the level of off-system sales margin Empire actually experienced during the historical twelve months ending March 31, 2006—the end of the update period ordered by the Commission in this case. In contrast, the Office of the Public Counsel proposes the Commission use a five-year unadjusted average of Empire's actual off-system sales levels and Empire proposes the Commission use an adjusted five-year average, with December 2001 through June 2003 American Electric Power transactions excluded from the average. (Fischer rebuttal pp. 2-3; Fischer surrebuttal p. 3).

Notably the Staff's position on this issue is only $101,000 above that of the Office of the Public Counsel while Empire's position exceeds the Staff's position by approximately $1.2 million. (Reconciliations filed August 25, 2006). In other words, if American Electric Power transactions in December 2001 through June 2003 are included when determining the five-year average, the result is near that the Staff obtained by using the level of off-system sales Empire actually experienced during the historical twelve months ending March 31, 2006! The dollar

values associated with the December 2001 through June 2003 American Electric Power transactions are in no way abnormal or out-of-line compared to the level of sales margin achieved by Empire during the test year. (Smith surrebuttal, p. 3)

The Staff initially reviewed Empire's off-system sales over the past five years (Fischer direct p. 29), later extending its review to seven years (Fischer Rebuttal p. 2) and decided to use the level for the most recent twelve months ending with the end of the ordered update period because: (1) the level of off-system sales during the twelve months ended March 31, 2006 better matches the levels of all other generation related costs included in the Staff's revenue requirement (Fischer Rebuttal pp. 4-5), (2) coal supply constraints in the market that began about June 2005 and are expected to continue for an indefinite period allowed Empire to increase its off-system sales margin dollars per MWH for each MWH sold thereby encouraging Empire to maximize its off-system sales (Fischer Rebuttal p. 5-6), and (3) the correlation between off-system sales revenues, costs and margins is stronger in the short term (January 2005 through March 2006) than in the long term (1999 through March 2006) (Fischer Rebuttal p. 6 and Fischer Highly Confidential Schedule 2). Additionally, the Staff believes the pronounced increase in gas and purchased power costs affecting the fuel and purchased power markets in the last five years supports using the recent twelve months ending with the end of the ordered update period for determining the level of Empire's off-system sales. Notably, no party in this case suggests use of a multi-year average for determining the level of Empire's fuel and purchased power expense. (Fischer surrebuttal p. 7)

The Staff believes Empire's stated rationale for excluding December 2001 through June 2003 American Electric Power transactions in its five-year average—that these transactions with a single entity generated over 71 percent of Empire's gross profit on off-system sales in 2002 and

2003—is an insufficient basis for excluding the transactions. If these transactions are excluded the off-system sales margin percentages of margin to revenue for 2002 and 2003 (annual), with the exception of three months, drop below those of each of the eighty-seven months (monthly) the Staff reviewed. (Fischer rebuttal pp. 3-4) Further, if these transactions are included in a five-year average, the resulting sales margin percentages are at the midpoint of the sales margin percentages of the eighty-seven months the Staff reviewed. (Fischer rebuttal p. 4) Finally, Empire did not exclude these transactions in its last rate case before this Commission, Case No. ER-2004-0570, when Empire sponsored a five-year average for of Empire's actual off-system sales levels. (Fischer surrebuttal p. 6)

FUEL AND PURCHASED POWER EXPENSE

What is the appropriate level of on-system fuel and purchased power expense Empire should be allowed to recover in rates?

It is the Staff's position that the annual level of on-system fuel and purchased power expense the Commission should use when setting rates in this case should be the adjusted level of on-system fuel and purchased power expense Empire actually experienced during the historical twelve months ending March 31, 2006—the end of the update period ordered by the Commission in this case. (Fischer direct pp. 20-27).

A primary goal in this case is to set rates in this case that best match what Empire's annual revenue requirement is anticipated to be while the rates set in this case are in effect. Part of that revenue requirement is what Empire is expected to pay for natural gas and electricity it purchases. The cost of purchased electricity is highly dependent on the cost of natural gas. Natural gas prices and purchased power prices have escalated, both during the last five years and in the test year itself. However, in this proceeding, there is no dispute concerning purchased power prices in determining Empire's revenue requirement.

There is much agreement among parties that natural gas prices are extremely volatile and future natural gas prices cannot be predicted accurately. Choe rebuttal ; Busch supp. direct, pp. 3-4; Fischer surrebuttal p. 9; Tarter rebuttal p. 12; Smith direct p. 9; Smith rebuttal pp. 3-4; Brubaker direct p. 10; Brubaker surrebuttal pp. 8-9) As a result there is much disagreement about the best approach for determining the prices of natural gas to use in determining Empire's annual revenue requirement. Here the Staff used two prices of natural gas to derive an overall natural gas price to use in determining Empire's annual revenue requirement. As explained following, the Staff first used historical information from the twelve months ended March 31, 2006 to arrive at average prices for "hedged" natural gas and "spot market" natural gas. Then the Staff used a weighted average of these two prices to generate an overall natural gas price to use in determining Empire's annual revenue requirement.

Empire's natural gas hedging program is intended to remove some of the risks associated with natural gas price volatility. By purchasing natural gas for future delivery, Empire can "lock-in" the price for part of its future gas needs. (Fischer direct, p. 25) In this proceeding, the Staff proposes the Commission use the actual hedged contract prices for natural gas taken from contracts Empire had in place by the end of the update period (March 31, 2006). Those contracts are for natural gas to be supplied to Empire during the period April 2006 to December 2007. By doing so the Commission would rely on natural gas price information that is known and measurable information by the end of the ordered update period but that will be delivered to Empire during the remainder of 2006, as well as calendar year 2007, a period when rates from this case likely will be in effect. (Fischer direct pp. 23-24)

The portion of Empire's natural gas needs that it does not meet with hedged purchases Empire buys on the "spot market" immediately before burning it. (Fischer direct p. 26) For

natural gas Empire buys on the spot market, the Staff averaged the actual prices Empire paid on the spot market for gas during the twelve months ended March 31, 2006. (Fischer direct p. 24)

To derive a single overall natural gas price to be used in setting Empire's rates in this proceeding, the Staff determined a reasonable weighted average of hedged gas costs and spot market gas costs. Empire's current "Energy Risk Management Policy" requires Empire to hedge a minimum of 60% of its anticipated natural gas needs up to a maximum of 80%. (Tarter Direct Schedule TWT-1, page 9) For anticipated natural gas needs in 2006, Empire exceeded its maximum percentage, and has over **_____** of its anticipated natural gas needs hedged.

Empire has over **______** of its anticipated natural gas needs in 2007 hedged at this time, and is considering additional hedges to increase that percentage up to **_____**. (Fischer surrebuttal, p. 12) Based upon this history, the Staff believes it reasonable to base a single overall natural gas price for Empire on an assumption that 80% of Empire's gas purchases would be hedged and the remaining 20% would be purchased on the spot market. Based upon this weighting and the average actual hedge price and spot price the Staff derived, the Staff arrived at an overall natural gas price to use in determining Empire's annual revenue requirement in this proceeding of **______** per MMBtu. (Fischer direct, p. 24)

In its case Staff consistently uses Empire's actual spot natural gas prices for the twelve months ended March 31, 2006, and known and measurable hedged contract costs for gas as of March 31, 2006. (Fischer direct pp. 23-25) In contrast, with its rebuttal filing, Empire uses forecasted calendar year 2007 natural gas prices as of July 10, 2006. (Tarter rebuttal pp. 2-3, 5-6) and, with their surrebuttal filing, Praxair and Explorer Pipeline use actual natural gas prices for the period January to August, 2006 and forecasted natural gas prices for the balance of 2006. (Brubaker surrebuttal p. 7).

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Given the lack of a significant correlation between natural gas prices in the futures market one year before closing of a contract and spot prices at the time of closing a year later (Choe rebuttal pp. 4-5), it is the Staff's position that the average price Empire paid for spot natural gas during the twelve months ended March 31, 2006, best reflects the spot natural gas prices that Empire will pay annually for spot natural gas in the near future while rates from this case are in effect.

The hedged natural gas price Empire uses is based upon its calendar year 2007 hedges in place as of July 10, 2006 (with approximately **_____** of its expected gas usage in 2007 hedged at that point in time). The remaining **_______** of Empire's gas usage for 2007 was valued by Empire at a higher spot gas price based on forecast (NYMEX futures prices as of July 10, 2006). (Fischer surrebuttal, p. 11). Recent history shows Empire has hedged **_____** or more of its natural gas usage; therefore, Empire's assumption of only **____** of its natural gas usage being hedged for ratemaking purposes serves only to overstate Empire's true natural gas costs, given that Empire has consistently hedged gas for delivery at prices below the prevailing spot market price when the gas was delivered. (Fischer surrebuttal 11-13)

There is an approximate $4.465 million revenue requirement difference between Empire and Staff in this case due to natural gas prices. (Reconciliations filed August 25, 2006) The majority of that difference is due to the different weights each party assigned to the hedged gas prices and spot market prices they used in determining their overall recommended gas cost for Empire. (Fischer surrebuttal, p. 13)

FUEL AND PURCHASED POWER EXPENSE RECOVERY METHOD

What method should be used for recovery by Empire of its fuel and purchased power expense?

alternatively,
IEC Continuation:

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Should the Commission continue to enforce the 3-year term of the Interim Energy Clause that was approved by the Commission in Case No. ER-2004-0570?

(1) Is the Commission barred from terminating the Interim Energy Clause by Section 386.266.8?

(2) Relying upon the four corners of the Stipulation and Agreement, are the terms of the IEC ambiguous?

(3) In the event that the Stipulation and Agreement is found to be ambiguous, does Empire's actions demonstrate its belief that it was bound to a 3-year term?
   (i) What is the practical construction that Empire has given to the agreement?
   (ii) What is the burden of proof of ambiguity and on whom does it rest?
   (iii)What is the significance of a burden of proof?

(4) Has Empire properly applied to terminate the Interim Energy Clause, approved by the Commission in Case No. ER-2004-0570?

(5) What standard should the Commission apply in deciding whether to prematurely terminate the IEC?

(6) Would be the extent of Empire's financial harm if it were bound to the remaining term of the IEC?
   (i) What is the comparative financial harm that would be experienced by the ratepayers if the agreement were prematurely terminated?

(7) In the event that Empire is permitted to prematurely terminate the Interim Energy Clause, what amount of revenues collected by Empire under the IEC should be refunded to customers?

The Staff has no position on this issue; however, Staff witnesses Oligschlaeger and Fischer are testifying on potential impacts to the Staff's revenues for Empire if the IEC is terminated.

GAIN FROM UNWINDING FORWARD NATURAL GAS CONTRACT

Should Empire's gain from unwinding a forward natural gas contract during the test year offset test year fuel and purchased power expense? If so, should the entire gain be an offset in the test year, or should it be amortized and only a portion of the gain be applied as an offset in the test year?

During the test year, Empire elected to "unwind" (or cancel) a forward natural gas contract with British Petroleum resulting in a gain to Empire in excess of $5 million that it used to reduce test year fuel/purchased power expenses. (Fischer direct, pp. 19-20) It is the Staff's position that Empire's forward natural gas contract with British Petroleum was simply a routine hedging contract; however, due to the exceptionally large gain Empire recognized from unwinding that contract in 2005, for ratemaking purposes, the gain from unwinding that contract should be "smoothed out" by amortizing it over a five year period, and then the annualized amount should be netted against Empire's annual fuel expense. (Fischer Direct pp. 19-20; Fischer surrebuttal p. 14) In contrast, Empire's position is that the gain should be excluded altogether and Praxair and Explorer Pipeline's position is that the full amount of the gain should be used as an offset to Empire's annual fuel expense. (Fischer Surrebuttal p. 14)

Empire argues the gain should be excluded as a "highly unusual and non-recurring" transaction. There are several flaws with this argument. First, **_______________ ____ ____.** This indicates that the nature of the transaction that led to the $5 million dollar gain is neither unusual nor unforeseen by Empire. (Fischer surrebuttal, p. 16) Second, from an accounting perspective an event must both be of an unusual nature and infrequent in its occurrence to be treated differently, and such items must be treated differently on a company's income statement—"they should be segregated from the results of ordinary operations and be shown net of taxes in a separate section of the income statement." (Fischer Surrebuttal p. 15) Empire's accounting statements filed with the SEC do not show this gain was given such accounting treatment, Empire's external auditor PriceWater Coopers did not reflect such special accounting treatment and Empire's Risk

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Management Oversight Committee continues to evaluate Empire's hedging contracts for whether it would be prudent for Empire to "unwind" them. (Fischer Surrebuttal pp. 15-16)

Further, Empire's position appears to the Staff to be an attempt to bolster an argument that Empire should be able to continue to designate forward natural gas contracts as normal purchases, as it currently does. If Empire unwinds forward natural gas contracts as a normal course of business, it will be required to account for its physical gas supply contracts on a mark-to-market basis to conform with Generally Accepted Accounting Principles (GAAP) and United States Securities and Exchange Commission (SEC) reporting requirements. This it does not currently do. Accounting under the mark-to-market basis requires recording the price or value of all gas hedges each quarter. That price or value is determined by calculating profits and losses from the hedge contract dates to the ending date of the company's financial statements, and may result in more volatility in a company's financial statements due to the effects of gas price volatility. (Fischer surrebuttal pp. 16-17)

Normalizing the amount of the 2005 unwinding gain over five years appropriately recognizes that ratepayers support in rates Empire's hedging program, and serves to share the benefit of the 2005 unwinding gain between Empire's shareholders and ratepayers. (Fischer direct, p. 20).

RATE DESIGN/COST-OF-SERVICE

How should any revenue increase for Empire that results from this case be implemented in rates?

It is the Staff's position that if the interim energy charge is not terminated then permanent rates should be changed in proportion to each class' percentage of current permanent revenues. (Busch direct p. 5)

It is the Staff's position that if the interim energy charge is terminated then permanent rates should be changed in proportion to each class's current share of total rate revenues, where total rate revenues are equal to current permanent revenues plus the IEC revenues. (Busch direct p. 6; Busch rebuttal p. 2)

The Staff's position on the implementation in rates of any revenue increase the Commission orders in this case is dependent upon whether the current interim energy charge is terminated because the basis for setting the interim energy charge is different than the bases for setting Empire's permanent rates. The interim energy charge was designed to collect revenues based on a portion of total fuel costs, whereas permanent rates were designed to collect revenues based on the costs associated with the entire cost to serve for Empire. (Busch direct p. 6-7) The interim energy charge is collected on a cents-per-kilowatt-hour basis while Empire's current permanent rates are based on collecting the costs associated with Empire's entire cost to serve its customers, aside from the fuel and purchased power costs collected through the IEC. Those permanent rates include customer, demand, and energy charges. (Busch direct p. 5)

The heart of the Staff's position is the Staff's belief the revenues Empire collects from each class under its current rates are an appropriate basis for collecting current revenues plus any change in total revenues the Commission may order, *i.e.*, with the exception of customer charges, all rate elements should be increased, or decreased, in the same proportion to collect any change in current revenues the Commission may order. (Busch direct pp. 6-8) The Staff excepts customer charges from an increase because fuel costs are typically not recovered in customer charges (the increase sought here is largely driven by fuel costs) and customer charges were changed in Empire's last recent rate case, Case No. ER-2004-0570. (Busch direct p. 8)

The revenue increase Empire is seeking in this case is largely driven by increases in Empire's fuel and purchased power costs. If the Commission terminates Empire's interim energy charge then all fuel and purchased power costs will be recovered through permanent rates. Those revenues already being collected for fuel should be recognized when calculating new permanent rates. Staff's approach accomplishes this by using permanent revenues plus interim energy charge revenues as the basis for increasing current permanent rates, if the Commission terminates Empire's interim energy charge. (Busch direct pp. 6-8)

In contrast to the Staff's proposed rate design, if the Commission terminates the interim energy charge, the Office of the Public Counsel proposes a rather complex formula for calculating the appropriate class revenues. The Office of the Public Counsel proposes application of an equal percentage increase to any increase associated with non-variable fuel costs and any net variable fuel costs, with a limitation that the variable fuel-related revenue requirement increase allocated on an equal percentage basis not exceed 29.91% (the base level of fuel from the previous case, $85,064,873, divided by current revenues in this case, $284,423,930 multiplied by 100%), and that any variable fuel-related revenue requirement increase over the limitation and purchased power expenses be allocated to the classes based on the class' share of total kWh divided by total kWhs. Unlike the Office of the Public Counsel's proposal, the Staff's proposal is easy to understand and implement, and maintains the current revenue relationship among the classes that was recently created in Empire's last general rate increase case, Case No. ER-2004-0570. (Busch rebuttal pp. 1-3)

The Staff and the Office of the Public Counsel agree on rate design if the Commission does not terminate the interim energy charge.

RATE DESIGN SUBISSUE

The sub-issue listed for rate design is an issue with Praxair and Pipeline Explorer. That sub-issue is:

What level of revenue credits should be recognized for purposes of allocating any revenue requirement increase?

With perhaps the exception of customer charges, the Staff and Praxair agree that in this case any change in rates should be implemented by an equal percentage across-the-board adjustment to all rate schedules. (Brubaker rebuttal pp. 2-3) However, they disagree on the revenues to be used to determine that equal percentage increase.

In determining Empire's revenues for purposes of rate design, it is the Staff's position that Empire's revenues from Praxair and Explorer Pipeline should be based on gross revenues from them (i.e., prior to the application of special discounts), not revenues net of special discounts. (Pyatte rebuttal p. 2-3; Wells rebuttal pp. 1-2)

Using revenue net of special discounts for purposes of rate design would violate the NonUnanimous Stipulation and Agreement Regarding Fuel and Purchased Power Expense the Commission ordered the parties to perform in Case No.ER-2004-0570. That stipulation and agreement, at page 12, states that stipulated discounts for Praxair and Explorer Pipeline should "…not affect the rates of Empire's other Missouri retail customers or be recovered from Empire's other Missouri ratepayers…" Using special discounts to Praxair and Explorer Pipeline in determining rate revenues for rate design has the impact of decreasing the percentage of any Commission-ordered revenue requirement to be recovered from Praxair and Explorer Pipeline and, as a result, would require either the other Missouri customers to pay more or for Empire's shareholders to bear the cost of these special discounts. (Pyatte rebuttal p. 3)

Using gross revenues does not run afoul of the NonUnanimous Stipulation and Agreement

Regarding Fuel and Purchased Power Expense the Commission ordered the parties to perform in Case No.ER-2004-0570. (Pyatte rebuttal pp. 3-4)

In their rebuttal case Praxair and Explorer Pipeline offset revenues by Praxair's interruptible credits for purposes of rate design. Their stated rationale for using the interruptible credit as an offset is that doing so "properly distribute[s] any revenue change and recognize[s] the interruptible nature of Praxair's load." (Brubaker rebuttal pp. 2, 4-5)

The Staff did not offset the revenues attributable to Praxair by the interruptible credits Praxair receives from Empire for purposes of rate design because the interruptible credit itself is a recognition of the interruptible nature of Praxair's load. When Staff annualizes and normalizes rate revenue, interruptible credits, as well as excess facilities are treated as other rate revenues, not as Total Missouri Normalized Revenue. (Wells direct, schedule CW-1) This is done so that customers receiving interruptible credits do not benefit from this twice—once through the credit itself and a second time by a smaller increase in rates than those imposed on other customers, assuming all rates are changed on an equal percentage basis. Note that if rates are decreased, if the interruptible credit offset is applied, customers receiving interruptible credits will receive a smaller decrease in their rates than other customers, if rates are changed on an equal percentage basis.

REGULATORY PLAN AMORTIZATIONS

Should Empire's revenue requirement include regulatory plan amortizations? If so, (i) how should Empire's off-balance sheet obligations be valued for purposes of the amortizations and (ii) should the amortized amount be subject to an income tax gross-up?

The Staff would note from the outset that the approach to additional amortizations that it is taking in the instant Empire rate increase case is the same approach that it is taking in the

pending Kansas City Power & Light Company (KCPL) rate increase case, Case No. ER-2006-0314 (Oligschlaeger Surrebuttal, p. 11, lns. 1-5).

In accordance with the Empire Regulatory Plan Stipulation And Agreement in Case No. EO-2005-0263, the Staff has performed calculations in the instant proceeding to determine whether regulatory plan amortizations are required under either the Interim Energy Charge (IEC) Continuation or the IEC Termination scenario. The Staff's analyses show that additional amortizations should be included in Empire's rates under both the IEC Continuation and IEC Termination scenarios (Oligschlaeger Supplemental Direct, pp. 1-2; Oligschlaeger Supplemental Direct Schedules 1 and 2).

It appears that the Office of the Public Counsel (OPC) and Praxair, Inc. and Explorer Pipeline Company are not the only parties with whom Empire disputes the terms of a recent Stipulation And Agreement. Empire also disputes the terms of the "III.D.2. Amortizations To Maintain Financial Ratios" section, pages 11-15, of its Regulatory Plan Stipulation And Agreement with the Staff, OPC and Praxair/Explorer Pipeline.

The Staff initially raised the additional amortizations issue in Staff's Response To Empire's Motion For Clarification, respecting the IEC Continuation versus the IEC Termination issue, filed in this case on April 24, 2006, wherein the Staff stated as follows in paragraph 16 of its pleading:

> The Staff would further note that the Agreement in Case No. EO-2005-0263, which constitutes Empire's regulatory plan respecting the construction of Iatan 2, provides for certain dollar amortizations to be included in Empire's cost of service in order to help Empire maintain investment grade credit metrics from the August 12, 2005 effective date until and including the time of Empire's required rate case filing which incorporates Empire's investment in Iatan 2 (estimated to be December 1, 2009). Consequently, if Empire finds, as a result of much higher prudently incurred fuel and purchased power expense, that its cash flows even with the IEC are falling below certain benchmarks, Empire may seek ratemaking recognition of this condition via the amortization mechanism provided for in that

Agreement.

Praxair, Inc. and Explorer Pipeline Company also addressed this matter in their April 24, 2006 Response To Motion For Clarification Or, In the Alternative, Request For Extension To Conduct Further Discovery And Motion For Hearing, wherein they stated in part as follows in their paragraph 50:

> . . . if Empire under-recovers fuel and purchased power expense under the IEC, and to the extent that this under-recovery is not offset by revenue growth or reductions in other expense items, it may have the effect on Empire's 'funds from operations'. To the extent that this under-recovery may cause Empire's ratio of: (1) Adjusted Funds from Operations Interest Coverage and (2) Adjusted Funds from Operations as a Percentage of Average Total Debt to slip below the ratio range set forth by Standard and Poor's and adopted by the Parties, then Empire will be eligible for additional amortizations to the extent necessary to bring these ratios back into line with those guidelines.

On May 1, 2006, Empire filed its Reply Concerning Responses To Motion for Clarification wherein it asserted that other parties are engaged in a "diversion" as follows in paragraphs 32 and 33:

> 32. The raising of this alleged "possibility" is a mere diversion intended to distract the Commission from the real issues before it. The amortization referenced by these parties is not designed to provide recovery of ongoing operation expenses. It is designed to provide additional cash flow to address cash needs (and the impact of those cash needs on investment ratings) during the period of construction related to Iatan 2. Furthermore, there is no construction underway at this time and Empire currently has not yet even executed an agreement to become a partner in Iatan 2. The Stipulation and Agreement in Case No. EO-2005-0263 states that it will become "null and void," if Empire does not become a partner with KCPL for an ownership interest in the Iatan 2 plant. Moreover, utilizing the amortization in this situation would be extremely unreasonable and unfair. Essentially, it would fund ongoing operating expenses (fuel costs), through a reduction in the Company's future rate base. Thus, earnings would be impacted negatively both now and in the future.
>
> 33. Additionally, it is not clear that the cited amortization provisions are even applicable to this situation. The Stipulation states in part that "Empire will not argue for or receive increased cash flows from its Missouri regulated electric operations needed to meet the financial ratio targets . . . to the extent caused by. . . any costs not included in Empire's Missouri jurisdictional electric revenue

> requirement by the Commission" (EO-2005-0263, Stipulation and Agreement, p. 14). The amortization "suggested" by the Staff and Praxair/Explorer would only be necessary because of a failure to include Empire's fuel costs in its revenue requirement. Thus, it does not appear to be applicable to the situation at hand.

This position of Empire next appears in the testimony of Mr. William L. Gipson, one of Empire's witnesses on this issue, wherein Mr. Gipson states in his Supplemental Direct Testimony, page 4, lines 14-16 that "[t]he amortization vehicle which resulted from the Company's regulatory plan docket is designed to maintain certain Standard & Poor's ("S&P") ratios during the construction of Iatan 2." In his Rebuttal Testimony, page 2, lines 9-10, Mr. Gipson says: "No substantial construction is underway to my knowledge. In any event, the construction of Iatan 2 is not a driving factor in this rate case." OPC witness Ted Robertson and Staff witness Mark L. Oligschlaeger each noted in Surrebuttal Testimony, Mr. Robertson at page 33, lines 1-12 and Mr. Oligschlaeger at page 4, lines 3-8 that according to Empire's response to OPC's Data Request No. 1024, Empire as of June 30, 2006 booked over $300,000 of Iatan 2 construction costs.

Mr. Oligschlaeger related in his Supplemental Direct Testimony, page 3, lines 6-10 that:

> . . . the Staff has viewed the [Case No. EO-2006-0263] regulatory plan amortizations as applying even before the construction of Iatan 2 literally commences. The Staff views the regulatory plan as a good faith effort to assist Empire in maintaining an investment grade credit rating commencing with the Commission's approval of the regulatory plan through the commercial operation date of Iatan 2 in 2010.

There is nothing that directly limits the amortization calculations solely to the financial impact of Iatan 2 construction expenditures on Empire's cash flow. (Oligschlaeger Rebuttal Testimony, p. 3, ln. 7 – p.4., ln. 2). In fact, as noted by Mr. Oligschlaeger in his Surrebuttal Testimony at page 2, line 19 to page 3, line 4, the Staff's position is consistent with the literal language of the Regulatory Plan Stipulation And Agreement, and Mr. Gipson's position is contrary to the very

language of the Regulatory Plan Stipulation And Agreement. The very terms of the Regulatory Plan Stipulation And Agreement, at pages 12-13, make the additional amortization provision applicable to the instant case and the pending circumstances:

> ***The Signatory Parties agree to support an additional amortization amount added to Empire's electric cost of service in any general rate case filed prior to the rate case that includes the Iatan 2 investment*** when the projected cash flows resulting from Empire's Missouri jurisdictional electric operations, as determined by the Commission, fail to meet or exceed the Missouri electric jurisdictional portion of the financial ratio targets shown in Appendix D , for the Adjusted Funds from Operations Interest Coverage ratio and the Adjusted Funds from Operations as a Percentage of Average Total Debt ratio. The Signatory Parties agree to support an amortization level necessary to meet the Missouri jurisdictional portion of these financial ratio targets identified in Appendix D and calculated in a manner consistent with Appendix D. [Emphasis added.]

OPC witness Mr. Robertson testifies that the amount of construction costs incurred to date is not the deciding factor upon which to include an amortization is to be based. (Robertson Surrebuttal, p.3, ln. 19 – p. 4, ln. 15). Praxair, Inc. and Explorer Pipeline Company witness Maurice Brubaker states in his surrebuttal testimony that (1) by its terms the amortizations of the Empire Regulatory Plan Stipulation And Agreement are available to Empire in the instant case, (2) the rationale for Empire for the Regulatory Plan went beyond Iatan 2, and (3) construction is underway regarding the gas-fired generating unit to be located at Riverton as well as the SCR equipment at the coal-fired Asbury generating station. (Brubaker Surrebuttal, p. 13, ln. 20 – p. 14, ln. 27).

Mr. Brubaker testifies that there is a balance under the Regulatory Plan Stipulation And Agreement between shareholders and customers, which Mr. Gipson is attempting to avoid:

> . . . Shareholders benefit from the fact that Empire receives revenues and associated cash flow to which it otherwise would not be entitled under a strict revenue requirement analysis. . . . while customers pay increased rates now, they receive recognition of these increased rates in future years in the form of an amortization reserve. Recognizing that this amortization reserve is an offset to rate base, the Company will have a lower rate base in the future and, all else being

> equal, the future rates will be lower than they otherwise would have been without the amortization reserve.
>
> .   .   .   .
>
> . . . The whole point of Mr. Gipson's testimony disavowing the use of the regulatory amortization mechanism is to avoid recognizing any rate increase as a result of regulatory amortizations and instead have the entire increase be recognized as a cost of service increase.

(Brubaker Surrebuttal, p.15, lns. 3-11; p. 16, lns. 6-9).

Given the Iatan 2 construction cost argument that Empire has chosen to make regarding the additional amortizations provision in the Empire Regulatory Plan, it must not have any concerns about arguments regarding Section 393.135 RSMo 2000, which often is also referred to as Proposition One.

Staff witness Oligschlaeger relates in his Surrebuttal Testimony at page 10, lines 15-23, that the Staff used an amortization approach as part of a settlement of a Staff earnings/revenues investigation of Kansas City Power & Light Company (KCPL) in 1994 In Case No. EO-94-199. (In the matter of the Customer Class Cost of Service and Comprehensive Rate Design Investigation of Kansas City Power & Light Company). In addition to a Phase I annual rate reduction of $9 million for electric service provided on and after July 9, 1996, and a separate Phase II annual rate reduction of $11 million for electric service which would take place no later than May 1, 1997, KCPL agreed to book an amortization totaling $3.5 million annually upon approval of the Case No. EO-94-199 Stipulation And Agreement. *See also Re Kansas City Power & Light Co.*, Order Approving Stipulation And Agreement, 5 Mo.P.S.C.3d 76 (1996). This amortization continued to the KCPL Experimental Regulatory Plan, which provides for its conclusion upon the effective date of the tariff sheets resulting from the pending KCPL rate case. The KCPL Experimental Regulatory Plan Stipulation And Agreement states as follows regarding the Case No. EO-94-199 amortization:

III.B.1.h. CURRENT AMORTIZATIONS

KCPL will continue to include as a component of cost of service $3.5 million in Missouri jurisdictional amortization expense, from the effective date of this Agreement until the effective date of the tariffs resulting from Rate Filing #1, per Paragraph III.B.3.a of this Agreement, to be filed in 2006, for rates effective in 2007**.** KCPL shall maintain adequate records that identify the $3.5 million of annual amortization expense originally authorized in *Re Customer Class Cost of Service and Comprehensive Rate Design Investigation of Kansas City Power & Light Company*, Order Approving Stipulation and Agreement, Case No. EO-94-199, 5 Mo.P.S.C.3d 76 (1996) on a state specific basis, by vintage year so that Missouri customers will receive recognition, of the amortization funds they have provided, in the determination of rate base for the Missouri jurisdiction, in future rate proceedings.

There is even another amortization at pages 31, 36, and 40 in the KCPL Experimental Regulatory Plan Stipulation And Agreement, Attachment No. 1 to the Commission's Report And Order in Case No. EO-2005-0329, as a result of the Staff's earnings audit of KCPL in the context of the development of the KCPL Experimental Regulatory Plan, of $17 million for the 2006, 2007 and 2008 rate cases, respectively.

The Staff would note that Mr. Olischlaeger did identify at page 5, lines 6-17 of his Rebuttal Testimony six bases set out in the Empire Experimental Regulatory Plan Stipulation And Agreement at page 14 for not allowing an additional amortization related amount and he stated that none of these bases applied to the Staff's recommendation in the instant case. These bases for denying Empire an additional amortization amount is if the need is caused by (1) inadequate cash flows from its non-Missouri retail regulated operations; (2) inadequate cash flows from any wholesale operations; (3) inadequate cash flows from the non-regulated subsidiaries; (4) any risk that is unrelated to Empire's Missouri regulated electric operations; (5) any Empire imprudent costs; or (6) any costs not included in Empire's Missouri jurisdictional electric revenue requirement by the Commission.

Both Mr. Gipson at page 2 of his Rebuttal Testimony, lines14-16 and Empire witness Steven M. Fetter at page 2 of his Rebuttal Testimony, lines 4-8 and 17-19 contend that the Staff

is proposing the additional amortization as a substitute for the timely recovery of prudently incurred fuel and purchased power expense. Mr. Gipson and Mr. Fetter go further and advocate action beyond the provision for additional amortizations. Mr. Gipson asserts that the additional amortization mechanism "was not designed . . . as a substitute for an adjustment to the Company's authorized return on equity in the absence of timely recovery of costs" (Gipson Rebuttal, p. 2, lns. 14-17), and Mr. Fetter contends that "[u]ntil a reasonable means of providing such timely recovery is established for Empire District, the return on equity that the Commission sets for the Company should be increased to reflect the greater operational risk that Empire District is facing" (Fetter rebuttal, p. 4, lns. 5-9).

Mr. Oligschlaeger responded in his Rebuttal Testimony at page 5, lines 3-5 that there are many factors besides recovery of fuel and purchased power expenses that affect Empire's cash flow and hence its need for regulatory plan amortizations. He testified that the additional amortization calculations are based on the entirety of the Staff's revenue requirement calculations for the IEC Continuation and IEC Termination scenarios reflecting the Staff's adjusted levels of revenues, expenses, rate base and rate of return. (Oligschlaeger Surrebuttal, p. 5, lns. 2-4).

Although Mr. Fetter refers to the Empire Regulatory Plan additional amortization mechanism as "an innovative component that has been viewed positively by the financial community," both he and Mr. Gipson warn the Commission from using the additional amortization mechanism. (Fetter Rebuttal, p. 2, lns. 11-12). Mr. Oligschlaeger ascribes this Empire approach to being veiled arguments by Empire against Commission adoption of the IEC Continuation scenario of Praxair/Explorer Pipeline and OPC. (Oligschlaeger Surrebuttal, p. 6, lns. 3-10). Mr. Oligschlaeger relates that there is no reason for the Empire Regulatory Plan

additional amortization mechanism to affect the Commission's decision on the IEC Continuation/IEC Termination issue. He also notes that the other issues in this case, and in future cases while the Empire Regulatory Plan is in place, relating to revenues, expenses, rate base and rate of return should be decided on their merits, independent of the availability of the Empire Regulatory Plan amortization mechanism. (*Id.* at 6, ln. 22 – p. 7, ln. 12).

Assuming there is an amortization calculation, the Staff and Empire appear to be in agreement as to what items constitute Empire's off balance sheet obligations, and how the off-balance sheet obligations should be valued. OPC disagrees with both the off-balance sheet obligations included in the amortization calculations by the Staff and Empire, and the quantification of the off-balance sheet obligations by the Staff and Empire. Mr. Oligschlaeger explained in his Supplemental Direct Testimony that operating leases and purchase power agreements are considered to be off-balance sheet obligations by credit rating agencies; off balance sheet obligations are considered fixed obligations by credit rating agencies; off-balance sheet obligations are either wholly are partially treated as debt for purposes of calculating leverage and coverage ratios; and off-balance sheet obligations are included in credit rating agencies analysis of a utility's debt levels. (Oligschlaeger Supplemental Direct, p. 8, ln. 22 – p. 9, ln. 8). To be conservative, the Staff used the Standard & Poor's estimate of $72 million total debt equivalent value for Empire's off-balance sheet obligations as reported in a May 18, 2006 Standard & Poor's Research Report which states:

> When conducting its credit analysis of Empire, Standard & Poor's makes various adjustments to the company's reported financial figures. We consider off-balance-sheet (OBS) obligations – including operating leases and PPAs such as the Elk River Windfarm Contract – fixed commitments, and impute debt and interest components when calculating credit measures. As of 2006, after these OBS obligations are accounted for, Empire's total debt and interest expense increase by about $72 million and $7 million, respectively.
> (Schedule 3-3)

(*Id.* at 10, lns.2-21).

OPC witness Ted Robertson testifies that the off-balance sheet obligations should be valued in the amortization calculating the net present value of the future stream of lease or contract payments, discounted back to their present value using a 10 % discount rate and once their present value is determined, a portion is treated as the debt-equivalent, based on the application of a debt equivalent. (Robertson Rebuttal, p. 22, ln. 28 – p. 24, ln. 4). Mr. Robertson states that the Standard & Poor's Rating Services Utility Financial Ratio Definitions, updated January 13, 2005 identifies a range of risk factors to be applied to off-balance sheet obligations to determine their debt equivalent value with 10 % being the lowest value of the possible values identified by Standard & Poor's. (*Id.*. at 23, ln. 29 – p. 25, ln. 6). OPC believes that the risk factor to apply should be no more than 10 % for the following reasons:

> . . . Since Empire is a regulated public utility operating within the state of Missouri, Public Counsel believes that the risk it will default on any individual off-balance sheet obligation is almost nonexistent. Therefore, the lowest risk factor available in the rating agency methodology should be utilized to the [sic] determine the debt-equivalent value of each off-balance sheet obligation. It is Public Counsel's belief that application of the lowest risk factor to the off-balance sheet obligations does not violate the methodology terms agreed to in the Experimental Regulatory Plan Stipulation & Agreement.

(Robertson Rebuttal, p. 25, lns. 12-20; *See also* Robertson Surrebuttal, p. 8, ln. 1 – p. 9, ln. 10). On this basis, OPC adjusted the Staff's amortization calculations to reflect its proposed debt equivalent value for off-balance sheet obligations, using a 10% risk factor (Robertson Surrebuttal, p. 6, lns. 5-15; p. 8, lns. 2-8).

OPC also adjusted the Staff's amortization calculations to remove the impact of the off-balance sheet obligation relating to the Plum Point Power Plant purchased power agreement, on the grounds that this transaction was entered into in April 2006, outside of the ordered test year

and update period for this proceeding. (Robertson Surrebuttal, p. 9, lns. 12-23). Since Mr. Robertson's regulatory plan amortization adjustments relating to off-balance sheet obligations appear in his Surrebuttal Testimony, the Staff did not have an opportunity to address these adjustments in prefiled testimony.

Both the Empire and the KCPL Regulatory Plan Stipulation And Agreements address taxes. The former states at page 13 and the latter states at page 21: "Additional taxes will be added to the amortization to the extent that the Commission finds such taxes to be appropriate." (It should be noted that the mechanism itself is referred to as an "amortization" in both Regulatory Plan Stipulations and Agreements.) The former states at Appendix F-2 and the latter states at Appendix D-2: "The Signatory Parties have not agreed to a methodology to determine the tax impacts related to additional FFO."

The Staff believes the appropriate approach regarding the regulatory plan amortizations, i.e., the treatment of the regulatory plan amortizations as additional allowances of depreciation/amortization expense, including a corresponding amount to the straight line tax depreciation deduction, only requires these amounts to be collected in rates from ratepayers on a dollar-per-dollar basis with no gross-up for tax purposes, and will not cause Empire to incur tax liability with rate recovery of the regulatory plan amortizations. (Oligschlaeger Surrebuttal, p. 9, lns. 6-21). Mr. Oligschlaeger testifies that if the regulatory plan amortizations were treated as taxable income by federal and state taxing authorities, it is probable that a utility's receipt of deferred tax benefits related to ongoing plant additions will compensate for any incremental tax liability associated with amortization amounts included in rates. (Oligschlaeger Supplemental Direct, p. 10, ln. 25 – p. 11, ln. 6).

OPC takes the position that the amortization amount should not be grossed up for income taxes for the same reasons as Staff and on the basis that the Experimental Regulatory Plan Stipulation and Agreement identifies the amortization as an expense item. (Robertson Rebuttal, p. 27, lns. 17-22). Mr. Robertson states that the following language in the Experimental Regulatory Plan Stipulation and Agreement indicates that the amortization is in fact additional depreciation expense, and, therefore, there should be no gross-up for income tax on the amortization amount:

> This paragraph does not preclude a party from requesting that this amortization be directed toward specific plant accounts or from requesting additional changes in depreciation rates that may result from depreciation studies.

(*Id.* at 28, ln.3. – p. 29, ln. 10).

Consistent with the ratemaking treatment used for any increase in allowed book depreciation expense, the Staff reflects for the Regulatory Plan amortization a straight line tax depreciation tax deduction consistent with the additional amortization amount in the Staff's cost of service determination. (Oligschlaeger Surrebuttal, p. 10, lns. 8-14).

Thus, Staff witness Oligschlaeger took issue with the testimony of Empire witness L. Jay Williams who testifies that the regulatory plan amortizations are akin to an additional allowance of return on equity (ROE); therefore, are not tax deductible expenses, but will be treated as taxable income by the Internal Revenue Service (IRS); and thus, must be grossed-up for tax purposes in the ratemaking process for recovery from ratepayers. (Oligschlaeger Surrebuttal, p. 8, lns. 9-14).

Under Generally Accepted Accounting Principles (GAAP) and regulatory accounting conventions, amortizations are considered to be an expense, and expenses are generally considered to be fully deductible for income tax purposes. Also consistent with utility company

collections of depreciation and amortization expense in rates, the Empire and KCPL Regulatory Plan Stipulation And Agreements require a rate base offset to be booked related to any amortization amounts collected in rates. In contrast, ROE allowances collected in rates have no associated rate base offset treatment. (Oligschlaeger Surrebuttal, p. 9, ln. 21 – p. 10, ln. 7).

The Staff's approach is consistent with the ratemaking treatment used for any increase in allowed book depreciation expense and with the annual $3.5 million amortization previously noted respecting KCPL in Case No. EO-94-199. The $3.5 million amortization has been booked by KCPL since the Commission's approval of the Case No. EO-94-199 Stipulation And Agreement in 1996 as an additional book depreciation with the accumulated balance being reflected as a reduction to rate base. A corresponding straight line tax depreciation deduction has been assumed in subsequent Staff earnings investigations of KCPL. (Oligschlaeger Surrebuttal, p. 10, lns. 15-23; *See also* Robertson Surrebuttal, p. 11, ln. 17 – p. 12, ln. 3).

KCPL filed the surrebuttal testimony of Bryan Weiss in response to the rebuttal testimony of OPC witness Ted Robertson that the additional amortization provided for by the Empire Regulatory Plan should not be grossed-up for income taxes, which is supportive of the Staff position expressed by Mr. Oligschlaeger at pages 11-12 of his Supplemental Direct testimony. (Weiss Surrebuttal, p. 2, lns. 4-17). Mr. Weiss testifies that KCPL is very concerned because the amortization provided for in Empire's Regulatory Plan is very similar to the amortization approach approved by the Commission for KCPL in Case No. EO-2005-0329. Since Mr. Weiss' testimony was filed as surrebuttal, the Staff did not have an opportunity to respond to it.

INCENTIVE COMPENSATION

Are all the costs of Empire's incentive compensation plan an expense Empire should recover from Empire's ratepayers? If not, what costs should be recovered?

Empire has three employee incentive compensation plans:

(1) management incentive compensation plan (MIP), which has three components;

(a) base salary

(b) cash incentive
(i) Threshold (50% of target payout),
(ii) Target (100% of target payout), and
(iii) Maximum (200% of target payout).

I long-term stock incentives
(i) Stock options
(ii) Performance shares

(2) discretionary compensation awards for salaried non-officer employees; and

(3) lump sum payments in the nature of bonuses for non-union salaried employees called "Lightning Bolts."

(McMellen Direct, p. 9, ln. 18 – p. 10, ln. 21). The Staff proposes adjustments respecting each of the programs.

Gene E. Bauer, Ph.D. of the HayGroup, Inc. submitted Rebuttal Testimony on behalf of Empire. He testifies that the Compensation Committee of Empire's Board of Directors, with guidance and information provided by HayGroup, has established the following compensation philosophy and target for each of three categories of executive pay and he believes that Empire's executive compensation levels are reasonable, when compared to its peer companies as well as the market place as a whole:

Executive Pay:

- Base salary – targeted at the 25th percentile, i.e., above 25% of comparable executives at other companies;

- Total cash compensation (base salary plus annual incentive) – targeted at the 25th percentile; and

- Total direct compensation (total cash plus long-term incentives – targeted at the middle point between the 25th and 50th percentiles.

(Bauer Rebuttal, p. 6, ln. 3 – p. 7, ln. 17). Ms. McMellen testifies that the targeted percentiles above are based on the HayGroup's Executive Compensation Report of 700 (All-Exec Group) organizations across all industry sectors, not the Peer Group Compensation Market (peer group) of twelve publicly traded electrical utilities referred to by Dr. Bauer in his Rebuttal Testimony. (McMellen Surrebuttal, p. 3, ln. 14 – p. 4, ln. 6).

Regarding Empire's compensation for non-executive salaried employees, Dr. Bauer states that Empire has established an appropriate process for constructing its compensation plan and making compensation decisions and follows best practices in compensation structure by allocating a fixed amount of an employee's compensation to a variable pay program tied directly to the attainment of goals and objectives set forth by management and aligned with Empire's overall vision and business strategy. (Bauer Rebuttal, p. 7, ln. 18 – p. 8, ln. 18.).

Dr. Bauer asserts that he is not aware of any expertise possessed by the Staff that would justify its recommended elimination of the compensation payments that were established by the Compensation Committee of the Empire Board of Directors. He states that determining compensation is the managerial province of the Compensation Committee and "the Commission should be extremely circumspect and careful when asked to substitute its judgment for that of the Committee on what should be a goal for incentive compensation." (Bauer Rebuttal, p. 12, lns. 1-18).

Ms. McMellen testifies that Dr. Bauer does not appear to believe that the Commission or its Staff should perform any review of the targets/goals utilized by Empire respecting incentive compensation and that this incentive compensation should be fully recovered in rates because it

is reasonable compared to a peer group of companies and the general market. This approach is not consistent with how the Commission and the Staff have proceeded regarding this matter in the past. (McMellen Surrebuttal, p. 4, ln. 7 – p. 6, ln. 4). Ms. McMellen notes that the incentive compensation amounts disallowed by the Staff are a small portion of Empire's total payroll costs. (McMellen Surrebuttal, p. 12, lns. 1-5).

MIP: Staff Disallowance = **____________**[1]

The MIP was available to Empire's six (6) senior officers (President and Vice Presidents). The MIP is based on recommendations from an executive compensation study prepared by HayGroup. The Staff is not opposed to a portion of executive compensation being placed "at risk" by Empire so long as Empire shows that the particular approach results in ratepayer benefits. The Staff is not aware of any executive retention problem at Empire and Dr. Bauer did not address any recruitment or retention problems at Empire in his Rebuttal Testimony. (McMellen Surrebuttal, p. 11, lns. 1-6, 15-18).

MIP: Base Salary

The Staff treated the base salary component of MIP the same as the base salary of other employees and included this entire amount in its annualization of payroll.

MIP: Cash Incentive – Staff Disallowance = **____________**[2]

Each senior officer had a list of goals with a specific performance measure for each goal for the senior officer, such as expense control, customer service, regulatory performance and financial performance, and a weighting for each goal for the senior officer. The amount of the award received by the senior officer was determined by the senior officer's attainment of a specific performance level. (McMellen Direct, p. 10, lns. 3-18). **____________________

[1] McMellen Surrebuttal, Schedule ACM 2-1 HC

[2] McMellen Surrebuttal, Schedule ACM 2-1 HC

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.** (McMellen Direct, p. 12, ln. 17 – p. 13, ln. 7).

Based on the Staff's view that financial goals primarily benefit shareholders, the Staff eliminated from recovery awards related to attainment of earnings goals, thus requiring shareholders to bear the cost of these incentives. The Commission historically has not allowed incentive payments for goals related to the financial performance because these goals primarily benefit shareholders. (McMellen Direct, p. 11, lns. 8-25; McMellen Surrebuttal, p. 5, lns. 4-24). The Commission stated this position in a 1997 Missouri Gas Energy (MGE) rate case, Case No. GR-96-285, Report And Order, 5 Mo.P.S.C.3d 437, 458 (1997), and reaffirmed its position in a 2004 MGE rate case, Case No. GR-2004-0209, 12 Mo.P.S.C.3d 581, 606-07 (2004):

> The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders, not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.
>
> If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the costs of that plan. The portion of the incentive compensation plan relating to the company's financial goals will be excluded from the company's cost of service revenue requirement.

In addition, on the basis that incentive pay should be for employee performance beyond basic job requirements and for the provision of benefits to Empire ratepayers, the Staff eliminated incentive payment for goals related to non-regulated activities. Ms. McMellen notes in her Direct Testimony on page 12 lines 4-9 that the Commission stated in its Report And Order

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in a 1987 Staff earnings/revenues complaint case against Union Electric Company, Case Nos. EC-87-114 and EC-87-115, Report And Order, 29 Mo.P.S.C.(N.S.) 313, 325 (1987) that:

> . . . At a minimum, an acceptable management performance plan should contain goals that improve existing performance, and the benefits of the plan should be ascertainable and reasonably related to the plan . . .

In its Report And Order issued in the Staff's 1988 excess earnings/revenues complaint case against Southwestern Bell Telephone Company (SWB), Case No. TC-89-14, et al., the Commission stated:

> In the Commission's opinion the results of the parent corporation, unregulated subsidiaries, and non-Missouri portions of SWB, are only remotely related to the quality of service or the performance of SWB in the State of Missouri. Achieving the goals of SBC [the parent company] and unregulated subsidiaries is too remote to be a justifiable cost of service for Missouri ratepayers. Accordingly, the Staff's proposed disallowances in the senior management's long-term and short term incentive plans…should be adopted. 29 Mo.P.S.C. (N.S.) 607, 627 (1989).

The Commission reiterated its position in its Report And Order in the Staff's 1993 excess earnings/revenues complaint case against Southwestern Bell, Case No. TC-93-224, et al.:

> The structure of the plan provides an implicit incentive for participants to try to increase SBC's stock price. This in turn could encourage senior managers to spend a greater percentage of time on non-regulated companies and discourage time and effort spent on Missouri operations…The likelihood of SBC managers emphasizing whatever they perceive will cause the market to react favorably to SBC stock, including giving priority to unregulated subsidiaries, further convinces the Commission that Missouri ratepayers should not fund the long-term incentives. 2 Mo.P.S.C.3d 479, 531-32 (1993).

Finally, the Staff eliminated Empire's cash incentives that were paid out for outcomes that were over budget or past the scheduled completion date. Empire uses "at budget" and "on schedule" as target levels, but commences payouts of cash incentives of 50% of the target level for outcomes that are over budget and past the scheduled completion date. Ms. McMellen testifies that by using over budget and past the scheduled completion date as bases for awarding incentive compensation, employees are being rewarded for performance below an appropriate

level of expectation. (McMellen Direct, p. 12, lns. 10-16; McMellen Surrebuttal, p. 5, ln. 25 – p. 6, ln. 4). Regarding awarding incentive compensation for being over budget, Ms. McMellen noted in her Surrebuttal Testimony that the executives at Empire receiving incentive compensation tied to budget goals are the same individuals who approve the budgets that are used as the performance indicators. Thus, there is an incentive for executives to set budgets at a level that can be achieved rather than at a level that represents true improvement in performance. (McMellen Surrebuttal, p. 6, lns. 5-14).

MIP: Long-Term Stock Incentives

Staff Disallowance = **__________** (Stock Options) + **________** (Performance Shares)[3]

The MIP long-term stock incentive is made up of stock options and performance shares. The number of performance shares awarded is determined by a HayGroup comparison of total shareholder return between Empire and the companies in a peer group. Stock options are considered part of the senior officers' total compensation and have a three-year vesting period. The granting of these stock options is not associated with any increase in duties of or achievement of goals by the executives and no measurement of whether any specific level of performance was met or exceeded. The triggering mechanism for the awarding of these stock options is appreciation in share price and appreciation in share price can result from operating results involving many variables, such as weather, which are beyond the control of the individuals receiving the incentive compensation. (McMellen Direct, p. 10, ln. 19 – p. 11, ln. 5; McMellen Surrebuttal, p. 6, ln. 15 – p. 7, ln. 5).

The Staff eliminated all expenses for stock options and performance shares. The stock options also accumulate dividend equivalents during the three-year vesting period which are supposed to keep the senior officers focused on dividend maximization. Ms. McMellen testifies

[3] McMellen Surrebuttal, Schedule ACM 2-1 HC

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hat the Staff views these dividend equivalents as focused on stockholder benefits with no direct connection to improvement in operating performance or quality of service to the ratepayer. The triggering mechanism for awarding performance shares is total shareholder return (TSR), which is defined as Empire's stock price plus dividend paid out. Empire's TSR is compared to a peer group chosen by the HayGroup for the awarding of performance shares. The payout is tied to financial criteria, and the financial criteria are beyond Empire's control. It is the Staff's position that the MIP long-term stock incentive may benefit Empire's shareholders, but Empire and Dr. Bauer have not shown that there is a direct correlation between the related financial criteria or performance (stock price levels and dividend payouts) and benefit to Empire's ratepayers. (McMellon Direct, p. 13, ln. 8 – p. 14, ln. 3; McMellen Surrebuttal, p. 7, lns. 6-16; p. 8, lns. 3-16).

Ms. McMellen states that the peer group analysis referred to by Dr. Bauer was only used for awarding MIP long-term incentive performance shares based on the TSR goal. She testifies that the Staff agrees that commonality of industry and size are important traits for an executive compensation peer group, but the Staff's review of available information of the peer group companies reveals several of the utilities are considerably larger than Empire, there are utility companies within the peer group analysis performed by the HayGroup for Empire for which no annual incentives and/or long-term incentives are shown for the comparable executive positions selected, there is a mix of regulated to non-regulated business activity among the utilities, the utilities have varied corporate structures, and the utilities are located in different regions with different costs of living. (McMellen Surrebuttal, p. 9, ln. 8 – p. 10, ln. 12). The Staff would also note the comment of the Commission regarding the usefulness of industry analyses in the KCPL Wolf Creek Nuclear Generating Station case, *Re Kansas City Power & Light Co.*, Case Nos. EO-

85-185 and EO-85-224, Report And Order, 28 Mo.P.S.C.(N.S) 228, 281 (1986): "The Commission reiterates its position set out in Re: *Union Electric Company*, 27 Mo.P.S.C.(N.S.) 183 (1985). Industry comparisons do not establish a standard of prudence."

Discretionary Compensation Awards: Staff Disallowance = **__________**

The Staff eliminated from recovery a portion of this program. The amounts paid out per person range from **________________.** In aggregate, Empire has awarded the following amounts for the last three years: 2003 - $339,132; 2004 - $358,385; and 2005 - $412,445. **___

____

____________________________________.** The Staff reviewed a sample of salaried non-officer employees provided by Empire that received discretionary compensation awards and a description of the criteria under which the awards were granted to these individuals. Certain employees were receiving awards for objectives that were part of the employees' normal job duties, for involvement in charitable contribution campaigns or activity that did not involve traditional cost-of-service matters. The Staff determined a percentage for these activities for the sample and applied the percentage to the total discretionary compensation funds awarded to salaried non-officer employees. The Staff disallowed this amount from Empire's cost of service as being unnecessary for the provision of safe and adequate service at just and reasonable rates. Ms. McMellen states there is no direct correlation between these discretionary compensation awards and benefits to Empire's ratepayers. (McMellen Direct, p.14, ln. 8 – p. 15, ln. 16).

"Lightning Bolts": Staff Disallowance = **_________**

Ms. McMellen testifies that the "Lightning Bolts" is a discretionary cash award program for non-union salaried employees who deliver results beyond the results normally associated with their positions. There are no set criteria established or attached to the earning of "Lightning

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Bolts" awards. Thus, employees cannot ascertain the level of performance necessary for such an award. Payments are made solely at the discretion of management. Empire responded to a Staff Data request that reasons for making "Lightning Bolts" awards included working on the United Way campaign, working on the Aquila gas property acquisition, and performing normal job duties. The Staff eliminated these incentive awards for the not meeting the criteria established by the Commission in the previously identified Report And Orders. For 2005, the amounts paid out per person range from **_____________.** In the last three years the amount paid out has totaled as follows: 2003 - **_______**; 2004 - **_________**; and 2005 - **__________.** (McMellen Direct, p.15, ln. 17 – p. 16, ln.14).

Dr. Bauer does not specifically address Empire's position respecting the "Lightning Bolts" awards in his Rebuttal Testimony. (McMellen Surrebuttal, p. 11, lns. 19-22).

RATE OF RETURN ISSUES

1. Return on Common Equity: What return on common equity should be used for determining Empire's rate of return?

2. Capital Structure: What quantification of total long-term debt and preferred stock should be used in determining Empire's capital structure for ratemaking purposes?

In determining Empire's Rate of Return (ROR), the Commission must ensure that returns for Empire's shareholders are commensurate with returns realized by investors in other enterprises with corresponding risks.[4] Just and reasonable rates must include revenue sufficient to cover prudent operating expenses, service debt and pay a dividend commensurate with the risk involved.[5]

[4] *See Fed. Power Comm'n v. Hope Nat. Gas Co.,* 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943); *Bluefield Water Works & Improv. Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923).
[5] *Id.*

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The fair rate of return is simply the Company's weighted average cost of capital (Murray Direct, p. 16). The weighted average cost of capital is obtained by multiplying each component of the Company's capital structure by its cost and summing the results (*id.*). The capital structure consists of some proportion of debt and some proportion of equity at a given moment in time (*id.*). The costs of the various components of the capital structure vary considerably; in general, debt costs less than equity (King Direct, p. 4). However, as the proportion of debt in the capital structure increases, the Company's financial risk also increases (*id.*). For debt and preferred equity, the cost is a known quantity – "embedded." However, the cost of common equity must be determined by expert analysis.

Return on Common Equity (ROE):

Staff's expert, David Murray, determined Empire's cost of common equity (COE) at 9.5% to 9.6%, using a Discounted Cash Flow (DCF) analysis of five comparable companies (Murray Rebuttal, p. 3; Murray Direct, p. 18). Murray states, "I continue to believe that the DCF model is the most reliable model to use when estimating a utility company's cost of common equity, whether the estimation is based on a comparable company analysis or on a company-specific analysis" (Murray Direct, p. 4). Murray used a Capital Asset Pricing Model (CAPM) analysis as a check on the result of his DCF analysis (Murray Direct, pp. 19, 23-26). He considered the results of 10.26%, 8.98% and 6.24% to provide "considerable support" for the results of his DCF analysis of five comparables (Murray Direct, p. 25).

Public Counsel's expert, Charles King, also used a DCF analysis of 16 comparable companies to determine Empire's COE at 9.65% (King Direct, p. 3). King described the DCF analysis as "the most credible test of market return" (King Direct, p. 2) and "the most reliable basis for estimating returns to equity" (*id.,* at p. 19). Like Staff analyst Murray, King also used a

CAPM analysis as a check on the results of his DCF analysis (King Direct, p. 3). The result of King's CAPM analysis was 9.85%, a result that King testified "supports" the result of his DCF analysis (King Direct, p. 23).[6]

Staff and Public Counsel's expert are clearly in general agreement as to Empire's COE. By contrast, Empire's expert, James Vander Weide, is not in agreement at all. Vander Weide estimated Empire's COE at 11.7% (Vander Weide Direct, p. 6). Vander Weide used a two-step analysis: first, he produced a preliminary result of 11.3% by applying "several standard cost of equity methods to market data for proxy groups of comparable companies" (Vander Weide Direct, p. 4-5). The analytical methods he used were the DCF, the CAPM, and the *Ex Ante* and *Ex Post* Risk Premium approaches (Vander Weide, pp. 5, 33-44). Second, Vander Weide "adjusted the average cost of equity for [his] proxy groups [by adding 0.4%] for the difference in the perceived financial risk of [the] proxy companies in the marketplace and the financial risk implied by [his] recommended capital structure for Empire" (Vander Weide Direct, pp. 4, 6). In other words, when the result obtained from Vander Weide's use of traditional methods of financial analysis was not high enough, he simply raised it. Vander Weide's final result, consequently, is utterly subjective and not worthy of credence.

Vander Weide justified the second step of his analysis – the 40 basis points "gross up" – because "Empire's recommended capital structure . . . embodies greater financial risk" (Vander Weide Direct, p. 6). His reasoning is that because "financial leverage, that is, the use of debt financing, increases the risk of investing . . . the cost of equity would be higher for a capital structure containing more leverage" (Vander Weide Direct, p. 50). This second analytical step is a new twist in Vander Weide's methods and he only started using it in 2004 (Murray Rebuttal, p.

[6] It is worth noting that the result of Vander Weide's own DCF analysis was 9.9%, a value comparable to the results obtained by Murray and King (King Rebuttal, p. 5).

5). Vander Weide admitted in his deposition in Empire's last rate case, Case No. ER-2004-0570, that no utility regulatory commissions have accepted his new method and that there are no journal articles endorsing it (Murray Rebuttal, p. 10). Murray states that Vander Weide's new methodology "can be confusing and lead to illogical results" (Murray Surrebuttal, p. 2).[7]

However, the truth is that Empire is not as risky an investment as its capital structure might suggest. First, the Missouri General Assembly has, with SB 179, allowed a Fuel Adjustment Clause (FAC). The effect on Empire is to reduce its risk significantly (King Direct, p.16). Vander Weide admits that this is so (Vander Weide Direct, p. 53). Second, Empire is operating under a Regulatory Plan, approved in Case No. EO-2005-0263, that calls for amortizations to be included in Empire's rates if necessary to protect its investment-grade-credit ratings.[8] The Regulatory Plan will protect Empire from any continued deterioration in it cash flow ratios (Oligschlaeger Rebuttal, p. 4). Third, Vander Weide's conclusion that Empire is a riskier investment than his group of comparables is based upon a conceptually flawed, "apples-to-oranges" comparison (King Rebuttal, p. 7). The equity valuation of Vander Weide's proxy group is based on market valuations while Empire's is based on book value (*id.*). In fact, Empire's market-value equity is 60.99% and thus directly in line with the 61.46% figure for Vander Weide's comparables (King Rebuttal, p. 8). The reality is that Empire "has a **lower financial risk** than the typical electric utility" (King Rebuttal, p. 8 – emphasis added). Vander

[7] *See* the extensive discussion in Murray's Rebuttal Testimony, pp. 17-26, and Surrebuttal Testimony, pp. 27-28.

[8] The Staff is recommending in this case that amortizations be reflected in Empire's rates under both revenue requirement scenarios before the Commission – with and without the Interim Energy Charge (IEC). This is particularly important if Empire is required to continue its current IEC in this proceeding, as the regulatory plan allows for Empire to recover any lost cash flow related to this treatment of its fuel expenses through an amortization mechanism.

Weide's "gross up" procedure should be rejected because it is a bogus analytical step, created solely to raise the Company's ROE.[9]

Vander Weide's "gross up" procedure has another fundamental infirmity: it violates fundamental principles of ratemaking long observed by this Commission. It is unvarying Missouri practice to value assets at original book value (Oligschlaeger Rebuttal, p. 7). Correspondingly, the equity that represents the shareholders' investment in those assets is also carried at original book value (*id.*). Subsequent market fluctuations in the value of either the assets or the equity are ignored for ratemaking purposes (Oligschlaeger Rebuttal, pp. 7-8), the reason being that these fluctuations do not yield any additional capital to the utility (*id.,* at 9). Vander Weide's "gross up" procedure based upon a comparison of market and book values violates the fundamental principles of original cost ratemaking (*id.,* at p. 11). Its purpose is to artificially raise Empire's ROE and increase the revenue stream realized by the Company from its captive ratepayers (*id.,* p. 12-13). Vander Weide's "gross up" procedure must be rejected.

Vander Weide's use of the standard cost of equity methods to obtain a preliminary result was also flawed.[10] He used the Quarterly Compounding Model with his DCF analysis to "inflate the rate of return" (King Direct, p. 18). While Vander Weide adjusted his results upwards to account for the greater risk of Empire's more heavily-leveraged capital structure, he failed to make any downward adjustment to correct for actions taken by Empire's management that tend to artificially inflate its DCF results. King testified, "there are factors specific to Empire that undoubtedly bias its DCF results upward" (King Direct, p. 16). King specifically notes Empire's

[9] The Commission should note that Staff expert Murray also made a 20 basis points upward adjustment in order to correct for Empire's comparatively low credit rating, which is a measure of risk (Murray Direct, p. 34; Murray Surrebuttal, p. 25).
[10] *See* King Rebuttal, pp. 3-5, for an exhaustive catalogue.

"arguably unwise" practice of "issuing larger dividends than its earnings per share" (King Direct, p. 16).

Vander Weide also used the Risk Premium approach and concluded from its results "that his own DCF return indications are understated" (King Direct, p. 24). However, the Risk Premium approach is conceptually flawed in that it requires its result as an input to the analysis (*id.*). King characterized Vander Weide's *Ex Post* Risk Premium analysis as having "serious problems . . . from both a statistical and conceptual standpoint" (*id.*) and concluded "that very little credibility can be ascribed to Dr. Vander Weide's ex post risk premium approach" (*id.,* at p. 27). Similarly, King dismissed the results of Vander Weide's *Ex Ante* Risk Premium approach as "useless as a test of equity return" due to "self-contradiction" (King Direct, p. 25).

In summary, while the results obtained by Staff expert Murray and Public Counsel expert King are similar and mutually-supporting, Company witness Vander Weide used a bizarre method of his own devising to reach a recommendation that is significantly higher. The explanation, as convincingly shown by both Murray and King, is that Vander Weide's method has been concocted for the sole purpose of producing a high ROE recommendation. The Commission should disregard Vander Weide's shamelessly manipulated results and select an ROE from within the range defined by Murray and King: 9.5% to 9.65%.

Capital Structure:

Once ROE has been selected, it can be plugged into the capital structure and the fair rate of return can be calculated.

Staff expert Murray used Empire's consolidated capital structure as of March 31, 2006 (Murray Direct, p. 16 and Sch's 9 and 20):

Component	Percentage of Capital Structure	Embedded Cost	Weighted Cost
Long-term Debt:	43.99%	7.02%	3.09%
Short-term Debt:	0.00%	0.00%	0.00%
Trust-preferred Stock:	6.27%	8.90%	0.56%
Common Equity:	49.74%		
	100.00%		

Murray included no Short-term Debt because its value, net of Construction Work in Progress (CWIP), was negative on March 31, 2006 (Murray Direct, p. 17 and Sch. 9, Note 3). In valuing the debt component of Empire's capital structure, Murray used net values calculated by deducting certain unamortized costs in order to determine the embedded cost of Empire's debt.

Public Counsel's expert, Charles King, used Empire's capital structure as disclosed to the Security and Exchange Commission (SEC) for the quarter ending March 31, 2006 (King Direct, p. 5; King Rebuttal, pp. 1-3 and Sch. CWK-1(Revised)):

Component	Percentage of Capital Structure	Embedded Cost	Weighted Cost
Long-term Debt:	51.64%	7.04%	3.64%
Short-term Debt:	0.00%	0.00%	0.00%
Preferred Stock:[11]	0.00%	0.00%	0.00%
Common Equity:	48.36%		
	100.00%		

Unlike Murray, King simply used the book values of Empire's debt.

Empire's witness Vander Weide used Empire's capital structure as of September 30, 2005 (Vander Weide Direct, pp. 51 and 53):

[11] King includes what Murray refers to as "Trust-preferred Stock" in Long-term Debt.

Component	Percentage of Capital Structure	After Tax Cost	Weighted Cost
Long-term Debt:	42.45%	4.29%	1.823%
Short-term Debt:	0.00%	0.00%	0.000%
Trust-preferred Stock:	6.11%	8.91%[12]	0.544%
Common Equity:	51.45%		
	100.01%		

The capital structure and values used by Vander Weide are wholly inappropriate because they have not been updated to March 31, 2006. Murray and King, on the other hand, both used updated capital structures. The Commission has said, "The use of updated figures is generally preferable as they more nearly reflect the Company as it will exist on the day that the new rates will take effect."[13] Murray used the net balance of Empire's debt to calculate Empire's embedded cost of debt. The Commission has said, "Where possible, the cost used is the 'embedded' or historical cost."[14] Murray's capital structure and component values are most accurate because it matches the costs with the values used to calculate these costs and should be adopted by the Commission.

Using the mid-point value of the range proposed herein by Staff as the ROE, Empire's fair Rate of Return can be calculated:

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[12] Murray testified that this figure should be 5.44% because the dividends are tax deductible (Murray Rebuttal, p. 20).

[13] *In the Matter of the Tariff Filing of The Empire District Electric Company,* Case No. ER-2004-0570 (*Report & Order,* issued March 10, 2005) at 38.

[14] *Id.,* at 37.

Component	Percentage of Capital Structure	Embedded Cost	Weighted Cost
Long-term Debt:	43.99%	7.020%	3.09%
Short-term Debt:	0.00%	0.000%	0.00%
Trust-preferred Stock:	6.27%	8.900%	0.56%
Common Equity:	49.74%	9.575%	4.76%
	100.00%		8.41%

In summary, Staff urges the Commission to determine Empire's fair Rate of Return using an ROE value from within the range proposed by Staff expert David Murray and Public Counsel's expert Charles King, and using the capital structure and embedded costs used by Staff expert David Murray.

LOW INCOME ASSISTANCE PROGRAM

Should Empire's Experimental Low-Income Program (ELIP) be continued with changes? If so, what should those changes be, should the Customer Program Collaborative (CPC) determine those changes and have oversight responsibility respecting the program, and how should the cost of the program be included in Empire's cost-of-service for collection from ratepayers? What should be done with unspent ELIP funds?

The Staff has not briefed this issue because the Staff believes that this issue is close to being settled. As a consequence, the Staff expending its resources elsewhere.

UNSPENT FUNDING OF CURRENT ENERGY EFFICIENCY AND AFFORDABILITY PROGRAMS

What should be done with unspent funds from the current energy efficiency and low-income weatherization programs? What should be the amortization amount respecting the demand side management (DSM) regulatory asset account?

The Staff has not briefed this issue because the Staff believes that this issue is close to being settled. As a consequence, the Staff expending its resources elsewhere.

Respectfully submitted,

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