BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Empire District Electric Company of Joplin, Missouri, for authority to file tariffs increasing rates for electric service provided to customers in the Missouri service area of the company.	)))))	Case No. ER-2008-0093

STAFF'S PREHEARING BRIEF

Comes now the Staff of the Commission by and through the Commission's General Counsel, and for its Prehearing Brief, states as follows:

INTRODUCTION

The Empire District Electric Company (Empire) filed tariffs seeking a general rate increase, together with direct testimony, on October 1, 2007. The tariffs seek a revenue increase of $34.7 million, representing a 10.1% increase in Missouri jurisdictional revenues. Empire describes the major driving factors for the rate increase as: 1. Capital additions made in 2007 including the Riverton 12 generating plant and pollution control facilities at the Asbury power station; 2. The financial impact of the January 2007 ice storm; and 3. Capital expenditures made to participate in new coal-fired generation at Iatan II and Plum Point. Empire also requests a fuel adjustment clause. (Gipson Direct, p. 4).

On October 3, 2007, the Commission suspended the effective date of Empire's tariffs until August 28, 2008, in order to enter upon a hearing concerning the propriety of Empire's proposed rates. The determination of just and reasonable rates follows a two-step analytical process: First, the revenue requirement is calculated. This is the sum of prudent operating costs and maintenance expenses plus a fair return on the depreciated value of the assets dedicated to the public service. Second, rates must be determined for each class of customers according to their consumption characteristics, such that the revenue realized from each customer class covers the cost to serve that class.

AGREEMENT AS TO CERTAIN ISSUES

On April 4, 2008, the Staff, Empire and the Office of the Public Counsel filed a Stipulation and Agreement proposing to resolve the following issues:

Outside Services

Edison Electric Institute Dues

State Income Tax Flowback

Rate Case Expense

Ice Storm Costs – Rate Base Treatment

Ice Storm Costs – Deferred Taxes

Amortization of January and December 2007 Ice Storm Expenses

Production Maintenance Expense (all issues except Asbury SCR), and

Deferred Taxes – VEBA

The result of the Stipulation and Agreement, approved by the Commission on April 23, 2008, was to increase Empire's revenue requirement by $1,248,000, exclusive of December 2007 ice storm expenses.

THE ISSUES AND ARGUMENT

The following issues are those requiring Commission determination

REVENUE REQUIREMENT

Rate of Return Issues

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

   a. In the event the Commission grants Empire a fuel adjustment clause, what, if any, is the appropriate adjustment to the authorized return on equity?

Introduction:

One of the most important and most difficult tasks facing the Commission in this and every rate case is determining the cost of common equity, or return on equity (ROE), to be used in calculating the rate of return (ROR) that is intended to compensate Empire's shareholders for the use of their private property committed to the public service. This task is important because each "basis point" is worth approximately $67,043 that Missouri working families and small business owners will have to provide to Empire by paying their electric bills.[1] The task is difficult because it is a matter of expert analysis and the Commission will have to sift through the conflicting opinions of various expert witnesses in seeking a reliable and fair estimate of Empire's ROE. Using similar data and methods, the experts reach significantly different conclusions, depending on whether they are testifying for the Company – which naturally desires a high ROE in order to maximize its profits – or testifying for the other parties, who desire a low ROE in order to minimize the electric bills they will have to pay.

[1] Empire's rate base is approximately $670,433,463, which, when multiplied by one basis point – one hundredth of a percentage point, 0.0001 – yields $67,043. *See Staff Accounting Schedules,* Schedule 1.

An expert witness is a witness that is qualified by "knowledge, skill, experience, training, or education" to assist the tribunal in understanding the evidence or determining a fact in issue.[2] Expert witnesses differ from ordinary witnesses in at least two important respects: first, they may testify as to their opinions and, second, they are paid – often very handsomely – to testify.[3] "Evaluation of expert testimony is left to the Commission which 'may adopt or reject any or all of any witnesses' testimony.' " *State ex rel. GS Technologies Operating Co., Inc. v. Public Service Commission of the State of Missouri,* 116 S.W.3d 680, 690 (Mo. App. W.D. 2003); *State ex rel. Associated Natural Gas Co. v. Public Service Commission of the State of Missouri,* 37 S.W.3d 287, 294 (Mo. App., W.D. 2000), quoting *State ex rel. Associated Natural Gas Co. v. Public Service Commission,* 706 S.W.2d 870, 880 (Mo. App. 1985). In evaluating the expert testimony in this case regarding Empire's ROE, Staff urges the Commission to be ever mindful of the bias inherent in the testimony of these hired guns. It is worth noting, in this regard, that only the Commission's Staff has no axe to grind.

The Recommendations of the Experts:

Staff has presented the expert testimony of Matthew J. Barnes, a member of Staff's Financial Analysis section. Using classic, time-tested methods applied to a comparable group of 17 electric utilities, Barnes proposes a range of 9.72% to 10.80% for Empire's ROE, selecting 10.26% as his final recommendation. (Barnes, Rebuttal, p. 2). Barnes relies primarily on the comparative, annual Discounted Cash Flow (DCF) method, tested for reasonableness against the results of the Capital Asset Pricing Model (CAPM).

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[2] Section 490.065.1, RSMo 2000.

[3] In a recent KCP&L rate case, Case No. ER-2006-0314, expert witness Robert Camfield testified that he had been paid $160,000 for his testimony.

The Company has presented testimony by James H. Vander Weide and the Industrial Intervenors have offered the testimony of Michael Gorman. The Commission has encountered both of these witnesses in recent rate cases. The recommendations of the several experts are summarized below:

Witness	**Party**	**ROE**
Vander Weide	Empire	11.60
Barnes	Staff	10.26
Gorman	Industrials	10.00

The Zone of Reasonableness:

Because the evaluation of expert ROE testimony is so fraught with difficulty and because the Commission rightly regards this expert testimony with some suspicion, the Commission has adopted in recent years a benchmark referred to as the "zone of reasonableness" against which the recommendations of the experts may be compared. This zone is defined as extending one hundred basis points – one percentage point – above and one hundred basis points below the recent national average of ROE awards in the appropriate regulated industry. The average ROE awarded in the electric industry for the most recent four quarters is 10.21%; therefore, the zone of reasonableness extends from 9.21% to 11.21%.[4] While the recommendations of both Barnes (10.26%) and Gorman (10.00%) are located comfortably within this zone, and close to the industry average at 10.21%, that of Professor Vander Weide at 11.60% is not. Professor Vander Weide's recommendation is 139 basis points above the industry average.

[4] First quarter 2008, 10.15%; fourth quarter 2007, 10.39%; third quarter 2007, 10.02%; and second quarter 2007, 10.27%, as reported by Regulatory Research Associates (RRA) (36 cases).

The construction of the zone of reasonableness is a significant matter. In his Surrebuttal Testimony, for example, Dr. Vander Weide suggests that only ROEs awarded to integrated electric utilities should be considered because such companies are more risky than mere "wires-only" utilities. (Vander Weide Surrebuttal, p. 9). He goes on to demonstrate that, with the "wires-only" values excluded, different averages can be obtained by including different quarters:

Example ROE Awards	
Period	**Average Award**
Calendar year 2007	10.51%
10-07 through 3-08	10.70%
4-07 through 3-08	10.60%

(Vander Weide Surrebuttal, p. 10 and Sch. JVW-1).

Staff concedes that it is possible to construct the zone of reasonableness in such a way that Dr. Vander Weide's recommendation is within it, although close to its upper limit. However, it is for the Commission, in its sound discretion, to define the zone of reasonableness. "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances." *Federal Power Commission v. Natural Gas Pipeline Co. of America,* 315 U.S. 575, 586, 62 S.Ct. 736, 743, 86 L.Ed. 1037, ___ (1942). "Not only can the Commission select its methodology in determining rates and make pragmatic adjustments called for by particular circumstances, but it also may adopt or reject any or all of any witnesses' testimony. *Associated Natural Gas, supra.* Staff notes that the manipulations suggested by Dr. Vander Weide cannot conceal the fact that, while the recommendations of Barnes and Gorman are clustered close together near the industry average figure, Vander Weide's is an outlier, significantly higher than the others,[5] and indeed higher than the highest ROE awarded in the nation in the year 2007. (Barnes Rebuttal, p. 9).

The Significance of the Zone of Reasonableness Analysis:

The Commission is guided in its difficult task of estimating Empire's cost of common equity by two decisions of the United States Supreme Court. In the earlier of these cases, *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia,* 262 U.S. 679, 692-93, 43 S.Ct. 675, 679, 67 L.Ed. 1176, 1182-83 (1923), the Court stated:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

Similarly, in the later of the two cases, *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943), the Court stated:

> '[R]egulation does not insure that the business shall produce net revenues.' But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be

[5] It is 134 basis points higher than Barnes', which is the second highest recommendation.

> commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

320 U.S. at 603, 64 S.Ct. 288, 88 L.Ed. 345 (citations omitted). From these two decisions, three guiding principles can be discerned:

(1) An adequate return is commensurate to the returns realized from other businesses with similar risks.[6]

(2) An adequate return is sufficient to maintain the utility's credit and to enable it to obtain necessary capital.

(3) An adequate return is sufficient to assure confidence in the financial integrity of the utility.

The first of these principles unmistakably requires a comparative process. The cost of common equity set by the Commission must be about as much as other, similar utilities are earning. The second principle, simply stated, refers to the effect of the Commission's decision on the utility's credit rating. If the Commission's decision will not cause it to drop, then the utility's credit is maintained and its ability to attract capital is unimpaired. The third principle is the summation of the other two: if the utility is earning about as much as other, similar utilities and its credit rating isn't damaged, then one may presume that confidence in its financial integrity is undiminished.

The Commission's analytical tool referred to as the zone of reasonableness is squarely founded on the first principle derived from the controlling decisions of the United States Supreme Court, *Bluefield Water Works, supra,* and *Hope Natural Gas, supra.* That is the principle of the commensurate return. The business entities that face

[6] What other businesses face similar risks? Other utilities.

"corresponding risks and uncertainties," in the language of *Bluefield,* are other electric utilities that do business in the same manner as Empire. Therefore, the Commission must look to the returns realized by those comparable companies in setting Empire's return on common equity.

Adjustments Up and Down:

Expert testimony on the subject of ROE often includes suggestions that the result of the comparative company analysis be adjusted up or down to reflect conditions specific to the utility under consideration. These conditions include such factors as unusual construction risk, heightened regulatory risk due to an adverse regulatory climate, increased financial risk due to a comparatively greater level of debt financing, and the like.

In the present case, Empire suggests an upward adjustment to account for regulatory risk. Empire presents the testimony of H. Edwin Overcast to the effect that Dr. Vander Weide's recommendation of 11.60% is not nearly high enough.[7] (Overcast Rebuttal, pp. 13-15). Overcast's rationale is that Missouri is a less-friendly regulatory climate than many other states and Empire, consequently, is less likely to achieve its authorized rate of return than the various comparable companies analyzed by the experts. Staff witness Mark Oligschlaeger points out that Mr. Overcast evidently missed the unusually favorable regulatory treatment afforded Empire by this Commission via the approval of a Regulatory Plan including an extraordinary amortization mechanism intended to maintain the Company's investment-grade credit rating. (Oligschlaeger Surrebuttal, pp. 10-13).

[7] Dr. Vander Weide, while not sponsoring an "adder" in this case, makes it abundantly clear that he believes such an upward adjustment is warranted. Vander Weide Direct, p. 42; Rebuttal, p. 7.

Michael Gorman, testifying for the Industrial Intervenors, suggests that Empire's ROE be reduced if the Commission chooses to grant Empire a Fuel Adjustment Clause (FAC). Gorman Direct, pp. 3-4. Staff notes that the effects of a FAC are already included in its comparable company analysis because the great majority of the proxies it used have a FAC.

Conclusion:

For these reasons, Staff urges the Commission to adopt an ROE determined using well-accepted methods and close to the industry average such as those recommended by Staff's expert witness Matthew Barnes and Michael Gorman. Barnes' recommended ROE, 10.26%, is sufficient to provide a fair return on the value of Empire's assets devoted to the public service.

Rate Base Issues

1. Asbury SCR: Should Empire's Asbury SCR equipment plant addition be included in Empire's rate base in this case? If yes, should it be included through an adjustment to Empire's revenue requirement or through a true-up procedure? If the Asbury SCR equipment is not included in Empire's rate base in this case, should any future emission revenue associated with that equipment flow through the FAC?

The Asbury SCR should not be included in Empire's rate base because it did not meet in-service criteria within the test year or update period ordered in this case. Empire installed Selective Catalytic Reduction (SCR) equipment at its Asbury generating station in order to reduce the amount of nitrogen-oxide (NOx) emissions from its generating units. The project is one of several rate base additions planned for 2005-2010 under Empire's regulatory plan approved in Case No. EO-2005-0263. In the regulatory plan case the parties agreed to develop in-service criteria and agreed that the Asbury SCR project will meet in-service criteria before the costs of the equipment will be included in rate base. (Oligschlaeger Rebuttal, p. 2).

When Empire filed this rate case on October 1, 2007, the Asbury SCR project was scheduled to be completed during a planned maintenance outage for the Asbury unit that was to be completed by the end of November 2007. The parties, including Empire, after an early prehearing conference agreed to jointly recommend a test year ending June 30, 2007, and a test-year update to include known and measurable changes through December 31, 2007 for this proceeding. No true-up beyond December 31, 2007 was recommended by the parties or ordered in this case. The Asbury SCR project was not verified to be fully operational and used for service as of December 31, 2007, because of mechanical problems during the maintenance outage for the Asbury generating unit. The outage lasted beyond the November 2007 projected date into 2008. The Staff concluded that the SCR finally met the in-service criteria sometime in February 2008, well outside the update period. (Taylor Surrebuttal, pp. 3-4). Empire asserts that the in-service date for the SCR equipment was February 29, 2008. (Mertens Rebuttal, p. 3) .

Empire claims the SCR should still be included in rate base because the SCR has met in-service criteria and will be operational before the costs for the SCR will be included in rate base. Empire also asserts that the SCR was complete and useful by December 31, 2007. It was only due to other issues unrelated to the SCR that the SCR could not be tested by December 31, 2007. (Mertens Surrebuttal, p. 3).

Section 393.135 RSMo. 2000 provides that any charge made or demanded by an electrical corporation for service based on the costs of construction or any other costs associated with owning, operating, or maintaining property before it is fully operational and used for service is unjust, unreasonable and prohibited. Consideration of this provision resulted in the parties agreeing to in-service criteria so that a determination could me made when the SCR became fully operational and used for service. The parties also agreed to a cut-off date to determine what will be included in rate base and what will not. Because the Asbury SCR did not meet the in-service criteria within the test-year update period, the SCR was not fully operational and used for service as required by law as of December 31, 2007.

Empire's argument that the SCR equipment should be included in rate base because it is in-service prior to the effective date of new rates in this proceeding (Mertens Rebuttal, p. 4) fails because that position ignores the agreement of all parties, including Empire, to a cut-off of known and measurable costs being included in the case as of year-end 2007. Such deadlines are established and enforced to allow for inclusion of all elements of a utility's revenue requirement to be reflected in rates in a matched and balanced way. The Commission also made clear in its *Suspension Order and Notice* in this case, dated October 3, 2007, that it expects all questions involving establishment of test years, update periods and the need for true-ups to be resolved as early as possible in the rate case. Reopening the question of the timing of known and measurable costs at this time is hardly consistent with this reasonable policy of the Commission. (Oligschlaeger Rebuttal, p. 6).

Empire argues that the Staff agreed to inclusion in rate base of the Asbury SCR equipment once it met in-service criteria agreed to by the Company, and purports to supports this argument with a quote from the Stipulation and Agreement in Case No. ER-2005-0263. (Mertens Rebuttal, p. 3). In response, the Staff states that while meeting in-service criteria is a necessary condition for inclusion of a plant addition in rate base, it is not a sufficient one. The plant addition in question still needs to be appropriately matched in time with other elements of the utility's cost of service, which can only be accomplished by adhering to the Commission's deadlines and cut-offs for inclusion of known and measurable costs in rates. (Oligschlaeger Surrebuttal, p. 14). The Staff further strongly disagrees that agreement to a set of in-service criteria is ever meant to supersede or override the establishment of known and measurable cut-off dates by the Commission. (Oligschlaeger Surrebuttal, p. 15).

Empire takes a further quote from the in-service criteria themselves to attempt to justify late inclusion of the Asbury SCR equipment in rate base, by noting that the criteria appear to allow evidence of in-service status to be discussed in Staff rebuttal or surrebuttal testimony. (Mertens Rebuttal, p. 5). In response, Staff Witness Taylor opined that Empire's quotations from the Asbury SCR in-service criteria were made in a selective and misleading fashion. The language quoted by Empire pertains to certain operational contract guarantee matters that may not be fully satisfied until several years after the equipment is installed. (Taylor Surrebuttal, p. 3). Staff witness Oligschlaeger noted that in some circumstances, when true-up audits are authorized by the Commission, meaningful evidence of in-service status may be introduced in Staff surrebuttal testimony or later. However, those circumstances do not apply here. (Oligschlaeger Surrebuttal, pp. 14-15).

Empire's claims that its position of only requesting recovery of costs expended on the Asbury SCR project through December 31, 2007 complies with the Commission's cut-off for inclusion of known and measurable costs in this proceeding is specious.

(Mertens Rebuttal, pp. 4-5). Staff responded by stating that all of Empire's investment in the Asbury SCR project as of year-end 2007 was reflected in its Construction Work in Progress (CWIP) account. Legally, of course, electric utility CWIP cannot be included in a utility's rate base until the addition is "fully operational and used for service." There is no dispute from Empire that the Asbury SCR equipment was not operational and used for service as of December 31, 2007. As the Asbury SCR project was not included in Empire's Plant in Service accounts as of year-end 2007, there are no costs related to that project that are relevant to a proper "matching" of the Company's rate base, revenues and expenses as of that point in time. (Oligschlaeger Surrebuttal, p. 15).

If the Commission determines that the SCR project should be in rate base, the Staff recommends that this is best accomplished through ordering a true-up rather than as an "isolated adjustment" to Empire's revenue requirement. Utilizing the true-up procedure will include an assessment of all of Empire's revenue, expense, rate base and rate of return components at a consistent point in time with the SCR project's in-service date, thereby appropriately matching and measuring those items consistently in time with the inclusion of the SCR. (Oligschlaeger Rebuttal, p. 6).

Finally, the Commission should note that not including the Asbury SCR in rate base will reduce Empire's cash flow compared to the scenario where it is included in rate base, which will likely result in an amount of additional amortizations from the Regulatory Plan Amortizations (RPA) mechanism. Therefore, the Staff asserts that Empire will likely receive compensation in rates for its investment in the Asbury SCR equipment through the RPA mechanism even if this investment is not included in its rate base. But Empire would not be compensated for any operating and maintenance expenses it incurs attributable to the SCR equipment until its next rate case. (Oligschlaeger Rebuttal, p. 7).

In Mertens surrebuttal testimony (pp. 4-5), Empire claimed for the first time that the Staff's position of denying rate base treatment to the Asbury SCR equipment is inconsistent with the Staff's position of including emission allowances in the FAC, including NOx allowances attributable to the SCR equipment, which would create an alleged violation of the matching principle. The biggest flaw in Empire's argument is that use of an FAC, a single-issue ratemaking mechanism, would inherently create many mismatches in timing of when different elements of Empire's cost of service are reflected in rates. Furthermore, Empire has not presented any conclusive information regarding elimination of a need to purchase or an ability to sell NOx emission allowances due to the installation of the SCR at Asbury Plant. To the Staff's knowledge, Empire has also not requested authority from the Commission to sell NOx allowances (similar to the authority granted in Case No. EO-2005-0020 for managing Empire's sulfur dioxide allowance inventory).

Expense Issues

1. <u>Off-System Sales Margins:</u> What amount of off-system sales margins, if any, should be included as an offset to Empire's cost of service?

The Staff concludes that the amount of off-system sales (OSS) margins that should be attributed to reduce Empire's cost of service is $4,415,779 (all amounts cited in this section of the brief are Total Company). This amount was calculated using Empire's OSS margins for the period from January 1 to June 30, 2007, and doubling the result to annualize the total over the year. This amount more accurately reflects the current status of Empire's experience in the OSS environment because Empire joined the Energy Imbalance Services (EIS) market operated by the Southwest Power Pool (SPP) in February 2007. Access to the SPP EIS market has allowed Empire to increase the level of OSS margins it has been able to achieve. (Staff Report, Cost of Service, Eaves, pp. 32-33).

The Office of Public Counsel claims that OSS sales margins of $5,955,336 should be used because that is the amount Empire made in calendar year 2007 and that this amount better reflects what Empire will make on an ongoing basis operating in the EIS market. (Kind Rebuttal, p. 3). As Empire's OSS margins in 2007 were the highest level Empire has been able to achieve by a substantial amount for at least the last nine years, Staff believes its calculation provides for a more conservative and reasonable approach to this issue. (Eaves Surrebuttal, pp. 3-4).

Staff also recommends that OSS margins be incorporated into any fuel adjustment clause pass through mechanism that the Commission authorizes. (Rebuttal, Mantle p.4) Including OSS revenues would mean that the majority of any difference between future achieved OSS margins and the OSS level reflected in rates to reduce the cost of service would be passed on to customers in the form of an increase or decrease in the company's FAC rate. (Eaves Surrebuttal, p. 4).

2. <u>Asbury SCR O&M Expenses:</u> Should Empire's projected operating and maintenance expenses associated with the Asbury SCR equipment be included in Empire's cost of service?

No, Empire's projected operating and maintenance expenses associated with the Asbury SCR should not be included in its cost of service. Because the SCR was not fully operational and used for service by December 31, 2007, it should not be included in rate base and any projected operating and maintenance expenses should not be considered in Empire's cost of service.

3. Asbury SCR Property Taxes: Should property taxes associated with the Asbury SCR equipment be included in Empire's cost of service?

Property taxes associated with the Asbury SCR should not be included in Empire's cost of service because the SCR should not be included in rate base. Even if the Commission determines that the Asbury SCR should be included in rates pursuant to a true-up period designed to capture the SCR's in-service date, the amount at issue for Asbury SCR property taxes still should not be allowed in cost of service. Empire will not incur or book any property tax expense related to the SCR project until January 2009 because the taxing authority assesses property taxes based on plant in service, materials and supplies, and construction work in progress as of the January 1 of each tax year. On January 1, 2008, the entire amount of Empire's investment in the Asbury SCR was booked to construction work in progress (CWIP). Therefore, any property taxes assessed the Asbury SCR investment in CWIP on January 1, 2008, will be capitalized by Empire and recovered through depreciation expense once the Asbury SCR project is included in rate base. No amount of property taxes attributable to the SCR project will be charged to expense by Empire until January 2009 at the earliest, so no recovery of property tax expense in this case associated with the Asbury SCR project is appropriate. (Mapeka Surrebuttal, pp. 12-15).

4. Asbury SCR Depreciation Expense: Should Empire's depreciation expense associated with the Asbury SCR equipment be included in Empire's cost of service?

No, SCR depreciation expense should not be included in Empire's cost of service because the SCR was not in service within the test year update period agreed to by the parties and ordered by the Commission.

The Commission should note that not allowing Empire to recover depreciation expense for the Asbury SCR project in this case will reduce Empire's cash flow compared to the scenario where the depreciation expense is included in rates, which will likely result in an amount of additional amortizations from the RPA mechanism. (Oligschlaeger Rebuttal, p. 7).

5. Commission Rules/Tracker: Should Empire's projected costs of compliance with the Commission's rules concerning vegetation management and infrastructure inspections be included in Empire's cost of service? If yes, should such costs be recovered using a "tracker mechanism" similar to that currently in place for Ameren UE? Should Empire be allowed deferral treatment of any incremental expenses it incurs above the amount reflected in its rates to comply with these rules?

Yes, the projected costs of compliance with the pending rules should be included as an expense in this proceeding. The estimated incremental costs for all vegetation management and infrastructure inspection activities expended to comply with Commission rules should be provided to Empire in advance and Empire should be required to expend the projected amounts each year for the next two years until the required Iatan II rate case is filed, now projected for 2010. A "tracker" mechanism should be employed to track Empire's costs to ensure that all of the projected expenditures are made. Deferral treatment of incremental expenses above an amount reflected in rates should not be allowed because it is not necessary. Empire will receive upfront rate recovery of the amounts needed to comply with Commission rules during the period of time these rates are expected to be in effect.

Final orders of rule making for the Commission's electrical infrastructure standards rule promulgated in Case No. EX-2008-0231 and the vegetation management standards rule in Case No. EX-2008-0232 were printed in the May 1, 2008 Missouri Register. They will be published in the June 1, 2008 Code of State Regulations with an effective date of June 30, 2008. Based upon data supplied by Empire, the incremental cost of compliance with these rules is expected to be $2.42 million for the first year and $2.7 million for the second year. When combined with Empire's current tree trimming costs, the total first year cost for tree trimming and rule compliance will be approximately $8.4 million in Missouri in year 1 and slightly higher in year 2. The additional amount of expense to comply with the Commission's new rules that should be included in rates is the average of the incremental expense of compliance for the first two years, or $2.575 million. (Oligschlaeger Surrebuttal, p. 22). A "tracker" mechanism will allow the Staff to track Empire's expenditures and make certain that Empire is spending the required amounts for tree trimming and infrastructure. If Empire does not spend the required amount in each year, it must spend the shortfall in the next year with interest, along with its spending requirement for the next year.

OPC opposes Staff's recommendation for use of a tracker mechanism for Empire's rule compliance costs, stating that such costs are not known and measurable. (Robertson Surrebuttal, pp. 8-9). To respond to that point, the Staff notes that the Commission rules themselves call for the extraordinary mechanism of cost deferrals to be used to handle higher vegetation management and infrastructure inspection costs incurred by Missouri utilities to comply with the rules. Given that Empire is currently before the Commission in a rate proceeding, the Staff asserts that a better alternative to the cost deferral mechanism in the Commission's draft rules is simply to provide the Company with the financial resources upfront to comply with the rules, with the protection of the tracker mechanism in place to ensure that the funds provided to Empire are expended for their intended purpose. The Staff believes that its recommendation in this case is most consistent with the public interest. (Oligschlaeger Surrebuttal, pp. 23-24).

Finally, the Staff's recommendation in this proceeding is not without prior precedent; a similar tracking mechanism was agreed to for Ameren UE in its most recent Missouri rate proceeding (Case No. ER-2007-0002) to allow that utility to receive a higher amount of vegetation management costs in rates than it had previously incurred. (Oligschlaeger Rebuttal, pp. 10-11).

6. <u>Depreciation Rates:</u> Should Empire's depreciation rates be subject to change during the duration of its Regulatory Plan? If yes, should Empire's proposed changes to its depreciation rates be adopted in this proceeding? Are Empire's record keeping practices regarding its plant assets and depreciation accounting adequate?

Empire's depreciation rates should not changed in this proceeding because Empire is currently operating under the regulatory plan approved in Case No. EO-2005-0263. Any revenue impact brought by a change in depreciation rates would be offset by a change in the additional amortizations allowed under the regulatory plan. The Commission previously addressed the issue of changing depreciation rates while a company is operating with regulatory plan amortization mechanism in the 2006 Kansas City Power & Light (KCPL) rate case, Case No. ER-2006-0314. There, the Commission stated its policy in its Report and Order: "What is more, any decrease in depreciation likely would not affect rates in this case, because KCPL would be allowed additional amortizations to meet the credit metrics agreed to in Case No. EO-2005-0329." (Report and Order, ER-2006-0314, p. 51). Likewise, any increase or decrease in Empire's depreciation rates would be offset by a corresponding decrease or increase in regulatory plan amortizations so that any change in depreciation rates would not impact customer rates or company revenues. (Schad Rebuttal, pp. 2-3; Oligschlaeger Surrebuttal, pp. 16-18).

In addition, the depreciation study performed by Mr. Roff for Empire appears to have relied upon inappropriate methodologies and unreliable data. The Commission should not accept the results of Mr. Roff's study given Staff's concerns with inappropriate methodologies including: 1. the proposed change in the cap for interim cost removal (negative net salvage) percentage in the depreciation calculation, and 2. the way that utility reimbursements are included in the calculation of net salvage percentage. Mr. Roff provided no support for changing the cap for the interim net salvage percentage from -100 to -125 in his direct filing. Also, the Staff was unable to ascertain the level of reimbursements (payments made by external parties to cover the cost of removal expenditures) because the historical salvage/cost of removal data provided by Empire did not have any entries coded as reimbursements and did not indicate whether the company had received insurance proceeds, third party reimbursements, or any other type of reimbursement. (Schad Rebuttal, pp. 4-7).

Mr. Roff also proposes that many small dollar property items should be amortized to achieve administrative efficiencies, instead of applying traditional depreciation techniques. If the Commission determines that the Company's concerns regarding administrative efficiency have merit, the Staff believes a preferable alternative is to increase Empire's capitalization threshold on small dollar items, so that such items currently capitalized into Empire's plant in service accounts may prospectively be charged to expense if their original cost falls below a certain threshold. Unlike Mr. Roff's suggestion, the Staff's alternative has been previously ordered by the Commission in a UtiliCorp United, Inc. rate proceeding, Case No. ER-97-394. (Schad Rebuttal, pp. 4-5).

The Staff has concerns that the data relied upon by Mr. Roff in his depreciation study does not have sufficient integrity to be reasonably reliable within the meaning of section 490.065.3 RSMo. 2000. Empire cannot code retirements that are not regular retirements, cannot code reimbursements separate from salvage (except manually), and has admitted to errors in trying to develop historical mortality data files for the Staff. (Schad Rebuttal, p. 10).

Finally, Empire's depreciation study does not meet the requirements of the Commission's rule 4 CSR 240-3.175 requiring an estimated date of final retirement and surviving dollar investment for each warehouse, electric generating facility, combustion turbine, general office building or other large structure. (Schad Rebuttal, p. 11).

In summation, there is no reason for the Commission to authorize a current change to Empire's depreciation rates, because any such change will have no impact on customer rates in this case due to the regulatory plan amortization mechanism. Even absent the existence of that mechanism, the Staff recommends no change to Empire's current depreciation rates because of the aforementioned flaws and deficiencies in the Company's current recordkeeping for depreciation matters.

REGULATORY PLAN AMORTIZATION

1. Ice Storm Costs: Should the expense amortization of the January 2007 and December 2007 ice storm costs be reflected in the regulatory plan amortization calculation? Has Empire raised this issue out of time?

Yes, the expense amortizations of the January and December ice storms should be reflected in the regulatory plan amortization (RPA).

In its direct filing, the Staff proposed to include in expense a five-year amortization of the January 2007 ice storm costs. Amortization is a non-cash expense to Empire. Therefore, this adjustment increased Empire's cash flow as it is measured within the RPA calculation, and thus reduced the amount of the RPA that Empire would otherwise receive in rates. There is a line item in the RPA calculation formats agreed to in this proceeding and in Empire's prior Missouri rate case for amortization expenses, and this calculation correctly treats amortization expense as increasing Empire's cash flow. The Staff believes this treatment to amortization expense in the RPA, specifically including that component attributable to ice storm cost amortizations, is fully consistent with the analysis by credit rating agencies of the cash flow of electric utilities such as Empire.

Empire did not respond to or object in any way to this treatment of the January 2007 ice storm amortization in the RPA calculation in its rebuttal testimony. Staff did not recommend an amortization of the December 2007 ice storm expenses in its direct filing because of a belief that Empire would not seek recovery of these costs in this case. Concurrent with its rebuttal, however, the parties filed a Stipulation and Agreement, dated April 4, 2008, that called for inclusion of a five-year amortization of the December 2007 costs in concept and stated that the estimated amount of the annual amortization was $1.7 million and would be determined later. (April 4, 2008 Non-Unanimous Stipulation and Agreement, p.1, footnote, and p.2). The Staff later calculated the amount to be $1,710,149 and included that number in its surrebuttal. (McMellen Surrebuttal, p. 3, l. 1-3). Empire filed surrebuttal in opposition to including either the January 2007 or the December 2007 amortization amounts in the RPA calculation.

Apparently, Empire did not fully understand the impact of the five-year amortization of the January 2007 ice storm costs in reducing the amount of the RPA rate recovery it would otherwise receive, or presumably it would have objected to Staff's treatment of this matter in Staff's direct filing in a timely manner in rebuttal testimony. However, although Staff's position of treating the December 2007 ice storm amortization in the RPA calculation as an increase to Empire's cash flow exactly duplicated its earlier treatment of the January 2007 ice storm amortization in the RPA, Empire now belatedly opposes the inclusion of any ice storm costs in the RPA calculation in its surrebuttal filing. (Sager Surrebuttal, p. 2-3). But Empire cannot now object to what it agreed to or implicitly accepted earlier; Empire's surrebuttal opposing the amortization of the January 2007 and December 2007 ice storm costs should be stricken. Alternatively, the parties should be given the opportunity to respond to the surrebuttal of Empire with an additional round of testimony in writing or in responsive "live" testimony at the hearing.

FUEL COST RECOVERY

1. <u>Fuel Adjustment Clause:</u> Should the Commission authorize Empire to use a fuel and purchased power recovery mechanism as authorized by law?

A. Is Empire barred by the terms of the Stipulation and Agreement in Case No. ER-2004-0570 from requesting a fuel adjustment clause while an interim energy charge is pending?

B. If the Commission authorizes Empire to use a fuel adjustment clause (FAC), how should it be structured?

a. What proportion of future increases and decreases in fuel and purchased power costs (increases and decreases) from base rates should be assigned to Empire and what proportion to its customers?

b. What components of fixed and variable fuel and purchased power costs should be recovered through a FAC?

c. What heat rate testing of generation plants should be conducted?

d. What rate design should be applied to FAC charges?
1. Should the base cost of fuel be determined by season?
2. How should the actual $/kWh cost of fuel and purchased power energy be determined?
3. How should the Cost Adjustment Factor be determined?

e. What incentive mechanisms, if any, should be included in the FAC?

f. Should off-system sales be included in the FAC?

g. Should the net cost of emissions (Account 509) costs be recovered through the FAC?

Perspective

The 93rd General Assembly in passing, and Governor Blunt in signing, Senate Bill 179 (Session Laws 2005 - Section 386.266) authorized the Commission the discretion to adopt a fuel adjustment clause for electrical corporations under its jurisdiction. The Missouri Supreme Court in *State ex rel. Utility Consumers Council of Missouri, Inc. v. Public Serv. Comm'n*, 585 S.W.2d 41 (Mo. banc 1979) (*UCCM*) had determined that the Commission did not have the authority to look at less than all relevant factors, such as fuel and purchased power, and grant an electrical corporation a rate increase on this basis alone. Among other things, the Court in 1979 did not find persuasive the argument that fuel is distinguishable on the basis that it is an electrical corporations' largest single expense item and noted that "[w]hile fuel costs are to a large extent dependent on general market conditions and periodically fixed contract costs, the utility does exercise control over its fuel costs when it negotiates fuel contracts or chooses what fuel to buy or burn in what generating unit." 585 S.W.2d at 54, 53.

The *UCCM* case involved the review of the Commission's Report And Orders in Case No. 17,730 (In the Matter of the Investigation of the Fuel Adjustment Method for the Recovery of Fuel Costs by Electric Utilities Operating In the State of Missouri) where it authorized (1) the use of a FAC for recovery of fuel costs by electrical corporations subject to the Commission's jurisdiction; (2) the roll-in to basic rates of amounts collected under a prior FAC; and (3) a surcharge of fuel costs covering costs incurred by the electrical corporations during the period the prior FAC was in effect but which were not collectible under the terms of the prior FAC before it was superseded. On February 1, 1974, in Case No. 17, 730, 18 Mo.P.S.C.(N.S.) 371, the Commission issued a Report And Order granting temporary authorization for a FAC for all sales of electricity for a two year period. On September 12, 1975 the Commission began review of the FAC in Case No. 17,730, extended the February 1, 1974 Report And Order to April 15, 1976, held hearings in February 1976, and on April 14, 1974 issued a Report And Order in Case No. 17,730. In its April 14, 1976 Report And Order in Case Nos. 17,730 and 18,663 (*Re Mo.P.S.C. Staff vs. Kansas City Power & Light Co.*), 20 Mo.P.S.C.(N.S.) 563, the Commission extended the original FAC to May 31, 1976, authorized use of a modified FAC effective on billings commencing June 1, 1976, and made the modified FAC effective until May 31, 1978. The 1976 FAC was extended by order of the Commission until either decision of the Missouri Supreme Court or December 31, 1978, whichever was earlier, and was extended by order of the Commission until such time as the Commission ruled on the appropriate amount of the electric utilities' annual fuel adjustment, which did not occur by the time the Missouri Supreme Court rendered its *UCCM* decision. 585 S.W.2d at 44-45.

In addition to the 1974 and the 1976 FACs, the Commission also authorized under a surcharge collection plan submitted by each electric utility, uncollected fuel cost increases incurred up to April 30, 1976 for which increases in fuel adjustment costs had not been charged to customers because these costs were not collectible under the lag procedures of the 1974 FAC before the 1974 FAC expired on May 31, 1976. These costs also were not permitted to be collected under the 1976 FAC approved on April 14, 1976 effective for billings commencing on June 1, 1976. 585 S.W.2d at 46. The Commission permitted the electric utilities to utilize a surcharge to recover these costs that (1) were incurred when the 1974 FAC was in effect but were not collectible before the 1974 FAC expired and (2) were not collectible under the 1976 FAC. It is this surcharge that the Missouri Supreme Court in the *UCCM* case found to constitute retroactive ratemaking and required to be restituted to ratepayers.

Should the Commission authorize Empire to use a fuel and purchased power recovery mechanism as authorized by law?

In Aquila, Inc.'s recent rate case, Case No. ER-2007-0004, the Commission authorized Aquila a FAC on the basis of the following criteria:

1. Fuel and purchased power costs must be a significant portion of the utility's costs;

2. Fuel and purchased power costs must fluctuate significantly; and

3. Fuel and purchased power costs are outside the utility's control.

Empire meets a greater percentage of its needs with gas-fired generation and spot purchased power than Aquila does. Since the cost of natural gas and spot purchased power costs have fluctuated significantly in the past and are expected to continue to be volatile, and these costs are to a large part outside of Empire's control, Staff recommends the Commission approve a FAC for Empire. (Staff Rev. Req. Report, pp. 60-61).

A. Is Empire barred by the terms of the Stipulation and Agreement in Case No. ER-2004-0570 from requesting a fuel adjustment clause while an interim energy charge is pending?

On May 1, 2008, the Commission issued a Notice Regarding Pending Motion To Reject Specified Tariff Sheets And Strike Testimony in which it stated that the issues in the Industrial Intervenors' Motion shall be taken up as part of the case and that the parties shall be prepared to fully litigate any and all issues related to the testimony and tariffs identified in the Industrial Intervenors' April 11, 2008 Motion. Empire's Suggestions In Opposition To Industrial Intervenors' Motion To Reject And Strike notes that oral argument in SC88390 is scheduled for May 13, 2008. The Staff will address this issue as required when warranted in this proceeding.

B. If the Commission authorizes Empire to use a fuel adjustment clause (FAC), how should it be structured?

a. What proportion of future increases and decreases in fuel and purchased power costs (increases and decreases) from base rates should be assigned to Empire and what proportion to its customers?

See "e." below.

b. What components of fixed and variable fuel and purchased power costs should be recovered through a FAC?

Upon review of Empire's rebuttal testimony, Staff concurs that some fixed costs should be included in the FAC. The costs and revenues that should be used to calculate Empire's base FAC rates are as follows:

FUEL
Fuel
Gas Transportation – Fixed (including FERC Pipeline Transportation Costs)
Gas Transportation - Variable
Gas Capacity Release - Variable
Gas LUF at Cost of Gas
Total Fuel

FUEL RELATED COSTS

PURCHASED POWER ENERGY CHARGES
Purchased power (including SPP Energy Imbalance Market Settlements and Revenues Neutrality Uplift Charges (transmission costs))
Cost of off-system sales
Energy exchanged – Southwest Power Administration (SWPA)

OFF SYSTEM SALES MARGIN
A base level of off-system sales margin should be included in the FAC base. Actual off-system sales margin should be included in each six month accumulation period and the FAC rate should be adjusted on the basis of the difference of what was included in the base and the actual off-system sales margin.

(Mantle Surr., p. 2 and Sched. 1; Mantle Rebuttal, p. 4).

g. What heat rate testing of generation plants should be conducted?

The Commission's FAC rules (4 CSR 240-3.161 Electric Utility Fuel and Purchased Power Cost Recovery Mechanisms Filing and Submission Requirements) have applicable provisions on heat rate testing of generation plants. 4 CSR 240-3.161 provides, in part, as follows:

> 4 CSR 240-3.161(2) When an electric utility files to establish a RAM as described in 4 CSR 240-20.090(2), the electric utility shall file the following supporting information as part of, or in addition to, its direct

testimony:

. . . .

> (P) A proposed schedule and testing plan with written procedures for heat rate tests and/or efficiency tests for all of the electric utility's nuclear and non-nuclear generators, steam, gas, and oil turbines and heat recovery steam generators (HRSG) to determine the base level of efficiency for each of the units

. . . .

4 CSR 240-3.161(3) When an electric utility files a general rate proceeding following the general rate proceeding that established its RAM as described by 4 CSR 240-20.090(2) in which it requests that its RAM be continued or modified, the electric utility shall file with the commission and serve parties, as provided in sections (9) through (11) in this rule the following supporting information as part of, or in addition to, its direct testimony:

. . . .

> (Q) The results of heat rate tests and/or efficiency tests on all the electric utility's nuclear and non-nuclear steam generators, HRSG, steam turbines and combustion turbines conducted within the previous twenty-four (24) months

(Taylor Rebuttal, pp. 2, 6-7).

In "Ordered: 5." of its May 17, 2007 Report And Order in Case No. ER-2007-0004, the Commission directed as follows: "Aquila, Inc., shall complete the proposed heat rate and/or efficiency schedule and testing plan with written procedures, as described in 4 CSR 240-3.161(2)(P) that is either agreed to by all parties to this case or has been approved by the Commission no less than sixty (60) days before the effective date listed on the tariff for its initial fuel adjustment clause filing for the purpose of adjusting a fuel adjustment clause rate pursuant to 4 CSR 240-3.161(7) and 4 CSR 240-20.090(4)."

On November 9, 2007, Aquila filed a Motion To Establish A Docket For Approval Of Heat Rate Schedule And Testing Plan establishing Case No. EO-2008-0156. The Staff on December 20, 2007 filed a Staff Recommendation in Case No. EO-2008-

0156 recommending that the Commission issue an Order approving Aquila's heat rate testing and scheduling proposal, as filed on November 9, 2007 and subsequently amended and supplemented on November 27, 2007. On January 15, 2008, the Commission issued its Order Approving Heat Rate Testing And Scheduling Proposal in Case No. EO-2008-0156. (Taylor Rebuttal, p. 5).

Staff believes the procedures filed by Aquila and approved by the Commission provide a benchmark for comparison purposes and Staff expects heat rate testing procedures appropriate for adoption for Empire and other investor-owned utility corporations to be comparable to the Aquila procedures with respect to substantive technical issues. For example, Staff expects the "base level of efficiency" to be determined in a manner that reflects optimum operating conditions for generating units unless there are known and expected degradations that need to be taken into account. For newer generating units, the "base level of efficiency" could be determined from performance guarantee tests following construction of the unit. For older generating units, however, the "base level of efficiency" must be determined through a rigorous process that verifies the unit is performing at a level consistent with its age, hours of service, and prudent preventive and corrective maintenance. (Taylor Rebuttal, pp. 5-6).

h. What rate design should be applied to FAC charges?

1. Should the base cost of fuel be determined by season?

Yes. Instead of a single annual base cost, the base cost of fuel and purchased power energy should be determined on a seasonal basis. Empires's rate schedules are designed to recover seasonal costs on a billing month basis. Under Staff's proposal, fuel and purchased power energy costs will also be recovered by billing month, as part of the standard billing process. Since the average cost of fuel and purchased power is significantly higher in the summer than in the winter, seasonally differentiating the base costs avoids certain undesirable situations such as greater fluctuation in customer bills which over-collect or under-collect more than need be. (Watkins Direct, p. 3; Staff Class Cost-of-Service Report And Rate Design Report, p. 8). Empire's base fuel and purchased power costs are roughly 10% higher in the summer than in the winter. (Watkins Surr., p. 2). Contrary to Empire's assertion, the calculation of seasonal base costs is not complex, and even if it were true, would not justify a single annual base as Empire proposes. (Id. at 2-3).

2. How should the actual $/kWh cost of fuel and purchased power energy be determined?

The base cost of fuel and purchased power energy should be determined at the generator for the season (summer or winter), then adjusted for losses to the meter whether secondary or primary. Staff takes Empire's costs at the generator and multiplies it by loss adjustments from Empire's most recent loss study to determine the base cost at the secondary meter or the primary meter to capture the differences in line losses. (Watkins Direct, p. 3; Watkins Surr., pp. 3, 5). Empire's proposed methodology of determining costs by allocating the total costs among the jurisdictions, then applying "expansion factors" to correct for line losses, is not appropriate. (Watkins Surr., p. 4).

Sales for the Recovery Period need to be forecasted. The purpose of the Recovery Period is to recover or refund any total dollar differences in fuel costs between "base" and "actual" fuel costs. In order to determine a rate for the Cost Adjustment Factor that will recover or refund the total differences in fuel costs as closely as possible, the Cost Adjustment Factor has to be calculated using the best available estimate of sales during the Recovery Period. The best estimate of sales during the Recovery Period is not likely to be actual sales during the Accumulation Period, but a forecast of sales. (Watkins Surr., pp. 4-5).

The Empire energy charge for all customer classes is designed to recover some portion of Empire's fixed costs in addition to its base fuel and purchased power costs. Therefore, when customer growth occurs Empire is collecting through its base energy charge more than its variable cost of providing service. This excess revenue above the actual base cost of fuel and purchased power should be netted against any increase in energy costs above the base to determine whether or not Empire is losing revenues when customer growth occurs as Empire asserts in the rebuttal testimony of its witness H. Edwin Overcast. (Mantle Surr., pp. 5).

3. How should the Cost Adjustment Factor be determined?

Whereas Aquila proposed that the Recovery Period be, and the Recovery Period for the Aquila FAC is, periods of twelve months, Empire has proposed that the Recovery Period for its FAC be periods of six months. Staff has no objection to this proposal of Empire; except the two Accumulation Periods should be: (1) the calendar months of September through February with a Recovery Period of the billing months of June through November and (2) the calendar months March through August with a Recovery Period of the billing months of December through May. (Staff Class Cost-of-Service Report And Rate Design Report, p. 7). Fuel cost accumulation should be done on a calendar month basis, but the recovery should be billed on a billing month basis. (Watkins Direct, p. 3).

i. What incentive mechanisms, if any, should be included in the FAC?

Section 386.266.1 RSMo gives the Commission the authority to approve incentive programs within a FAC to provide the electric utility with "incentives to improve the efficiency and cost-effectiveness of its fuel and purchased power procurement activities." A 100% pass through of fuel and purchased power costs for Empire would only be correct for Empire if 100% of fuel and purchased power costs were completely removed from Empire's control, which is not the case. There are actions that Empire can undertake, or not undertake, that affect the efficiency and cost-effectiveness of its fuel and purchased power procurement costs. Being responsible for a portion of any increase in cost or receiving the benefit of any savings provides Empire an incentive to manage its fuel and purchased power costs. (Mantle Surr., p. 3). Staff's proposal is symmetrical. (Id. at 4; Oligschlaeger Surr., p. 9). Contrary to Empire's allegation concerning Staff's proposal, Staff has not assumed that Empire will be imprudent or wasteful in its future fuel and purchased power decisions under a FAC. Staff's proposed FAC structure does properly recognize, however, that there are inherently stronger incentives for utility efficiency under traditional rate treatment of fuel and purchased power costs than under a FAC pass-through type mechanism. (Oligschlaeger Surr., pp. 3-9).

In Aquila's recent rate case, Case No. ER-2007-0004, the Commission concluded that allowing Aquila to pass through 95% of its prudently incurred fuel and purchased power costs, above those included in its base rates, through its FAC would not violate Section 386.266.4(1), in that it would afford Aquila a sufficient opportunity to earn a fair return on equity. By passing through 95% of its fuel and purchased power costs, Aquila would be protected from extreme fluctuations in fuel and purchased power costs, and would retain a significant incentive to take all reasonable actions to keep its fuel and purchased power costs as low as possible. (Report And Order, pp. 54-55). The Commission agreed with the view that "1) after-the-fact prudence reviews alone are insufficient to assure Aquila will continue to take reasonable steps to keep its fuel and purchased power costs down; and 2) the easiest way to ensure a utility retains the incentive to keep fuel and purchased power costs down is to allow less than 100% pass through of those costs." Id. at 53.

It is Staff's position that the five percent (5%) level gives Empire very little serious incentive to manage its fuel costs efficiently. (Mantle Rebuttal, p. 6; Oligschlaeger Surr., p. 6). The Staff estimated that over the period 2003-2006 Empire absorbed approximately $85.5 million of fuel and purchased power costs between rate cases, which equates to allowing about 40% of the fuel and purchased power costs to flow through a FAC to Empire's ratepayers. Any pass-through greater than 40% would shift more of the fuel and purchased power risks to the ratepayers than the ratepayers had without a FAC in place. (Staff Rev. Req. Report, pp. 61-62). Staff looked at a range. In this proceeding, Staff is recommending a pass through to ratepayers of 70% of fuel and purchased power costs so that Empire still has an incentive to control and reduce fuel and purchased power costs by, among other things, keeping a portion of the fuel costs it saves. Ratepayers are taking on a significant portion of the fuel and purchased power risk. (Id. at 63; Mantle Rebuttal, pp. 6-7).

j. Should off-system sales be included in the FAC?

Staff proposes that a base level of off-system sales margin be included in the FAC base cost to which each six month accumulation period is compared. Off-system sales margin should also be included in the accumulation period costs. The adjustment to the FAC rate in each recovery period would then be based on the difference between what was included in the base and the actual off-system sales margin during the accumulation period. (Mantle Rebuttal, p. 5).

g. Should the net cost of emissions (Account 509) costs be recovered through the FAC?

In the recent Aquila rate case, Case No. ER-2007-0004, the Commission in its June 14, 2007 Order Rejecting Tariff, Granting Clarification, Directing Filing and Correcting Order Nunc Pro Tunc states at page 4: "SO_2 emission allowance costs are variable fuel related costs in that they vary based upon the volume of coal used, as well as, the market prices of the allowances themselves." Therefore, Staff recommends emission allowance purchases be included in the FAC, and if purchases are included, then Staff recommends that revenues from the sale of emission allowances also be flowed through the FAC. (Mantle Rebuttal, p. 5).

2. Fuel and Purchased Power Expense: Should Empire's recovery of fuel and purchased power expense be based upon its current adjusted expense levels, or on the rate allowance for this item ordered by the Commission in Case No. ER-2004-0570?

Fuel and purchased power expense should be based upon Empire's current cost levels, as adjusted. Also, because the Commission terminated the 2005 IEC agreement in its Order in Case No. ER-2006-0315, the Staff believes the fuel and purchased power level incurred by Empire several years ago on which the IEC agreement was based is no longer relevant for purposes of current ratemaking for Empire.

NON-REVENUE REQUIREMENT

1. Energy Efficiency Programs: Should the Missouri Department of Natural Resources' recommendations concerning Empire's interaction and involvement with the Customer Program Collaborative be adopted?

DNR recommends that Empire, in cooperation with the CPC, implement and ramp up the five energy efficiency programs currently in place. Because of Empire's slow progress toward full implementation of the programs, DNR requests that the programs' implementation be expedited, that Empire and the CPC evaluate options to accelerate the programs, and the Empire dedicate additional staff to the programs. (Wilbers Direct, pp. 5-6). Staff does not have a witness on this issue.

2. Low Income Assistance Program: Should Empire's Experimental Low-Income Program (ELIP) be continued with changes? If so, what should those changes be? What should be done with unspent ELIP funds? Should interest be paid to customers on the unspent funds? If yes, how should the interest be calculated?

Empire's ELIP should be continued until the Iatan II rate case in 2010. Prior to that case, an evaluation should be conducted by an outside party to determine the ELIP's impact on Empire's low-income customer's ability to pay their electric bills.

The program, begun in 2003, provides monthly bills credits of $20 or $50 to customers with household income of 125% or less of the federal poverty level. Since the program began, $1.4 million has been provided to fund the program, one-half from shareholders and one-half from ratepayers. Only $0.5 million has been spent to date. Since there is about $1 million of unspent funding for the ELIP in Empire's possession, the Staff proposes that half of the unspent funds be returned to ratepayers and that the other half, the shareholder contribution, be used to fund the program through the Iatan 2 rate case in 2010. This would mean that customers receive a refund of $0.5 million plus interest on that sum and that there would be no funds for this program included in the cost-of-service.

Prior to the Iatan II case, Empire will have an evaluation conducted of the program to determine its impact on Empire's low-income customer's ability to pay their electric bills. Given the results of that evaluation, Empire will propose in the Iatan II case to either to make the program permanent or discontinue the program. (Mantle Rebuttal, pp. 2 -3).

Empire proposed essentially the same program in its rebuttal testimony with the exception of the provision of interest on the ratepayer funds that would be refunded. (McCormack Surrebuttal, p.2). In surrebuttal testimony, Empire agreed with Staff that interest should be accrued and paid to the customer. (McCormack Surrebuttal, p. 2).

Respectfully submitted,

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, or transmitted by facsimile or electronic mail to all counsel of record this 6th day of May, 2008.

/s/ Steven C. Reed