Exhibit No.
Issue: Fuel and Purchased Power
Witness: Steven M. Fetter
Type of Exhibit: Supplemental Direct Testimony
Sponsoring Party: Empire District
Case No. ER-2006-0315

Before the Public Service Commission of the State of Missouri

Supplemental Direct Testimony

of

Steven M. Fetter

July 2006

SUPPLEMENTAL DIRECT TESTIMONY
OF
STEVEN M. FETTER
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2006-0315

Q. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.

A. My name is Steven M. Fetter. I am President of Regulation UnFettered. My business address is 1489 W. Warm Springs Rd., Suite 110, Henderson, NV 89014.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

A. I am testifying on behalf of The Empire District Electric Company, which I shall refer to as "Empire District" or the "Company".

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am President of Regulation UnFettered, a utility advisory firm I started in April 2002. Prior to that, I was employed by Fitch, Inc. ("Fitch"), a credit rating agency based in New York and London. Prior to that, I served as Chairman of the Michigan Public Service Commission ("Michigan PSC"). My full educational and professional background is described in the attached Schedule SMF-1.

Executive Summary

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. It is my understanding that because of an agreement that Empire entered into in its last rate case the Company's options for requesting a means to

recover its energy costs in this case may not include what is known in the industry as a "fuel adjustment clause" ("FAC") mechanism. For the policy reasons stated in my testimony and schedules, I encourage the Commission to authorize and implement a FAC for Empire District as soon as is possible. Until that occurs, however, as Empire District continues to operate without being able to utilize a FAC, thus increasing its risk of non-recovery of prudently-incurred energy costs, this higher risk should be reflected in the return on equity that the Missouri Public Service Commission ("Commission") authorizes in this case.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. In an Order issued in this case on May 2, 2006, the Commission ruled that Empire District may not request implementation of a FAC within this proceeding. Thereafter, on June 20, 2006, the Commission issued an Order directing the parties to this proceeding to respond to five specific questions in order to provide additional information for the Commission's consideration. My testimony responds to Question Number Five: "Is there any other relevant information you wish to provide the Commission in response to this request?" In connection with this, attached as Schedule SMF-2 is a document which discusses a variety of topics which bear on the issue of energy cost recovery, including the Development and Status of Fuel and Purchased Power Cost Recovery Mechanisms; Experience in States Where FACs Are Not Utilized; Jurisdictions in which FACs are Utilized; How the Financial Community Views FACs; Credit Ratings;

Current Environment; and Public Policy Reasons for Fuel and Purchased Power Recovery Mechanisms.

Q. IS THERE A PROBLEM WITH A UTILITY RELYING ON THE RECOVERY OF ITS FUEL AND PURCHASED POWER COSTS EXCLUSIVELY THROUGH BASE RATES?

A. No, not as long as the utility's prudent expenditures for such items are fully and fairly recovered without undue delay. However, that would not be the usual situation and is probably not the case with Empire District.

Q. PLEASE EXPLAIN.

A. In this proceeding, Empire District sought to terminate its existing Interim Energy Charge and thereafter implement a FAC to better match its actual fuel and purchased power expenditures with its ongoing cost recovery. However, because of the Commission's ruling that a FAC may not be sought by Empire District in this case as a result of an agreement in its last rate case, the Company may be left with the ability to recover its fuel costs only through base rates.

Q. IS THIS A PROBLEM?

A. It could be.

Q. WHY IS THAT?

A. Price variations related to fuel and purchased power, as well as amounts utilized by a utility, can vary greatly from year-to-year, and thus are not easily captured through the setting of base rates periodically within the context of a full-blown rate case. The result is that, at any particular

moment in time, based upon then-existing circumstances, the utility and its shareholders might come out as winners, or, alternatively, customers might benefit. Of course, the zero-sum nature of static rates means that the party on the other side will be the loser.

Q. COULD THERE BE CONSEQUENCES FOR EMPIRE DISTRICT FROM LESS THAN FULL AND TIMELY RECOVERY OF ITS ENERGY COSTS?

A. Yes. One of the consequences is a possible credit rating downgrade.

Q. IN VIEW OF EMPIRE DISTRICT'S BORDERLINE INVESTMENT-GRADE RATING STATUS, CAN YOU DESCRIBE SOME OF THE SPECIFIC CONSEQUENCES OF A UTILITY'S CREDIT RATING FALLING BELOW INVESTMENT-GRADE QUALITY?

A. Yes I can. There would be a marked change in the investor profile for that utility. Major utility investors such as insurance companies and pension funds operate under legal restrictions that severely limit their ability to invest in below investment-grade debt instruments, or "junk bonds." Mutual funds could also be affected based upon what a particular fund has communicated to investors as to its investment profile. Moreover, a utility with a junk bond rating would likely have to post bond or put up cash as collateral in various contracts (such as for energy supply) or to meet certain regulatory commitments (such as Independent System Operator agreements or environmental remediation requirements). This, of course, would come at a time when access to a utility's existing credit facilities

likely would be limited by the financial institutions previously providing the assistance.

Q. WHAT WOULD THE IMPACT BE OF A DOWNGRADE TO JUNK STATUS FOR EMPIRE DISTRICT AND ITS CUSTOMERS?

A. Very injurious.

Q. PLEASE EXPLAIN.

A. With the caveat that each utility's situation is different and specific to its own circumstances, I can offer an example of how costly a downgrade of one utility, APS ("Arizona Public Service") to the lowest investment-grade rating of "BBB-" by S&P was for that company, as well as its forecast of how financially harmful a further downgrade into junk status would be. Donald E. Brandt, the APS Chief Financial Officer, included the following information in his filing in an emergency interim rate proceeding which I participated in:

> The downgrading by S&P that occurred on December 21, 2005, has already increased the Company's financing costs by approximately 10-50 basis points on new long-term debt (amounting to $100,000 to $500,000 in additional interest costs each year for each $100 million in borrowing). Higher short-term debt rates and increased bank facility costs add over another $1 million per year to the eventual burden on customers....The increased costs that APS is already experiencing as a result of the recent downgrades will seem small in comparison to the enormous impact of noninvestment grade credit ratings....APS will need to raise billions of dollars of new debt over the next ten years...the cost to the ratepayers of a further credit downgrade will total

between $625 million and $1.2 billion through 2015, depending on actual interest rate spreads[1]

While the dollar impact for Empire District would be different, based upon its particular circumstances, it should be clear that a downgrade into below investment-grade status would be very harmful for both customers and investors. Indeed, a utility's stock price can weaken in the face of negative credit rating actions, reflecting the fact that investors will require a more attractive return to maintain their interest. This, in turn, would result in a higher cost of capital that gets factored into rates that customers pay.

Q. WHAT MESSAGE WOULD YOU GIVE TO THE COMMISSION ON THIS POINT?

A. The primary message is that an effort should be made to not allow prudent fuel and power supply costs to diverge significantly from recovery of such costs, whether in the ultimate recovery amount or the timing between expenditure and recovery.

Q. WHAT IS YOUR UNDERSTANDING OF THE FINANCIAL COMMUNITY'S REACTION TO THE SITUATION FACING EMPIRE DISTRICT WITH REGARD TO COST RECOVERY RELATED TO ITS FUEL AND PURCHASED POWER EXPENDITURES?

A. The reaction has been negative. On May 17, 2006, Standard & Poor's lowered its Empire District corporate credit rating to "BBB-", the lowest

[1] Testimony of Donald E. Brandt on Behalf of Arizona Public Service Co., Arizona Corporation Commission, Docket No. E-01345A-06-0009, March 13, 2006 at 33-35.

investment-grade level, with senior unsecured debt ratings dropping into below-investment grade status at "BB+". The primary reason S&P cited for the downgrades was "that Empire's financial measures will be constrained over the next several years by fuel and power costs that continue to exceed the level recoverable in rates."[2] S&P further explained the importance of timely fuel and purchased power cost recovery for Empire District in the future:

> Historically, Missouri regulation has been restrictive regarding fuel and purchased-power costs because a permanent energy cost recovery (ECR) rider was not statutorily authorized. Under a new Missouri law, utilities operating in the state can seek Missouri Public Service Commission approval of an ECR rider, that, if authorized, would provide for the pass-through of rising fuel and power costs. Timely recovery of such expenses, particularly when commodity prices rise rapidly, is important for Empire's credit quality because the company relies on a relatively high level of natural-gas-fired generation and power purchases for its supply. Although Empire filed for a $30 million electric base rate increase in Missouri that, if authorized, would strengthen creditworthiness, the inability to implement an ECR in the near term weakens credit quality, particularly since fuel and power costs currently exceed the level recoverable through base rates and the company's interim energy charge.

S&P concluded that Empire District's Stable ratings "outlook could be revised to positive if rate recovery is supportive during the [Company's] construction program, if a reasonable energy cost recovery mechanism is adopted, and if financial measures begin to show sustainable improvement."

[2] S&P Research Update: "Empire District Electric Downgraded to 'BBB-' on Expected Tight Financials," May 17, 2006.

Q. WHAT ABOUT FITCH?

A. Fitch holds a similar opinion, viewing the regulatory flexibility provided by SB 179 as having positive credit implications for Missouri electric utilities. Fitch noted, however, that Empire District "continues to be negatively affected by persistent high natural gas prices, resulting in additional fuel and purchased power costs in excess of the total cost set in rates." Fitch's Stable credit ratings outlook is predicated on Empire District receiving "a reasonable outcome in its [current rate case], including a mechanism under which it will be able to recover its fuel and purchased power expense, including the cost of natural gas." Fitch warned, however, that negative rating action could result if there were to be an "adverse outcome" in its rate case, or if a "fuel cost recovery mechanism is not implemented in a timely manner, and [Empire District's] credit ratios continue to erode due to underrecovery of fuel costs."[3]

Q. WHAT ABOUT MOODY'S?

A. Moody's has also expressed concern about Empire District's fuel cost recovery situation: "Recent operating results have been adversely affected, however, by higher fuel and purchased power costs as the company is relatively heavily dependent on natural gas generation and does not yet have a fuel adjustment clause in place."[4]

Q. HAVE EQUITY ANALYSTS DISCUSSED THIS TOPIC?

[3] Fitch Credit Analysis: "Empire District Electric Company," January 25, 2006.
[4] Moody's Liquidity Risk Assessment: "Empire District Electric Company," March 17, 2006.

A. Yes. Equity analysts have stated similar concerns about fuel cost recovery and the potential benefits that a FAC could provide:

> **A.G. Edwards** ("Missouri's lack of a true fuel clause continues to plague Empire District and roughly $4.9 million of Missouri's fuel costs during the quarter were unrecoverable...Since the implementation of the IEC in March 2005, approximately $18.4 million of fuel and purchased power costs have gone unrecovered.... Unfortunately, until [Empire District] is able to take advantage of recently passed Missouri legislation which will enable full recovery of fuel and purchased power costs, the company's earnings will continue to be susceptible to rising commodity prices."[5]);
>
> **Value Line** ("For instance, in 2005 Empire District incurred $13.5 million of power costs that weren't recovered in rates or through the Interim Energy Charge [IEC] that the utility was granted last year. A similar situation will hurt earnings this year as well." [6]);
>
> **Jefferies & Company, Inc.** ("We...expect the Missouri PSC to enact a fuel adjustment clause contained in the company's recently submitted rate increase for Missouri electric customers. The current Missouri Commission recognizes the financial stress placed on the company based on its under recovery of these costs and is

[5] A.G. Edwards Report: "Empire District Electric," May 1, 2006.
[6] Value Line Report: "Empire District," June 30, 2006.

concerned about the resulting weakness to the company's interest coverage ratios and bond ratings."[7]); and

Lehman Brothers ("...we believe [Empire District's] profitability is highly dependent on: full relief for fuel beginning in '07...We expect [Empire District] to be eligible for the pending MO fuel clause mechanism."[8]).

Q. HAS REGULATORY RESEARCH ASSOCIATES COMMENTED ON FUEL COST RECOVERY IN MISSOURI?

A. Yes. Regulatory Research Associates ("RRA"), a respected utility regulatory analysis company that provides information to utility companies and the financial community, ranks state regulation from an investor perspective based upon the types of regulatory risks that could affect a utility's cost of capital. Notwithstanding praise for the regulatory flexibility provided by SB 179, RRA has maintained its ranking of Missouri regulation at Average/3, pending resolution of the Commission rulemaking proceedings that are a necessary step toward implementation of the law. Missouri's ranking places it in the lower 40% of jurisdictions. I note that positive movement to the next highest category of Average/2 would place the state at or above the median state ranking. I note that, of the seven states ranked one category lower than Missouri in the Below Average/1 category, three of them – Illinois, Vermont and West Virginia – do not

[7] Jefferies & Company, Inc. Report: 'Empire District Electric," May 1, 2006.
[8] Lehman Brothers Report: "Empire District Electric," June 19, 2006.

provide for use of a FAC for pass-through into rates of fuel and purchased power costs, and a fourth – Arkansas – is considering ending use of a FAC for that state's largest utility.

Q. SHOULD THE COMMISSION CARE ABOUT THESE RANKINGS?

A. Yes.

Q. WHY?

A. The activities of a regulated utility require the expenditure of significant amounts of funds to achieve the goal of reliable service delivered in a cost-effective manner. When providing those funds, investors expect that a regulated utility's prudently-incurred costs will be fully recovered on a timely basis. Accordingly, investors (and, of course, rating agencies) compare regulatory jurisdictions as to their mechanisms for timely recovery, and, most importantly, whether a state commission will stand behind its established recovery methodology, even under potentially difficult circumstances, such as is occurring with the rapidly-escalating cost of natural gas, both as a fuel and for end-use. As Moody's has stated with regard to the water industry, though equally applicable to the energy sector:

> [W]hen utilities are permitted a fair rate of return and timely rate adjustments to reflect the costs of providing this essential service, they will be more able to implement the necessary safeguards to protect the public health."[9]

[9] Moody's Special Comment: "Credit Risks Are Increasing for U.S. Investor Owned Water Utilities," January 2004 at 5.

Taking that cue, major utility investors' level of confidence that a particular state commission will do the right thing, even under extremely trying circumstances, will have a major impact on where those institutions are willing to provide their funds.

Q. DO YOU HAVE CONCLUDING THOUGHTS?

A. I do. In these times of escalating commodity costs and uneasiness within the capital markets, dating back to the California and Enron debacles, timely recovery of fuel and purchased power expenses is imperative. I note that the median credit rating across the regulated utility sector has moved from "A-" in 2000 down two notches to "BBB" by 2005. This trend is not good news for a utility like Empire District that holds a corporate credit rating at the lowest investment-grade rating of "BBB-" from S&P. The financial situation of Empire District does not allow much margin for either Company or regulatory missteps. My advice to utility companies, investors and regulators alike is that nothing should be taken for granted in the current investing environment.

Thus, any regulatory or other action that creates the possibility that prudently-incurred costs will go unrecovered by a regulated utility will draw the attention of the financial community and will likely lead to diminishing investor interest. The end result for customers would be increased costs and potentially lower system reliability.

If Empire District continues to operate without being able to recover its prudently-incurred costs, the Company will fall outside the norm for

regulated utilities across the country. Such higher risk, in turn, increases the return on equity that investors will require, and, thus, should appropriately be reflected in the return on equity that this Commission authorizes.

Similarly, on the debt side, inadequate cost recovery of prudently-incurred expenditures, coupled with higher operational risk, will weaken Empire District's already-weak credit profile, potentially placing onto customers the higher debt financing costs that accompany a below investment-grade corporate credit rating. Under the circumstances that currently exist within the electric utility sector and utility capital markets, I strongly urge the Commission to seek to stabilize and potentially improve Empire District's weak financial standing by approving and implementing a FAC as soon as is legally permissible and, in the meantime, to reflect the Company's higher risk in the return on equity that the Commission authorizes in this case.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

STEVEN M. FETTER

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Education University of Michigan Law School, J.D. 1979
Bar Memberships: U.S. Supreme Court, New York, Michigan
University of Michigan, A.B. (Communications) 1974

April 2002 – Present
President – REGULATION UnFETTERED – Henderson, NV/Rumson, NJ

Founder of advisory firm providing regulatory, legislative, financial, legal and strategic planning advisory services for the energy, water and telecommunications sectors; federal and state testimony; credit rating advisory services; negotiation, arbitration and mediation services; and skills training in ethics, negotiation, and management efficiency.

- Service on Boards of Directors of: CH Energy Group (Chairman, Governance and Nominating Committee; Member, Audit; Previous Chairman, Audit and Compensation Committees), National Regulatory Research Institute (at Ohio State University), Keystone Energy Board, and Regulatory Information Technology Consortium; Member, Wall Street Utility Group and American Public Power Association; Participant, Keystone Center Dialogue on Financial Trading and Energy Markets.

October 1993 – April 2002
Group Head and Managing Director; Senior Director -- Global Power Group, Fitch IBCA Duff & Phelps -- New York/Chicago

Manager of 18-employee ($15 million revenue) group responsible for credit research and rating of fixed income securities of U.S. and foreign electric and natural gas companies and project finance.

- Led an effort to restructure the global power group that in three years time resulted in 75% new personnel and over 100% increase in revenues, transforming a group operating at a substantial deficit into a team-oriented

- Profit center through a combination of revenue growth and expense reduction.

- Achieved national recognition as a speaker and commentator evaluating the effects of regulatory developments on the financial condition of the utility sector and individual companies; Cited by Institutional Investor (9/97) as one of top utility analysts at rating agencies; Frequently quoted in national newspapers and trade publications including The New York Times, The Wall Street Journal, International Herald Tribune, Los Angeles Times, Atlanta Journal-Constitution, Forbes and Energy Daily; Featured speaker at conferences sponsored by Edison Electric Institute, Nuclear Energy Institute, American Gas Assn., Natural Gas Supply Assn., National Assn. of Regulatory Utility Commissioners (NARUC), Canadian Electricity Assn.; Frequent invitations to testify before U.S. Senate (on C-Span) and House of Representatives, and state legislatures and utility commissions.

- Participant, Keystone Center Dialogue on Regional Transmission Organizations; Member, International Advisory Council, Eisenhower Fellowships; Author, "A Rating Agency's Perspective on Regulatory Reform," book chapter published by Public Utilities Reports, Summer 1995; Advisory Committee, Public Utilities Fortnightly.

March 1994 – April 2002
Consultant -- NYNEX -- New York, Ameritech -- Chicago, Weatherwise USA -- Pittsburgh

Provided testimony before the Federal Communications Commission and state public utility commissions; Formulated and taught specialized ethics and negotiation skills training program for employees in positions of a sensitive nature due to responsibilities involving interface with government officials, marketing, sales or purchasing; Developed amendments to NYNEX Code of Business Conduct.

October 1987 - October 1993
Chairman; Commissioner -- Michigan Public Service Commission -- Lansing

Administrator of $15-million agency responsible for regulating Michigan's public utilities, telecommunications services, and intrastate trucking, and establishing an effective state energy policy; Appointed by Democratic Governor James Blanchard; Promoted to Chairman by Republican Governor John Engler (1991) and reappointed (1993).

- Initiated case-handling guideline that eliminated agency backlog for first time in 23 years while reorganizing to downsize agency from 240 employees to 205 and eliminate top tier of management; MPSC received national recognition for fashioning incentive plans in all regulated industries based on performance, service quality, and infrastructure improvement.

- Closely involved in formulation and passage of regulatory reform law (Michigan Telecommunications Act of 1991) that has served as a model for other states; Rejuvenated dormant twelve-year effort and successfully lobbied the Michigan Legislature to exempt the Commission from the Open Meetings Act, a controversial step that shifted power from the career staff to the three commissioners.

- Elected Chairman of the Board of the National Regulatory Research Institute (at Ohio State University); Adjunct Professor of Legislation, American University's Washington College of Law and Thomas M. Cooley Law School; Member of NARUC Executive, Gas, and International Relations Committees, Steering Committee of U.S. Environmental Protection Agency/State of Michigan Relative Risk Analysis Project, and Federal Energy Regulatory Commission Task Force on Natural Gas Deliverability; Eisenhower Exchange Fellow to Japan and NARUC Fellow to the Kennedy School of Government; Ethics Lecturer for NARUC.

August 1985 - October 1987
Acting Associate Deputy Under Secretary of Labor; Executive Assistant to the Deputy Under Secretary -- U.S. Department of Labor -- Washington DC

Member of three-person management team directing the activities of 60-employee agency responsible for promoting use of labor-management cooperation programs. Supervised a legal team in a study of the effects of U.S. labor laws on labor-management cooperation that has received national recognition and been frequently cited in law reviews (U.S. Labor Law and the Future of Labor-Management Cooperation, w/S. Schlossberg, 1986).

January 1983 - August 1985
Senate Majority General Counsel; Chief Republican Counsel -- Michigan Senate -- Lansing

Legal Advisor to the Majority Republican Caucus and Secretary of the Senate; Created and directed 7-employee Office of Majority General Counsel; Counsel, Senate Rules and Ethics Committees; Appointed to the

Michigan Criminal Justice Commission, Ann Arbor Human Rights Commission and Washtenaw County Consumer Mediation Committee.

March 1982 - January 1983
Assistant Legal Counsel -- Michigan Governor William Milliken -- Lansing

Legal and Labor Advisor (member of collective bargaining team); Director, Extradition and Clemency; Appointed to Michigan Supreme Court Sentencing Guidelines Committee, Prison Overcrowding Project, Coordination of Law Enforcement Services Task Force.

October 1979 - March 1982
Appellate Litigation Attorney -- National Labor Relations Board -- Washington DC

Other Significant Speeches and Publications

- Perspective: Don't Fence Me Out (Public Utilities Fortnightly, October 2004)
- Climate Change and the Electric Power Sector: What Role for the Global Financial Community (during Fourth Session of UN Framework Convention on Climate Change Conference of Parties, Buenos Aires, Argentina, November 3, 1998)(unpublished)
- Regulation UnFettered: The Fray By the Bay, Revisited (National Regulatory Research Institute Quarterly Bulletin, December 1997)
- The Feds Can Lead...By Getting Out of the Way (Public Utilities Fortnightly, June 1, 1996)
- Ethical Considerations Within Utility Regulation, w/M. Cummins (National Regulatory Research Institute Quarterly Bulletin, December 1993)
- Legal Challenges to Employee Participation Programs (American Bar Association, Atlanta, Georgia, August 1991) (unpublished)
- Proprietary Information, Confidentiality, and Regulation's Continuing Information Needs: A State Commissioner's Perspective (Washington Legal Foundation, July 1990)

I. DEVELOPMENT AND STATUS OF FUEL AND PURCHASED POWER COST RECOVERY MECHANISMS ("FACs")

Q. CAN YOU PROVIDE SOME BACKGROUND ON THE ISSUE OF PURCHASED POWER AND FUEL PROCUREMENT?

A. Yes. Virtually every integrated electric utility has a need for both the procurement of fuel to fire its power plants and purchased power to deal with the peaks and valleys of electricity supply needed to serve its core regulated customers. Both utilities and regulators agree that overbuilding would place too large a financial burden on regulated customers, while a paucity of internal electricity supply would jeopardize the ongoing ability to provide reliable utility service to those same customers. Purchased power helps to fill the gap between a regulated utility's internal generation capacity and the fluctuating needs of its core customers. In addition, with the advent of competitive wholesale markets, a utility has the option of buying from the market when the market purchase price is less than the cost of self-generation.

Q. CAN YOU PROVIDE SOME BACKGROUND ABOUT FACS, INCLUDING HISTORICAL PERSPECTIVE WITH REGARD TO THEM?

A. Yes I can. The concept of a FAC is to allow recovery of fuel or purchased power costs without a utility having to go through all of the procedural steps and time required for a traditional rate case. Utility companies and their customers benefit from the saving of costs of the regulatory process as well as a decrease in regulatory uncertainty that is a major concern of

both equity and debt investors. Of course, regulatory commissions also benefit from the decrease in the frequency and complexity of contested cases; and, as discussed below, with FACs being the prevailing norm across the United States, customers benefit from the greater investor interest that accompanies the presence of FACs within a particular jurisdiction. As regulatory uncertainty decreases, investors are more willing to commit funds to a utility at reasonable cost, and this translates into lower rates for customers. I note, however, that while the intent of FACs is to provide a means by which a utility can recover fuel and purchased power costs without undue process or time lag, it is still incumbent upon the utility to have expended those funds in a prudent manner – and a properly-structured FAC will include a means to ensure this result.

Q. HOW LONG HAVE FACs BEEN IN USE?

A. While there are instances of FAC-like devices dating back to World War I, the trend toward inclusion by regulators of such mechanisms within utility tariffs began in earnest during the 1970's in the face of escalating and volatile oil prices. Over the past thirty years, regulators and/or legislators in a majority of the states have adopted some form of FAC suited to the characteristics of the utilities located within their jurisdiction. While restructuring at first affected the number of states utilizing FACs, with a few states deciding to forgo such mechanisms in favor of market-or-incentive-driven cost recovery, the less than successful track record of

utility competition has solidified the number of states with such mechanisms for electric utilities at 42, according to Regulatory Research Associates ("RRA"), a respected utility regulatory analysis company that provides information to utility companies and the financial community.[10] In addition, according to the American Gas Association, 49 jurisdictions (all but Vermont and Hawaii) have purchased gas adjustment mechanisms ("PGAs") for gas utilities.[11]

II. EXPERIENCE IN STATES WHERE FACS NOT UTILIZED

Q. WHAT HAS BEEN THE EXPERIENCE IN STATES WHERE FACs HAVE NOT BEEN UTILIZED?

A. A look at some of the few states where FACs are not utilized yields some interesting insights. In Maryland, regulators agreed to phase in (over the next two years) recovery of prudent fuel and purchased power costs for Baltimore Gas & Electric Company ("BG&E") that would equate to an average 72 percent rate increase. The legislature had enacted a restructuring law in 2000 that ended use of a FAC and provided for a process under which BG&E could seek recovery of the costs of serving core customers at the end of a mandated rate freeze. BG&E filed with the Maryland Public Service Commission a rate increase request reflecting costs of fuel and purchased power without any real return on its outlay of hundreds of millions of dollars. After Maryland regulators approved the

[10] Regulatory Research Associates Regulatory Focus Special Report: "Fuel and Wholesale Power Cost Recovery, A State-By-State Review," October 3, 2005.
[11] Email from Mr. Jay Copan, Senior Vice President, American Gas Association, May 19, 2006.

two-year phase-in of costs into rates, legislators passed a law that fired the sitting commissioners and provided for the highly-suspect step (in a constitutional sense) of nominating new commissioners themselves for the governor's consideration and appointment. The legislature has also directed the Maryland Attorney General to review the pending FPL, Inc. – Constellation Energy (parent of BG&E) merger. The Maryland Public Service Commission has commenced litigation to challenge the new law, so the ultimate outcome in Maryland will likely be in doubt for an extended period of time. In addition, the highly-charged political atmosphere became even more so last month when a state circuit court judge in Baltimore barred the phased increase from taking effect and ordered further hearings. This is precisely the type of interference from outside the regulatory arena that, in the view of rating agencies and investors, a properly-structured FAC is intended to prevent.

In Illinois, the governor, in an ill-conceived attempt to interfere with Illinois regulatory processes to prevent a rate increase after the end of another legislatively-mandated rate freeze, appears to have fired the sitting chairman of the Illinois Commerce Commission ("ICC"), giving him a new job. To forestall the rate increases that will likely come under a generation auction that was provided for under that state's restructuring law, the governor appointed a longtime consumer advocate to chair the ICC. He was promptly rejected by the Senate. The next appointee supported the auction after all, so the governor gained little other than a

substantial loss of reputation leading up to his re-election bid in November of this year.

In Vermont, I recently provided testimony on behalf of Central Vermont Public Service Co. ("CVPS"), which is attempting to regain its investment-grade credit rating status that it lost last year. The rating agencies are very concerned about CVPS's inability to maintain adequate cash flows after a negative rate decision a year ago and the uncertainty that arises with the lack of a FAC or PGA for fuel, natural gas, and purchased power expenses.

It is not surprising that RRA holds the view that utilities operating in jurisdictions without FACs "have always been, and continue to be, at risk for fluctuations in fuel and purchased power costs between rate cases."[12]

III. JURISDICTIONS IN WHICH FACS ARE UTILIZED

Q. WHAT ABOUT JURISDICTIONS IN WHICH FACS ARE UTILIZED?

A. On the other side of the coin, Indiana is a state which is viewed as having a very constructive regulatory environment. Part of the reason for its positive reputation is that it has not only utilized tracking mechanisms for fuel and power supply, it has also authorized trackers for other costs that are variable, outside the direct control of the utility, and highly variable from year-to-year, including costs related to environmental compliance and independent system operator activities. I testified on the issue of

[12] Regulatory Research Associates Regulatory Focus Special Report: "Fuel and Wholesale Power Cost Recovery, A State-By-State Review," October 3, 2005 at 2.

FACs on behalf of PSI Energy, Inc. ("PSI") in Cause No. 42200 before the Indiana Utility Regulatory Commission. The Commission's final order in that case sums up well the benefits of FACs:

> Sound regulatory policy supports the numerous regulatory decisions, in Indiana and elsewhere, authorizing purchased power trackers.... [A] utility should have a reasonable opportunity to recover the prudently incurred costs associated with meeting its obligation to provide adequate and reliable service to its customers.... [T]racking mechanisms are appropriate regulatory tools for reflecting costs that are volatile, substantial, and largely outside of the control of the utility.... As this Commission has previously stated, maintenance of credit quality is important both for utilities and their customers. "Reduced credit quality will result in higher debt costs which, in turn, will result in higher rates charged customers in the future." [Citation omitted.]... As we have previously recognized, rate adjustment mechanisms for fluctuating costs such as fuel and purchased power are viewed positively by rating agencies. ... We recognize that customers and shareholders share an interest in PSI's achievement of necessary financing at reasonable costs. We believe that the continuation of a purchased power tracker for PSI should assist PSI in attracting capital on reasonable terms and this, in turn, would also benefit customers. ... To terminate PSI's tracker at this point in time would deprive PSI of the opportunity to recover its prudently incurred costs of providing service. This we will not do.[13]

Q. WHAT INSIGHTS DO YOU DRAW FROM ACTIVITY RELATED TO FACS IN OTHER STATES?

A. What these experiences from other states say to me is that, where regulators have the opportunity to implement and utilize an appropriately-

[13] In the Matter of the Petition of PSI Energy, Inc. pursuant to the Commission's April 11, 2001 Order in Cause No. 41448-S1 and Ind. Code 8-1-2-42, for Authority to Extend and Expand PSI's Standard Contract Rider No. 67, to Allow Recovery of Certain Costs Associated with Wholesale Power Purchases Made by Petitioner to Meet its Retail Native Load Requirements, Beyond 2002 and in Months Outside of June through September, as necessary to Maintain Adequate Electricity Reserves, June 4, 2003 at 11-12, 14.

structured FAC that will provide expedited recovery of prudently-incurred fuel and purchased power costs, it does not represent good public policy to forgo the use of such a mechanism and throw one's lot in with the states that are allowing such issues of recovery of prudent expenditures to be fought out in the political arena.

Q. DID YOU HAVE EXPERIENCE WITH FACS AND PGAS DURING THE TIME THAT YOU SERVED AS A REGULATOR IN MICHIGAN?

A. Yes I did. When I served as chairman of the Michigan PSC, each year we went through proceedings for each utility to set a plan for their proposed fuel and natural gas procurement and power purchases from third-party providers. The plan the Michigan PSC approved served as a before-the-fact prudence finding to provide guidance to a utility as it dealt with these issues as the year went on. At the conclusion of the plan year, a reconciliation proceeding compared actual results with the approved plan and made prudence findings on any differences that existed. The goal throughout both processes was to assist utilities to prudently manage their fuel and natural gas procurement and purchased power needs.

IV. HOW THE FINANCIAL COMMUNITY VIEWS FACS

Q. CAN YOU EXPLAIN HOW THE FINANCIAL COMMUNITY VIEWS FACS BASED UPON YOUR EXPERIENCE AS HEAD OF THE UTILITY RATINGS PRACTICE AT FITCH?

A. Yes. Consideration of fuel costs in a manner that lowers uncertainty and risk, such as through use of a FAC, represents the mainstream position

across the United States. Accordingly, the financial community relies on the presence of such adjustment mechanisms to protect investors from the variability of fuel and purchased power costs that can have a substantial impact on the credit profile of a utility, even when prudently managed. These mechanisms mitigate a portion of the risk and uncertainty related to the day-to-day management of a regulated utility's operations. Conversely, the absence of such protection is factored into a utility's credit profile as a negative element.

Notably, Standard & Poors ("S&P"), a leading credit rating agency, stated in November 2002 its opinion concerning the importance of electric utilities having the opportunity to recover fuel and purchased power expenses:

> When assessing the importance of productive regulation to the credit strength of an electric utility, something to consider is the means by which the utility can expect to recover variable expenses, particularly fuel and purchased-power expenses, which have highly erratic unit costs. Recent, and in some cases, extreme volatility in the U.S. wholesale electricity markets, as well as in the natural gas markets, underscores this importance. It is no coincidence that utilities with stronger fuel and power cost recovery mechanisms typically enjoy loftier credit ratings.

S&P went on to comment upon the negative aspects of the absence of a FAC:

> In jurisdictions where FACs have been prohibited, electric utilities have always been subject to the uncertainties surrounding the recovery of incurred fuel and purchased-power expenses. With few exceptions, companies operating

exclusively in these jurisdictions have always had ratings below the industry average.[14]

Q. DO THE OTHER RATING AGENCIES SHARE S&P'S POSITIVE VIEWS WITH REGARD TO FACS?

A. Yes they do. Moody's Investors Service ("Moody's") has commented upon the importance of FACs in mitigating operating risk:

> Cost Recovery Provisions: States have various policies with respect to fuel and wholesale power cost recovery, and the recent volatility in commodity prices have made these provisions important elements of a utility's cost management capability. Such provisions make it possible for utilities to quickly adjust rates in the event of an unexpected hike in fuel costs. Although the number of states permitting such recovery has declined, particularly in those that have transitioned to a competitive market, they remain critical risk mitigants to those utilities still operating in regulated environments.[15]

Fitch has also discussed the credit implications of the presence of FACs:

> Fitch factors risks related to commodity price volatility into stress cases related to each company's individual circumstances and asset portfolios.... Potential risks for regulated distribution and integrated utilities: ... Utilities with frozen tariffs or those without the means to recover their higher fuel expense are most at risk.[16]

In February 2006, Fitch added these thoughts in a report discussing credit implications of commodity cost recovery:

> A utility's ability to weather a period of high and rising commodity costs is influenced by many related factors, including the state's market structure, rules regarding power procurement and the utility's obligation to serve customers' energy needs, the utility's

[14] S&P Research: "Constructive Regulation For U.S. Utilities Is More Important Than Ever," November 14, 2002 at 1.
[15] Moody's Global Credit Research: "Rating Methodology: Global Regulated Electric Utilities," March 2005 at 19.
[16] Fitch Special Report: "Electric Fuels Outlook: The Fuels Dilemma," November 11, 2004 at 7.

> resource mix relative to its load requirement, access to adequate liquidity and the state's regulatory/political environment. Within this context, **effective and timely commodity cost-adjustment mechanisms provide utilities with greater assurance of ultimate recovery in a rising energy price environment**. [Emphasis supplied.][17]

Last month, Fitch re-emphasized the impact that timely recovery of fuel and purchased power expenses has on electric utility credit ratings:

> Volatile and higher energy and fuel commodity prices represent a challenge to electric utilities.... Given [the current] environment, Fitch believes timely recovery of fuel costs is essential to an electric utility's creditworthiness and that its response to high and volatile cost pressures will be a key determinant to a utility's credit quality and rating in 2006 and beyond.[18]

V. CREDIT RATINGS

Q. ARE CREDIT RATINGS IMPORTANT FOR REGULATED UTILITIES AND THEIR CUSTOMERS?

A. Yes. Credit ratings reflect a credit rating agency's independent judgment of the general creditworthiness of an obligor or the creditworthiness of a specific debt instrument. While credit ratings are important to both debt and equity investors for a variety of reasons, their most important purpose is to communicate to investors the credit strength of a company or the underlying credit quality of a particular debt security issued by that company.

A credit rating is an indication of an issuer's ability to service its debt, both principal and interest, on a timely basis. It is a well-established

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[17] Fitch Special Report: "U.S. Electric Utilities: Credit Implications of Commodity Cost Recovery," February 13, 2006 at 1-2.

[18] Fitch Special Report: "Cost Recovery and Public Power: Who Is at Risk?," June 1, 2006 at 1.

fact that a utility's credit ratings have a significant impact as to whether that utility will be able to raise capital on a timely basis and upon favorable terms. As respected economist Charles F. Phillips stated in his treatise on utility regulation:

> Bond ratings are important for at least four reasons: (1) they are used by investors in determining the quality of debt investment; (2) they are used in determining the breadth of the market, since some large institutional investors are prohibited from investing in the lower grades; (3) **they determine, in part, the cost of new debt, since both the interest charges on new debt and the degree of difficulty in marketing new issues tend to rise as the rating decreases**; and (4) they have an indirect bearing on the status of a utility's stock and on its acceptance in the market.[19] [Emphasis supplied.]

Thus, the lower a regulated utility's credit rating, the more the utility will have to pay to raise funds from investors to carry out its capital-intensive operations – and, as noted by Dr. Phillips, credit ratings can also affect the amount of money that utilities can raise from equity investors at any point in time. In turn, the ratemaking process factors the cost of capital for both debt and equity into the rates that consumers are required to pay. Thus, a utility with strong credit ratings is not only able to access the capital markets on a timely basis at reasonable rates, it also is able to share the benefit from those attractive interest rate levels with customers through lower utility rates.

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[19] Phillips, Charles F., Jr., The Regulation of Public Utilities, Arlington, Virginia: Public Utilities Reports, Inc., 1993, at p. 250. See also Public Utilities Reports Guide: "Finance," Public Utilities Reports, Inc., 2004 at p. 6-7 ("Generally, the higher the rating of the bond, the better the access to capital markets and the lower the interest to be paid.").

Q. CAN YOU SHARE ANY RECENT EXPERIENCE YOU HAVE HAD WHERE FACS HAVE IMPACTED A REGULATED UTILITY'S CREDIT RATING IN A NEGATIVE WAY?

A. Yes I can. I was an expert witness for APS ("Arizona Public Service") before the Arizona Corporation Commission ("ACC" or "Arizona Commission") in a rate case that settled last year in which a power supply adjustor ("PSA") was agreed to by the parties to the rate case, then modified by the ACC before it was ordered into effect.[20] Thereafter, the rating agencies, most notably S&P, indicated problems that they saw with the framework of the PSA. These infirmities included: an annual cap of $776 million, after which additional amounts for fuel and purchased power would not be recoverable, even if prudently-incurred; a total cap of $0.004 per kWh over the five-year life of the PSA; delays between the time of expending funds and ultimate recovery, creating uncertainty in the minds of investors; and base rate levels, including an allocation for fuel and purchased power, based upon a *December 2002* test year, so that by the time the rate case was concluded by settlement agreement two years after it was filed, APS was already in a position where it had to file a new rate case in order to align costs and rates properly.[21]

With the run-up in gas prices during the past year, APS has accrued extremely large deferred cost amounts under the PSA, which has

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[20] *See* Arizona Corporation Commission Docket No. E-01345A-06-0009.

[21] S&P Research Summary: "Arizona Public Service Co.," May 24, 2005; RRA Focus Notes on Arizona, April 1, 2005 and November 4, 2005.

driven its credit ratings to "BBB-", the lowest investment-grade level. A downgrade of one notch for APS into below investment-grade or junk bond status would carry with it serious negative financial consequences not only for investors, but also for the regulated utility's customer base due to significantly-higher financing costs. I followed up that earlier testimony by testifying in APS's recent emergency interim rate proceeding in which that utility requested expedited cost recovery of deferred fuel and purchased power balances, notwithstanding the existing framework of the PSA. The Arizona Commission at first modified the PSA to better track with the amount and timing of APS's expenditures, and then in May 2006 provided interim rate relief in an effort to stabilize APS's weak credit profile.

Q. WHAT IS YOUR UNDERSTANDING OF THE VIEWS OF THE RATING AGENCIES WITH REGARD TO APS'S SITUATION?

A. In October 2005, S&P expressed growing concern about the level of APS's deferrals, related both to day-to-day power supply for core customers, as well as replacement power related to a nuclear outage earlier that year:

> ...it is clear that timely near-term [power] cost collection will be the key driver of credit quality. [S&P] is becoming increasingly concerned with the utility's ability to achieve this. A relatively weak power supply adjustment mechanism, in combination with rapidly escalating and volatile gas prices, as well as the potential for a protracted surcharge proceeding, could cause deterioration in financial

> performance which, year to date, has been sub par for the rating.[22]

Then, on December 21, 2005, S&P downgraded APS' corporate credit rating to "BBB-," the lowest investment-grade level. S&P explained its rationale:

> This action is based on increased regulatory and operating risk at APS. Specifically, [S&P] is concerned that the [ACC] is not expeditiously addressing APS' growing fuel and purchased-power cost deferrals, which have grown much more rapidly than expected in 2005, particularly because of elevated gas prices and the utility's increased dependence on this fuel. In November 2005, APS filed for a nearly 20% increase in customer electric rates, but it appears unlikely that a resolution will be reached until 2007, and may be delayed to mid-2007.[23]

S&P went on to discuss the infirmities it sees with the PSA:

> The stable outlook reflects [S&P's] expectation that the ACC will resolve at least a portion of APS's increasing deferred power costs in January 2006. In addition, the outlook presumes that progress will be made in addressing APS' general rate case and that any outcome will support the return of consolidated financial metrics to what until 2004 was a reasonable performance... Any adverse regulatory development or continued delays in resolving the pending surcharge request could result in a downward revision of the outlook or an adverse rating action.[24]

On January 25, 2006, the Arizona Commission ameliorated the flaws within the PSA to a minor degree. While S&P found these changes to be "favorable," the rating agency looked to the decision as "an important indicator that the ACC acknowledges that timely action is necessary to

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[22] S&P Research: Arizona Public Service Co., October 4, 2005 at 1-2.
[23] S&P Research Update: "Pinnacle West Capital's, Arizona Public Service's Ratings Lowered to 'BBB-'; Outlook Stable," December 21, 2005 at 1.
[24] *Id.* at 3.

limit cash flow pressure on the company." [25] Then on May 2, 2006, the Arizona Commission provided a rate increase to APS of approximately 8 percent to mitigate the growth in deferred fuel and purchased power deferred balances. Significantly, S&P noted that the deferrals were related to a mismatch between APS's base rates and its escalating fuel costs:

> Deferrals are resulting from the fact that APS' retail electric rates are based on a 2003 test year, but actual fuel and power costs have risen sharply since then. As a result, APS incurred about $173 million in deferred fuel and purchased power costs in 2005. In addition, APS estimates that in 2006 about $250 million in additional deferrals could be incurred.[26]

Q. WHAT IS YOUR UNDERSTANDING OF HOW MOODY'S AND FITCH VIEWED THE APS SITUATION?

A. On January 10, 2006, Moody's placed the "Baa1" senior unsecured credit rating of APS under review for downgrade. Moody's explained its concerns:

> The review is prompted by deterioration in the company's current and projected financial metrics as a result of increased fuel and purchased power costs that the company has not been able to recover on a timely basis...APS and [parent company Pinnacle West's] financial strength are highly dependent upon timely implementation of cost recovery mechanisms.... Last week, an [ALJ] recommended denial of APS' request to implement the special surcharge of approximately 2% even though the ACC staff and a major consumer group agreed to its implementation shortly after the request was made in July 2005.... Beyond 2006,

[25] S&P Research Update: "APS, PWCC's 'BBB-' Corporate Credit Ratings Affirmed on ACC Vote But Challenges Continue," January 26, 2006 at p. 1.
[26] S&P Research Update: "Pinnacle West Capital Corp., Arizona Public Service's 'BBB-' Ratings Affirmed," May 8, 2006 at 1.

> supportive regulatory treatment remains key to the company's ability to maintain financial strength in light of significant needs for capital investment to serve a growing service territory...An assessment of likely regulatory outcomes will be a significant factor in concluding the review for downgrade. The ratings of APS and Pinnacle are likely to be downgraded unless there are clear signals that APS will receive timely and full recovery of its increased costs....[27]

Three weeks later, on January 30, 2006, notwithstanding the Arizona Commission's modifications to the PSA structure and small rate increase a few days earlier, Fitch downgraded APS's senior unsecured ratings to "BBB" with a Stable Outlook, stating:

> ...the ACC bench order rejecting APS's $80 million surcharge request on procedural grounds and restriction of PSA adjustments to an annual reset is less favorable than Fitch had anticipated in its previous ratings and is a significant source of concern for [Pinnacle West] and APS fixed-income investors. The fact that there is no vehicle within the PSA protocol to recover supply costs more frequently than annually during periods of sustained high and rising energy costs subjects APS to significant cash flow volatility and working capital requirements.... The only option to recover fuel and purchase power costs above amounts determined annually in the PSA would be an emergency rate filing, in which the timing and amount of rate relief would be uncertain.[28]

Q. CAN YOU PROVIDE BACKGROUND ON ANY OTHER MISMATCH SITUATIONS INVOLVING RECOVERY OF FUEL AND PURCHASED POWER COSTS AND THE EFFECT ON CREDIT RATINGS?

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[27] Moody's Global Credit Research: "Moody's Places the Debt Ratings of Pinnacle West (Sr. Uns. Baa2) and Arizona Public Service Co. (Sr. Uns. Baa1) Under Review for Downgrade," January 10, 2006 at 1-2.

[28] Fitch Press Release: "Fitch Lowers PNW & APS' Sr. Unsecured Ratings to 'BBB-' and 'BBB', Respectively; Outlook Stable," January 30, 2006 at 1-2.

A. Yes. Analyses of credit rating experiences in California and Nevada are instructive as to how such mismatches can result in very severe financial consequences for a regulated utility and how difficult it can be to bounce back from a major negative ratings event.

In mid-1997, Pacific Gas & Electric Co. ("PG&E") and Southern California Edison Co. ("SCE") both held strong "A+" ratings from S&P with Positive Outlooks. We all are familiar with the regulatory debacle that ensued related to California's competitive restructuring initiative. Basically, retail rates were frozen while prices were rapidly-escalating in the wholesale market within which PG&E and SCE had to purchase power. As a result of that severe mismatch between purchased power costs and lack of recovery, both utilities went into default on their debt obligations in January 2001, with PG&E filing for bankruptcy and SCE agreeing to a regulatory settlement to avoid having to file for bankruptcy. Different leadership at the California Public Utilities Commission and within the California Legislature has led to new policies that seek to provide a degree of upfront guidance for procurement plans before utilities have to contract for power supply, a structure that is somewhat similar to the plan and reconciliation process with which I am familiar from my days as a Michigan regulator. This change in policy direction has provided a close match between costs and recovery and has proven to be much more supportive of the financial condition of the two utilities.

The result is that now, five years later, PG&E and SCE have seen significant improvement in their credit profiles, from "D" category signifying "default," back to the point of holding ratings in the investment-grade "BBB" category: PG&E is at "BBB" with a Stable Outlook, and SCE holds a rating of "BBB+" with a Stable Outlook. I note, however, that even with this strong recent regulatory support, the severe financial damage inflicted by the earlier flawed restructuring scheme has left PG&E four rating notches below its 1997 status, and SCE three notches lower.

Turning to Nevada, Nevada Power Co. ("Nevada Power") has its neighbors to the west to thank for the difficult situation it has found itself in. In April 1999, Nevada Power had a rating of "BBB+" with a Positive Outlook. Unfortunately, Nevada Power became what I describe as an "innocent victim" of the failed California competitive experiment that sent wholesale electricity prices soaring in the West. Nevada Power paid those prices to ensure continued reliable supply for its customers, only to have the Nevada Public Utilities Commission deny recovery of $437 million of deferred energy costs. By April 2002, Nevada Power's credit ratings from S&P had fallen to "B+" with a Negative Outlook, deep into non-investment-grade territory. Since that time, similar to what occurred in California, state regulators have sought to be supportive of Nevada Power's return to financial health, including presiding over a succession of much less contentious deferred energy proceedings. Today, however, four years later, Nevada Power's ratings still remain at 'B+', albeit with a Positive

Outlook. The sad truth is that a downgrade or multiple downgrades due to negative regulatory policies can occur quickly, but the process of recovery, beginning with the rebuilding of rating agency confidence in the regulatory environment, can take many years before a positive result can be achieved.

VI. CURRENT ENVIRONMENT

Q. HOW DO YOU VIEW FACS WITHIN THE CURRENT ENVIRONMENT OF RAPIDLY-ESCALATING FUEL AND PURCHASED POWER COSTS?

A. They are more important than ever.

Q. PLEASE EXPLAIN.

A. It should be clear from the experiences in Arizona, California and Nevada that attempts by regulators to artificially hold the line on seemingly prudently-incurred fuel and purchased power cost recovery solely because those costs are growing at a rapid rate can have very dire consequences. Properly-structured FACs, with appropriate monitoring and decision-making tied to prudence, are the best means to avoid negative financial impacts on regulated utilities.

Uncertainty with regard to fuel cost volatility is the very reason that a majority of states utilize a properly-structured power supply adjustment mechanism in the first place – so that a utility can carry out its responsibilities to provide reliable service to customers at the best cost

available under then-existing circumstances, without having to be concerned that its prudent expenditures in this regard might be found to be unrecoverable at a later time. Because regulated utilities in most cases do not earn any profit or return on their fuel and purchased power expenditures, barring unusual behavior on the part of the utility such expenses are presumed to be prudent, and rating agencies expect that utilities will recover them without undue delay.

Thus, a FAC is best-suited for a situation bearing the following characteristics: 1) uncertainty of costs; 2) volatility of costs; 3) large amount of costs when measured against a company's size, especially in view of the fact that no return is provided for the risk related to this substantial outlay of funds; and 4) no ability to control the size of these costs necessary to serve customers in a reliable and efficient manner.

All of these factors are present today with respect to fuel and purchased power expenditures by Empire District. Thus, the inability of Empire District and its customers to benefit from a properly-structured FAC is inconsistent with sound regulatory policy.

VII. PUBLIC POLICY REASONS FOR FUEL AND PURCHASED POWER RECOVERY MECHANISMS

Q. CAN YOU DISCUSS THE BENEFITS OF FACS?

A. Yes. The concept of utility regulation is to provide a surrogate for the competitive market that is not present when a company possesses monopoly or near-monopoly status with regard to an essential good, such

as utility service. FACs attempt to align the costs that a utility expends for fuel and purchased power with its recovery of those costs on a timely basis. Base rate cases with their high expense – for all participants -- and lengthy duration are ill-suited to deal with costs that 1) can vary widely from year-to-year; 2) are substantially outside the control of the utility; and 3) represent a considerable financial outlay by a utility, with no ability to receive a return on those expended funds. By being able to recover prudently-incurred costs expeditiously, a utility lowers the risk of its operations and achieves consistency with the level of risk faced by a wide majority of other utilities within the United States, all of which are chasing the same investor funds. Finally, it is wholly consistent with rational utility economics for customers to pay the actual costs of fuel and purchased power that are procured for customers' benefit, whether those costs are in an escalating mode or actually going down.