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 REPLY AND TRUE-UP BRIEF

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

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?

The Staff generally agrees with the comments and concerns of OPC and the Industrials regarding the Rate of Return issue. However, as regards the impact of the award of an FAC on the recommended ROE, Staff would clarify that its position is that while it would be appropriate to move toward the bottom end of Staff's recommended range should an FAC be authorized, it is not advocating an outright downward adjustment. (*see* Tr.. 527, L. 15 -25). Empire, at page 11 of its Initial Post-Hearing Brief, mischaracterized Staff's position on this matter, stating that Staff advocated such an explicit adjustment.

Empire also mischaracterizes Staff's position as to its actual ROE recommendation, in its suggestion, found at page 8 of its Initial Post-Hearing Brief, that it would be appropriate for the Commission to use the **upper bound** of Staff's recommended ROE range, and the **upper bound** of Mr. Gorman's recommended range, with the **average** of Dr. Vander Weide's recommended range to derive an average recommendation as a basis for its ROE decision. While Mr. Barnes did find, based on comparable company analyses, an ROE in the range of 9.72% - 10.78% to be an appropriate ROE for use in setting Empire's rates, (Ex. 219, Barnes Surrebuttal, p. 2, L. 14 -16), Mr. Barnes nowhere in his prefiled testimony or his cross-examination recommended or suggested that the Commission order the high end of Staff's ROE range be used to set rates. This outright attempt by Empire to misrepresent Staff's position, as well as that of the Industrials and OPC, is inappropriate. Simply put, Mr. Barnes' low-end recommendation of 9.72% for Empire is just as appropriate as his high-end recommendation of 10.78%.

Empire's Initial Brief at pages 9 – 13 includes discussion of Mr. Overcast's proposal to nudge up Empire's allowed ROE to compensate it for the purported regulatory risk inherent in Missouri's regulatory scheme. As discussed more fully in Staff's Initial Brief, Staff witness Barnes persuasively describes in his testimony the steps he took to arrive at a recommendation based on proxies of comparable risk to Empire. (*see* Ex. 204, Staff Cost of Service Report, p. 16). Further, Mr. Overcast's discussion of Missouri's regulatory practices and the associated impact on Empire's ability to actually achieve its allowed rate of return was persuasively refuted in the surrebuttal testimony of Staff witness Oligschlaeger. (*see* Ex. 202, Oligschlaeger Surrebuttal, pp. 12-13).

Primary among Empire's concerns was the allegedly more favorable test year policies allowed by other jurisdictions compared to Missouri. Mr. Oligschlaeger explained that the existence of the regulatory plan amortization mechanism for Empire, which has the effect of reflecting certain costs in Missouri rates earlier than under traditional rate regulation in this jurisdiction, directly offsets Mr. Overcast's concerns regarding the timing of inclusion of costs in rates relating to test year policy. (Ex. 202, Oligschlaeger Surrebuttal, pp. 12-13). It is not appropriate to adjust the return on equity determined through comparable-company analysis for a risk that has already been accounted for in the comparable-company analysis.

As a final note regarding Empire's discussion of ROE in its Initial Brief, Empire repeatedly postulates that things haven't gotten any better financially for Empire since previous cases, and poses this as a rationale for awarding Empire at least the same award as in those previous cases. (*see* Empire's Initial Post-Hearing Brief at p. 4) This is simply not the law. *Hope* dictates that a return should be based on the returns of enterprises with commiserate risks, not on the isolated utility's current risk relative to its prior level of risk. *Federal Power Commission v. Hope Natural Gas Company*, 320 US 591 (1944). The course charted by Empire with this flawed logic is not only improper in the sense of isolating Empire from the global capital market in which it participates, but in terms of the long-standing precedent underlying cost-of-service ratemaking.

Expense Issues

> <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 continues to recommend an approximate $4.4 million total company amount of off-system sales margin as the appropriate amount to use to offset Empire's cost of service in this case. Though Staff's true-up audit determined that Empire's margins for the 12 months ending February 29, 2008, were \$6.1 million, there is insufficient information regarding Empire's current off-system sales market to impute this amount in rates.

Staff recognizes two facts from its review of Empire's historical margins in this case: 1) the margins tended to fluctuate significantly from year to year; and 2) certain changes occurred in the test year (implementation of the Southwest Power Pool Energy Imbalance Service (EIS) market) that were likely to impact Empire's margin levels positively on an ongoing basis. Due to the recent introduction of the EIS market, Staff believes it is not appropriate to rely on a multi-year average of historical margin results for purposes of setting rates. (Tr. 171). However, introduction of the EIS market does not mean that some level of fluctuation in annual OSS margin results would not continue to be expected, due to unit outages and other unpredictable factors. (Tr. 177). For this reason, Staff does not find it appropriate to base its rate recommendation on the highest margin level achieved by the Company for nine years or more (\$5.9 million for the 12 months ended December 31, 2007; or \$6.1 million for the 12 months ended February 29, 2008). Staff believes a better and more conservative approach was to use the margin achieved in the first six months of 2007, and multiply that amount by two to annualize it. (Tr. 187-188). The Commission should include a conservative amount in rates and direct that actual off-system sales margins pass through a fuel adjustment clause if one is ordered.

> <u>Commission Rules/Tracker</u>: 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?

In its Post-Hearing brief, OPC emphasizes a belief that the Staff's proposed one-way tracker mechanism could lead to the Company spending more money for rules compliance activities than is necessary or prudent. In response, Staff suggests that OPC's position reflects a lack of understanding of what the Commission's new vegetation management rule will actually require of Empire and other Missouri electric utilities. Section 9 of this rule provides for phased compliance by electric utilities, with 15% compliance mandated for the first year, 40% compliance the second year, and 70% compliance in the third year for the utilities' urban distribution areas. (The rule's requirements for rural distribution areas are less stringent.) Full compliance with the mandated tree trimming cycles for rural and urban circuits are not required until the fourth year and sixth year of operation under the new rule, respectively. For this reason, Staff believes that, even in the event that the rate allowance granted to the Company in this case is in excess of the amount needed for minimal rule compliance in the next two years, it makes good sense and is in the public interest for Empire to expend the additional dollars received in rates to go beyond the minimum compliance requirements.

The Staff opposes Empire's suggestion that a two-way tracker provision for rules compliance costs be ordered so that any funds not expended by Empire for compliance activities will be eventually returned to customers. In light of the vegetation management rule's phased compliance provisions, Staff believes there is no good reason why Empire should not be able to prudently spend the entirety of Staff's recommended rate allowance for infrastructure maintenance and vegetation management activities to achieve full rule compliance faster than mandated under the Commission's directives. In fact, Staff is only willing to recommend the additional amounts in this case for rules compliance activities based upon a commitment by the Company that they will in fact expend those funds for their intended purpose, or face penalties. (Tr. 404). A two-way tracker mechanism for these costs is inconsistent with this commitment.

OPC also suggests in its brief that some amount of rules compliance costs may be reflected in the adjusted test year expenses in this case. Staff believes that the existence of any such "double-counting" between the adjusted test year amount and the proposed rules compliance allowance has not been established in the record, and that it is likely that the amount of any rules compliance costs incurred within the test year and update period would be immaterial if it occurred at all.

Empire's position on this issue differs from Staff's in that, in addition to upfront rate recovery of compliance costs, Empire also advocates deferral of any amount it expends above the compliance allowance established in this case for potential recovery in subsequent rate cases. A similar deferral mechanism is set forth in the Commission's infrastructure maintenance and vegetation management rules. However, Staff's position on this matter in this case goes beyond what would be allowed under the rules by granting the Company upfront recovery of compliance costs. Staff believes it would be excessive to allow Empire the "best of both worlds" regulatory treatment by giving it both upfront rate recovery and the ability to defer costs it may expend in excess of the that upfront recovery amount.

As discussed in Empire's brief, the monetary difference between its recommended rate allowance for rules compliance compared to Staff's recommendation is solely attributable to the Company's assumption that rates from this case will be in effect for approximately three years, as opposed to Staff's assumption of two years. Staff believes the evidence in this proceeding supports its assumption as to the likely longevity of rates established in this case. Empire witness Keith stated in prefiled testimony that "the rates coming out of this rate case will go into effect around September 1, 2008 and are expected to remain in place until June of 2010, or approximately 21 months." (Exhibit 2, Keith Direct, p. 15, L. 3). Mr. Keith also verified the estimated two-year duration of rates from this proceeding under cross-examination. (Tr. 387).

> <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 change. Empire's Post-Hearing brief regarding the effect of this issue on customer rates is wrong. On page 29 of its Brief, Empire claims that if no regulatory plan amortization is necessary in this case, then the Commission's decision on this issue will have an effect on rates. As was discussed in Staff's true-up testimony and was uncontroverted in Empire's true-up rebuttal testimony, all of the parties to this proceeding have agreed to potential reflection of a "negative" regulatory plan amortization (RPA) amount in rates in this case. (Exhibit 233, Oligschlaeger True-Up Direct, pp. 10-11). This means the parties have agreed that the RPA amount ordered in Empire's last rate proceeding should be reduced in this proceeding if the Commission's traditional revenue requirement findings so justify. Because of the Company's agreement to a negative RPA in this proceeding, any increase in depreciation rates ordered by the Commission in this case will be offset dollar for dollar by a decrease in the RPA component of Empire's rates. As the Staff 's recommended revenue requirement after true-up would lead to a negative RPA (Exhibit 234), any increase in Empire's depreciation rates above the level assumed by Staff would simply make the RPA more negative.

The Commission should not be misled on this point – the Commission's decision on this issue in this case will have absolutely no impact whatsoever on the level of rates to be charged to Empire's customers as a result of this case. In fact, because both depreciation expense and RPA amounts s are booked to the depreciation reserve, the Commission's decision on the depreciation rates issue in this case will have no impact on the Company's future rate base amounts, and hence the decision in this proceeding will have no impact whatsoever on Empire's future customer rate levels, either.

In its brief, Empire alleges that Staff's criticisms of Empire's property recordkeeping are primarily based upon an "isolated" instance in which negative cost of removal was recorded by the Company. That view ignores Staff's concerns with how Mr. Roff ignored third-party reimbursements in calculating his proposed depreciation rates. (Exhibit 217, Schad Rebuttal, pp. 5-7). Staff witness Schad stated under cross-examination that the plant record problems she encountered regarding the Company's reimbursements during this case were serious enough that as a result Staff could not complete a depreciation study and draw any conclusions regarding whether changes to Empire's current ordered depreciation rates were appropriate. (Tr. 343-344). Mr. Roff himself admitted on the stand that he could not affirmatively state that his depreciation study was in compliance with the Commission's rules. (Tr. 311). Mr. Roff's disregard of third party reimbursements in his study is a pervasive problem which calls into question the overall appropriateness and accuracy of Empire's depreciation rates proposal in this case.

Because of the major property record deficiencies noted in this case, and the lack of any rate impact from the Commission's decision on this issue in this case, Staff continues to recommend that the Commission order no change in Empire's depreciation rates in this proceeding.

FUEL COST RECOVERY

1. Fuel Adjustment Clause: 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?

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 ADJUSTMENT CLAUSE

Given Empire's Posthearing Brief, the Staff will endeavor to provide later in this section a more detailed explanation of the actual operation of Empire's and the Staff's proposed fuel adjustment clauses (FAC). In doing so, there will be some repetition in the Staff's efforts at explanation. The Staff apologizes in advance for the repetition, but suggests that even the repetition may be of benefit because of the complexity of the operation of the proposed FACs and the weakness of the efforts to date, the Staff included, to provide accessible explanations of what some of the parties are proposing.

At page 34 of its Posthearing Brief, under the heading "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?," Empire cites the Commission's *Report And Order Upon Reconsideration* in Case No. ER-2006-0315 wherein the Commission terminated the Interim Energy Charge Stipulation And Agreement from Case No. ER-2004-0570 that had been in place. The Commission's termination of the IEC Stipulation And Agreement is also relevant to Empire's and Dr. Overcast's assertions that:

> . . . there is no evidence that Empire has behaved imprudently in the past and no evidence that the Company will do so in the future. Dr. Overcast explained this fact as follows:

> There is no evidence that Empire has been imprudent. On the contrary, there is ample evidence that Empire has and continues to manage its fuel and purchased power costs prudently. . . .

(Ex. 10, Overcast Rebuttal, p. 4)

Although the Commission did not state that Empire had been imprudent in entering into the Case No. ER-2004-0570 IEC Stipulation And Agreement, the Commission all but said that when it stated as follows:

> Whatever limitation, if any, the terms of the 2005 Stipulation may have placed on Empire's ability to seek termination of the IEC within the three-year period, the terms of the 2005 Stipulation do not limit the Commission's ability to terminate the IEC if such action is in the public interest. The existing IEC agreement has and will continue to create a significant under-recovery of costs for Empire because of the volatility of natural gas prices that was unforeseen at the time the IEC agreement was reached. This Commission cannot abrogate its duty to both the utility and its customers simply because some of the parties have previously reached a Stipulation and Agreement that addresses the issue of fuel costs to the serious detriment of the utility. Given our statutory mandate, the Commission must set rates that are just and reasonable and that may better ensure Empire's solvency and its ability to provide safe and adequate service to its customers.

Report And Order Upon Reconsideration, Case No. ER-2006-0315, Mimeo, p. 50. The signatories to the Interim Energy Charge Stipulation And Agreement in Case No. ER-2004-0570 were Empire, Public Counsel and Praxair and Explorer Pipeline. The Staff filed a response stating its concerns respecting the nonunanimous Stipulation And Agreement, but also stating it would not oppose the Case No. ER-2004-0570 Stipulation And Agreement.

Of course, the Commissioners will recall that the Case No. ER-2004-0570 IEC Stipulation And Agreement is not the only fuel and purchased power agreement that Empire had to be saved from. While Empire relates not earning its authorized return on equity and rising fuel and purchased power costs this decade, it does not mention that it settled in entirety its rate increase case, Case No. ER-2002-424, filed on October 28, 2002, including fuel and purchased power and also the IEC from Case No. ER-2001-299. The Commission's November 14, 2002 *Report And Order* in Case No. ER-2002-424 states that the IEC authorized in Case No. ER-2001-299 and subsequently modified in Case No. ER-2002-1074 shall terminate at 12:01 a.m. of the Commission ordered effective date of the new rates as a result the Commission's acceptance of the Case No. ER-2002-424 Stipulation And Agreement.

In further response to Empire's protests that it never has and never will engage in imprudent behavior in relation to its fuel and purchased power activities, the Staff would again note the Staff's True-Up Direct Testimony of Mark L. Oligschlaeger respecting Empire's recent gas contract "unwinding" (undoing or canceling). The unwinding resulted in Empire booking a gain to the benefit of its shareholders in its income statement during the true-up period, but the unwinding actions are also likely to result in future customer detriment due to Empire having to purchase replacement gas to serve future customer loads at what will probably be a significantly higher cost than what Empire had previously contracted for in the unwound contracts. As indicated in Mr. Oligschlaeger's True-Up Direct Testimony and the Staff's Posthearing Brief, the Staff expects that the Commission will see this matter raised as an issue in the future. The Staff anticipates that it will seek prudence disallowances of higher gas costs incurred by Empire as a result of its unwinding decisions in future rate proceedings or FAC prudence audits. (Oligschlaeger True-up Direct, pp. 6-9).

Empire's unwinding of a forward natural gas contract is an issue that was before the Commission in Empire's last rate increase case, ER-2006-0315. In that case, Empire unwound a forward natural gas contract for deliveries in the summers of 2009, 2010 and 2011, and Empire recorded a gain of slightly over $5 million. The Staff argued in Case No. ER-2006-0315 that the gain should be amortized over a five-year period and netted against fuel expense. The Industrial Intervenors contended that the gain should flow through to retail customers: "'net impact of reflecting this gain along with current forward prices unhedged natural gas volumes is to decrease Empire's claims by approximately $12 million per year."'[footnote omitted.] *Re The Empire District Electric Company*, Case No. ER-2006-0315, *Order Granting Reconsideration Of Report And Order*, Mimeo, p. 52 (2008). The Commission stated: "Empire believes that, as the transaction was in the past and is of a non-recurring nature, it should be used to offset the under-recovery of fuel and purchased power expenses that occurred in the same year as the unwinding." [footnote omitted.] *Id.* The Commission adopted Empire's position. *Id.* at 53. Obviously, Empire was not forthcoming in how it characterized the transaction as being non-recurring since it has unwound another forward natural gas contract.

In its Posthearing Brief at page 31 Empire refers to increases in fuel costs beyond Empire's control that will be repeated in the future that have reduced Empire's earnings / return on equity between 12-65% for the period 2000-2006, citing Dr. Overcast's Direct Testimony, Exhibit 8, page 8. Empire does not mention that Dr. Overcast shows that for 2002 and 2003 Empire's total fuel costs decreased, thereby increasing Empire's earnings/return on equity between 9.21-14.41% for those years. (Ex. 8, Overcast Direct, p. 8).

Empire describes at length at pages 38-40 of its Posthearing Brief its assertion that it will not earn its authorized rate of return if its does not obtain full recovery of fuel and purchased power costs through an FAC mechanism. Such claims can only be made in complete nonrecognition of how single-issue ratemaking mechanisms such as FACs operate. As discussed by Staff witness Oligschaeger in the context of the Asbury SCR rate base issue, certain ongoing changes of a utility's cost of service, such as additional revenues from the increase in the number of customers and customers' usage (customer growth), which has been significant in the past for Empire, and the booking of depreciation expense to the depreciation reserve, actually improve a utility's earnings over time, all else being equal. (Vol. 5 Tr. 128-129). For that reason, increases in Empire's fuel and purchased power costs are likely to be offset to some degree by revenue requirement / cost of service decreases in these or other areas. Accordingly, it is incorrect and misleading to claim that allowing a significant majority, but not 100%, of increasing fuel and purchased power costs through a single-issue FAC, while allowing Empire to retain in entirety any cost of service decreases in other areas of its operations, will categorically result in the utility not earning its authorized return on equity. In fact, overearning by the utility might occur under Dr. Overcast's scenario.

At page 39 of its Posthearing Brief, Empire selectively quotes from page 4 of the Commission's September 21, 2006 *Final Order Of Rulemaking* in Case No. EX-2006-0472 respecting the promulgation of 4 CSR 240-20.090 Electric Utility Fuel and Purchased Power Cost Recovery Mechanisms. The full quote of the COMMENT and RESPONSE follows:

> COMMENT: Several lay commenters verbally suggested that it would only be fair for utilities to pass through only 50% of fuel costs and that the utility and its shareholders be required to pay the other 50%.
>
> RESPONSE: These commenters may be confusing the proposal by other commenters that no more than 50% of fuel and purchased power costs be

> recovered in a RAM and that 50% remain in base rates, a proposal to be discussed more fully below. If not, then the Commission must disagree with this comment in that it would not allow for the setting of just and reasonable rates that allow the utility a reasonable return.

The above RESPONSE can only be placed in context by a review of the relevant portion of another COMMENT and RESPONSE AND EXPLANATION OF CHANGE at pages 7-8 of the Commission's September 21, 2006 *Final Order Of Rulemaking* in Case No. EX-2006-0472 respecting the promulgation of 4 CSR 240-20.090:

> COMMENT: Some commenters believe these rules must be written so that the utility continues to have its own financial interests at stake, in order to ensure some level of prudence in utility practices with a RAM and that these incentives should be structured to align the interest of shareholders and ratepayers. Some commenters believe the proposed rules go beyond the strict construction of Section 386.266.1 and allow the Commission to impose a broad array of incentive and performance based programs.
>
> . . . .
>
> Other commenters support the inclusion of (11) and are especially supportive that the stated concept of alignment of interest between utility and ratepayer should be preserved and enhanced. Many comments about incentives have been discussed in the volatility mitigation section concerning flexibility to determine what percentage of fuel and purchased power cost are to be recovered in base rates and what percentage could be recovered in a RAM, because that financially connects obtaining fuel and purchased power at a lower cost to earning a higher return. However, commenters generally were not supportive of limiting, at this time, the kinds of incentive mechanisms that could be used or restraining the PSC Staff or any Party from proposing any incentive plan that would maintain the alignment of financial interests between the utility and ratepayers. Industrial Users recommended strengthening the provisions to enhance the likelihood of symmetrical sharing incentive provisions.
>
> RESPONSE AND EXPLANATION OF CHANGE: The Commission finds that the provisions for incentive mechanisms are sufficiently broad to encompass a wide range of programs, that the interests of both utilities and ratepayers are sufficiently safeguarded and that the rule does not exceed the scope of the authority for such programs in the statute. Therefore, no change will be made, except the grammatical change removing "or discontinuance."

At page 47 of its Posthearing Brief, Empire states that "each of the proposed [incentive] mechanisms would only deny fuel and purchased power costs that *have already been determined to be prudently-incurred*." [Emphasis supplied]. When is it that the fuel and purchased power costs were "already" determined to be prudently-incurred? The implication in this statement that only fuel and purchased power costs found to be prudently incurred will pass through to customers through an FAC is totally incorrect. The timing established under Section 386.266 for the Commission to review and approve changes to FAC rates are such that there is no reasonable way that prudency reviews can be performed prior to FAC rate changes going into effect. (Ex. 202, Oligschlaeger Surrebuttal, pp. 3-4). That is why Senate Bill No. 179 (Section 386.266) and the Commission's rules provide for after-the-fact prudency reviews of fuel and purchased power costs at least every 18 months while the fuel and purchased power costs are being collected, not before they are collected.

At page 50 of its Posthearing Brief, Empire asserts lack of control over various factors that determine its ongoing level of fuel and purchased power expense. Such statements tend to obscure the fact that Empire has, in fact, implemented various measures in the past few years to mitigate its exposure to higher fuel costs, primarily natural gas and purchased power costs. At page 2 of its Posthearing Brief, Empire lists some of these measures, including its implementation of its gas hedging program, management of coal contracts and purchases of wind power. The important point is that each of these measures was undertaken in an environment where Empire was exposed to the possibility of earnings detriment, at least in the short-run, if it did not take effective action to minimize its exposure to higher fuel costs. That environment simply will not be present with an FAC mechanism in place, when Empire will be insulated from the financial impact of higher fuel prices. The Staff's concern is that Empire will be less active or inactive in its efforts to protect its shareholders and its customers from higher fuel costs because of the different incentives it will face with an FAC in place. The best way to address this situation is to design an FAC that will still result in Empire having incentives to minimize its fuel and purchased power costs. (Ex. 202, Oligschlaeger Surrebuttal, p. 5).

In its Posthearing Brief at page 51, Empire seeks to back away from its official FAC "sharing" position of 95/5 found in Mr. Keith's Direct Testimony and replace it with Dr. Overcast's "no sharing" position of 100/0, but in straddling the issue Empire does not acknowledge the "Q and A" in Mr. Keith's Prepared Direct Testimony at page 29 where Mr. Keith recognizes that the Commission's 95/5 Aquila FAC decision is an incentive mechanism and not a penalty as Dr. Overcast asserts to the contrary in his Rebuttal and Surrebuttal Testimonies and Empire charges in its Posthearing Brief:

> Q. Does the FAC include any **explicit incentive measures**? [Emphasis added].
>
> A. **As I mentioned earlier, we have patterned our FAC proposal after the FAC authorized by the Commission in the last Aquila rate case.** [Emphasis added]. This includes limiting Empire's recovery of energy cost changes to 95 percent of the overall change in energy costs. This would mean that Empire would retain 5% of any decrease in energy costs during the accumulation period or absorb 5% of any increase in energy costs during the accumulation period.

(Ex. 2, Keith Direct, p. 29).

In its Posthearing Brief at page 45, Empire states that "the Company's proposed FAC would operate as follows" and then sets out seven bullet points citing to pages 21-22 of Scott Keith's Direct Testimony, Exhibit 2. The Staff will repeat below each of those bullet points from Empire's Posthearing Brief and then provide the Staff's proposal in those instances where Empire and the Staff have different positions:

- Empire: the base cost of fuel would be established at $0.03075 per kilowatt hour sold;

  Staff: the base cost of fuel and purchased power should be determined on a seasonal basis. Empire's rate schedules are designed to recover seasonal costs on a billing month basis. Fuel and purchased power energy costs would be recovered by billing month as part of the standard billing process. The "summer season" is June through September and the "winter season" is October through May. The average cost of fuel and purchased power is significantly higher in the summer season than in the winter season. Without seasonal differentiation, over- or undercollection may be exaggerated and customers would encounter bills that fluctuate more than necessary. Without seasonal differentiation, it is even possible that an undercollection could be calculated for recovery from customers when there has actually been an overrecovery of actual costs from customers. (Ex. 211, Staff Class Cost-of-Service Report And Rate Design Report, Watkins, p. 8; Ex. 31). Staff witness James Watkins refuted Mr. Keith's contention that the average energy cost differentials are insignificant and Mr. Keith's contention that calculation of seasonal base costs is complex. (*See also* the first full paragraph on page 46 of Empire's Posthearing Brief.) Mr. Watkins showed that in normal weather conditions summer base costs are approximately 10% higher than in winter and can be over 20% higher in an extreme summer/mild winter scenario. (Ex. 213, Watkins Surrebuttal, pp. 2-3).

  The Staff's proposed methodology further differs from Empire's proposal. To correct for line losses, Empire proposes to determine costs by allocating total costs among the various jurisdictions in which Empire operates (Arkansas, Kansas, FERC and Missouri), and then apply "expansion factors". (Empire Posthearing Brief, p. 46; Ex. 3, Keith Rebuttal, p. 6). Mr. Watkins testified that jurisdictional allocation factors do not account for the differences in the mix of customers by metering voltage among jurisdictions. He said that "expansion factors" applied to Missouri jurisdictional costs depend on the relative level of sales to primary customers versus secondary customers, which is constantly changing over time. Thus, he related that it would be mere coincidence if revenue collections using jurisdictional allocation factors and "expansion factors" actually recovered the correct total. (Ex. 213, Watkins Surrebuttal, p. 4).

  Mr. Watkins in his Direct Testimony, Exhibit 210, page 3, states that differences in losses should be accounted for between primary and secondary customers by adjusting the cost at the generator to the metering voltage of each customer's rate schedule. In his Surrebuttal Testimony, Exhibit 213, Mr. Watkins shows at page 4 a Table JCW-1 as shown below. Table JCW-1 does not reflect the Staff's True-Up numbers for fuel and purchased power but otherwise identifies the Staff's position:

Table JCW-1

FAC "Base" Costs ($/kWh)	Summer	Winter
At the Generator	$0.0301	$0.0273
At Primary (Loss adjustment factor: 1.0520)	$0.0316	$0.0287
At Secondary (Loss adjustment factor: 1.0728)	$0.0323	$0.0293

The base cost for primary customers is either the product of the summer or winter base cost times the loss adjustment factor at primary. The base cost for secondary customers is either the product of the summer or winter base cost times the loss adjustment factor at secondary. The loss adjustment factors are from Empire's most recent loss study. (Ex. 213, Watkins Surrebuttal, pp. 3-4).

Empire's Post Hearing Brief states at page 46 that the amount of any over/under recovery of energy costs during an accumulation period would be divided by the Missouri jurisdictional sales during the accumulation period to arrive at the average cost of under/overrecovery per kWh. Mr. Watkins stated that in order to determine a rate for the cost adjustment factor (CAF) that will recover or refund the total differences in fuel costs between "base" and "actual" as closely as possible, the CAF has to be calculated using the best available estimate of sales during the recovery period. He testified that the best available estimate of sales during the recovery period is the estimate of forecasted sales for the recovery period, not actual sales for the accumulation period. (Ex. 213, Watkins Surrebuttal, pp. 4-5).

Empire in footnote 26 in its Posthearing Brief at page 46 states as follows: "Although the Company does not believe that a seasonal adjustment to energy cost is necessary, Empire is willing to accept an FAC that is reflected in the exemplar tariff that Staff prepared (and which was received into evidence as Exhibit 31), provided the sharing requirement is the 95/5 customer/Company expense split proposed by Empire." (Vol. 9 Tr. 649-52).

Additionally, the $0.03075 per kilowatt hour number, which Empire is showing in its Posthearing Brief on pages 45 and 46, is the number in Empire's direct case filed on October 1, 2007, and is based on the test year for the 12 months ending June 30, 2007. The $0.03075 per kilowatt hour number does not reflect either the update period ending December 31, 2007 or the recently completed true-up authorized by the Commission's Order issued on May 13, 2008. The revenue requirement areas updated by the Staff for the true-up included fuel and purchased power. Staff witness Mark L. Oligschlaeger details in his True-Up Direct Testimony filed on June 10, 2008 at pages 4-5 the components of fuel and purchased power that the Staff trued-up and why the Staff's recommended level of fuel and purchased power expense increased as a result of the true-up. The FAC base cost level was not calculated for the true-up fuel and purchased power costs but can be supplied to the Commission.

- Empire: two changes in the FAC [fuel adjustment clause] would be made annually, one in June and the other in December [Staff explanation: June and December are the beginning of the two six-month Recovery Periods proposed by Empire and the Staff, and June and October are the beginning of four- and eight-month periods of summer and winter rates, respectively; the base cost of fuel will increase to the summer rate level in June, when there is also a CAF change possible, and decrease to the winter rate level in October, when there is not a CAF change; thus, customers will likely see three changes in rates per year, definitely in June and October and possibly in December; also, the Staff's calculation of the CAF would differ from Empire's calculation of the CAF because of the calculation of the base cost of fuel (annual by Empire and summer and winter by Staff) and because of the different loss adjustment factors used by Empire and the Staff];

- Empire: these two changes would be based on increases or decreases in fuel and purchased power costs actually incurred by the Company during two annual accumulation periods: September through February and March through August;

- Empire: over/under recoveries of Missouri-jurisdictional energy costs would be refunded/collected every six months;

- Empire: to provide an audit trail for use during true-up and prudence reviews, over/under recoveries would be recorded in the Company's books in appropriate FERC accounts using an asset/liability account to track over/under recoveries on the balance sheet and an offsetting expense account would be maintained to reflect the over/under recoveries on the income statement;

- Empire: carrying costs on any energy costs deferred as part of the operation of the FAC would be calculated on a monthly basis using Empire's embedded cost of short-term debt as the interest rate, with interest accumulating starting with the first month the FAC is in effect; and

- Empire: periodic prudence reviews would be conducted at least once every eighteen months.

	Recovery Period A						Recovery Period B					
	June	July	August	September	October	November	December	January	February	March	April	May
	Summer				Winter							
Seasonal Rate Changes												
Cost Adjustment Factor (CAF) Changes												
	Accumulation Period A						Accumulation Period B					
	September	October	November	December	January	February	March	April	May	June	July	August
	Summer	Winter	Winter	Winter	Winter	Winter	Winter	Winter	Winter	Summer	Summer	Summer

Under both Empire's and the Staff's proposals, the following will occur: Empire's rates will increase to the summer rate level in June. The June rate change at the beginning of the June-November Recovery Period will also include a Cost Adjustment Factor (CAF) related to the prior Accumulation Period (September - February). All of Empire's general application rate schedules provide for higher rates during the summer season and lower rates during the winter season. Empire’s rates will decrease to the winter rate level in October. A third rate change may be made at the beginning of the December-May Recovery Period in December related to the then most recent Accumulation Period (March - August). The exemplar tariff sheets supported by the Staff and shown in Exhibit 31 have the same Accumulation and Recovery Periods as shown in Schedule WSK-3.

Under both Empire's and the Staff's proposals, Empire's base cost of fuel and purchased power included in permanent rates will increase to the summer rate level in June and decrease to the winter rate level in October. This assumes that Empire's general application rate schedules properly reflect summer / winter fuel cost differentials.

Under the Staff's proposal, Empire's base cost of fuel and purchased power included in permanent rates would be used to determine any over- or undercollection in each month. Thus, in summer months the amount of fuel costs actually collected by Empire would be compared to the amount actually included in Empire's summer rates to determine whether too much or too little had been collected. In winter months the amount of fuel costs actually collected by Empire would be compared to the amount actually included in Empire's winter rates to determine whether too much or too little had been collected. (Ex. 213, Watkins Surrebuttal, pp. 2-3).

Under Empire's proposal, Empire would calculate an annual average of the actual base cost of fuel and purchased power included in permanent rates to be used to determine any over- or undercollection in each month. Thus, in both summer and winter months the amount of fuel costs actually collected by Empire would be compared to the annual average amount actually included in Empire's rates to determine whether too much or too little had been collected in that month. (Ex. 3, Keith Rebuttal, pp. 3-5).

Regardless of the Commission's determinations of what proportion of the increases and decreases in fuel and purchased power energy charges should be borne by consumers and the other FAC issues, the Commission should require Empire to file compliance tariff sheets based on the other language of the exemplar tariff sheets comprising Exhibit 31, rather than the exemplar tariff sheets proposed by Empire witness Mr. Keith in Schedule WSK-3 attached to his Direct Testimony.

The language of the exemplar tariff sheets in Exhibit 31 is more precise than the language in the exemplar tariff sheets in Schedule WSK-3. For example, Schedule WSK-3 defines costs eligible for FAC as "the Company's total book costs . . . ." Exhibit

31 defines costs eligible for FAC as "the Company's total book costs **as allocated to Missouri** . . . ." (Emphasis added). Another example is that Schedule WSK-3 states "the price per kWh of electricity **sold** will be adjusted subject to application of the FAC mechanism . . . ." (Emphasis added). Exhibit 31 states "the average price per kWh of electricity **generated or purchased** will be adjusted subject to application of the FAC . . . ." (Emphasis added).

The exemplar tariff sheets comprising Schedule WSK-3 include in their definition of "COSTS" on Original Sheet No. 17a emission allowance costs, but there is not in Schedule WSK-3, as there is in Exhibit 31, a statement that emission allowance revenues collected in the Accumulation Period will be used as an offset to costs. Although the wording is a bit awkward, the last sentence in the "COSTS" section of Schedule WSK-3 relates that "cost and revenue associated with off system-sales" is not part of the calculation, i.e., the off system sales margin collected in the Accumulation Period is not used as an offset to costs.

Exemplar tariff sheet 17b of Schedule WSK-3 does not show how the calculations in the prior exemplar tariff sheets apply to the calculation of the CAFs. The exemplar tariff sheets comprising Exhibit 31 tie all of the calculations shown on the prior tariff sheets to the calculation of the CAFs.

Finally, page 40 of the Posthearing Brief of the Industrial Intervenors notes that the Industrial Intervenors offered an alternative FAC proposal in Mr. Brubaker's Surrebuttal Testimony in response to the Staff's critique in Ms. Mantle's Rebuttal Testimony. The Staff appreciates the Industrial Intervenors' response, but the Staff still believes that the Staff's FAC proposal provides clearer and stronger incentives for efficiency and economy than the Industrial Intervenors' alternative surrebuttal proposal. However, the Industrial Intervenors' surrebuttal proposal is much superior to Empire's FAC proposal. (Vol. 9 Tr. 736-738).

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 3rd day of July, 2008.

/s/ Steven C. Reed