Exhibit No.
Issue: Fuel and Purchased Power Cost
Witness: W. L. Gipson
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Sponsoring Party: Empire District
Case No. ER-2006-0315

Before the Public Service Commission of the State of Missouri

Supplemental Direct Testimony

of

W. L. Gipson

July 2006

SUPPLEMENTAL DIRECT TESTIMONY
OF
W. L. GIPSON
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2006-0315

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. William L. Gipson, 602 Joplin Street, Joplin, Missouri 64801.

Q. WHO IS YOUR EMPLOYER AND WHAT POSITION DO YOU HOLD?

A. The Empire District Electric Company ("Empire" or "Company") is my employer. I hold the position of President and Chief Executive Officer.

Q. ARE YOU THE SAME WILLIAM GIPSON THAT FILED DIRECT TESTIMONY IN THIS RATE CASE BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. Yes.

Q. MR. GIPSON, WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL DIRECT TESTIMONY?

A. The purpose of my supplemental direct testimony is to respond to a portion of the Commission's request for additional information with respect to the recovery of fuel and purchased power costs in this rate case. In addition, I will introduce the other Empire representatives that will be responding to the Commission's request. In connection with all of this, I would like to emphasize that with respect to its fuel and purchased power costs, Empire is simply asking for timely recovery of the total amount of these expenses.

Q. PLEASE DECRIBE GENERALLY THE INFORMATION EMPIRE IS PROVIDING IN RESPONSE TO THE COMMISSION'S ORDER OF JUNE 20, 2006.

A. The Commission requested additional information on the following topics:

- Weather data in the Empire service area and its use in determining the overall revenue requirement in this rate case,
- A three year forecast of Empire's anticipated natural gas and purchased power usage,
- An analysis of the costs associated with hedging 100 percent of its expected natural gas usage for the next three years,
- What hedging strategy would offer the most benefit to the Empire consumers over the next three years, and
- Other relevant information

Q. WHO IS RESPONDING TO THE COMMISSION ON BEHALF OF EMPIRE IN EACH OF THESE AREAS?

A. The weather information will be provided by Jayna Long. The expected fuel and purchased power information will be provided by Todd Tarter. Rick McCord will provide an analysis of natural gas hedging strategy and a recommendation concerning a preferred hedging strategy. Finally, Steve Fetter and I will provide responses to the Commission's request for other relevant information.

Q. BY WAY OF BACKGROUND, WHY DOES EMPIRE NEED A MISSOURI RETAIL RATE INCREASE AT THIS TIME?

A. As has been stated in Empire's direct testimony, the major factors driving the request for a Missouri rate adjustment at this time are increases in both fuel and purchased energy costs.

This has been confirmed in the direct testimonies filed by certain other parties to this case; namely, the Staff of the Commission ("Staff"), the Office of the Public Counsel ("OPC") and the industrial interveners, Explorer Pipeline Company and Praxair, Inc. As indicated by Empire's direct testimony, the Company has been unable to recover its energy costs through the combination of base rates and the Interim Energy Charge ("IEC") authorized by the Commission in Empire's last rate case. This fact has also been confirmed in several of the testimonies filed by certain other parties in this case. As a result of the under-recovery of its energy costs, a fact that has contributed to a deterioration of the Company's return on equity, Empire has requested in this case that the IEC be terminated and that other means to recover its costs be implemented.

Q. HOW SHOULD THE COMMISSION ADDRESS FUEL COST RECOVERY IN THIS CASE?

A. As indicated, what Empire seeks is the timely recovery of its fuel and purchased power costs. In this regard, the Commission is aware that in the Company's last rate case Empire agreed "...for the duration of the IEC approved in this case ... to forego any right ... to request <u>the use of</u>, or <u>to use</u> ... a fuel adjustment clause." (emphasis added). (Empire believes that this means the Company cannot make a request to <u>implement</u> an FAC while the IEC is in effect. That is to say, the thrust of the agreement from the Company's perspective was to prevent the <u>use</u> of both an FAC as well as an IEC at the same time. Empire understands, however, that the Commission has interpreted the language of the agreement differently. Empire will not reargue this point, but does want to make it clear for the record that the Company believes its filing in this case, <u>to first terminate the IEC</u> and <u>only then to implement or use</u> <u>an FAC</u>, was consistent with this agreement.) Based upon my understanding of the Commission's order of May 2, 2006, the Commission has determined that because of the agreement in the last case, Empire may seek to eliminate the IEC, but the Company may not request a fuel adjustment mechanism. As a consequence the Company's options for energy cost recovery in this case may be limited to the traditional method of recovery of energy costs through base rates, a method which Empire proposed in its filing. I do not take this to mean, however, that some other energy cost recovery method, agreed to among the parties or directed by the Commission when it issues its final order in this case, is necessarily prohibited. In this regard, given the volatile nature of the fuel and energy markets at this time, it would be prudent, in my judgment, for the parties and the Commission to keep an open mind to other alternatives or interpretations of the agreement from the last case to allow timely energy cost recovery in this case.

Q. WOULD YOU VIEW SOME SORT OF AN AMORTIZATION AS AN ALTERNATIVE?

A. No. The amortization vehicle which resulted from the Company's regulatory plan docket is designed to maintain certain Standard & Poor's ("S&P") ratios during the construction of Iatan 2. It was not designed as a replacement for the timely recovery of prudently incurred fuel and purchased power expense or as a substitute for an adjustment to the Company's authorized return on equity in the absence of timely recovery of those costs.

Q. WHAT LEVEL OF FUEL AND PURCHASED POWER EXPENSE IS INCLUDED IN EMPIRE'S CURRENT BASE RATES?

A. The amount of total fuel and purchased power expense in Empire's base rates is $125,000,000 (total Company) as established in Case No. ER-2004-0570, the Company's last Missouri rate case. In addition, in that case, an IEC was established allowing the Company to collect an additional $10,000,000 (total Company) subject to refund.

Q. WHAT IS THE LEVEL OF FUEL AND PURCHASED POWER EXPENSE THE COMPANY INCLUDED IN ITS FILING IN THIS CASE?

A. In the original filing made on February 1, 2006, Empire included total fuel and purchased power expense of $162,888,204 on a total Company basis. At March 31, 2006, Empire's actual total Company fuel and purchased expense was approximately $162,000,000.

Q. HOW DO THESE NUMBERS COMPARE TO THE COMPANY'S FORECAST?

A. In the information presented in the Supplemental Direct Testimony of Todd Tarter in response to the Commission's order, it is shown that Empire's forecast of future energy costs range from $168,991,695 to $184,171,272, a difference of over $15 million. As indicated in the testimony, there are many factors, such as plant outages, weather and load growth in addition to the price of natural gas which can have a significant influence on future energy costs.

Q. WHAT WILL HAPPEN TO THE RATES CHARGED TO EMPIRE'S MISSOURI ELECTRIC CUSTOMERS IF THE COMPANY'S ENERGY COSTS DECREASE FROM THE HIGH LEVELS THAT ARE DRIVING THIS RATE CASE?

A. As I understand it, under the "fixed" or "point in time" method of energy cost recovery the base rates charged to the Missouri customers would not decline if energy costs decline. Conversely, rates would not increase if energy costs increase. Under the first scenario the Company would over-recover its energy costs and under the second scenario would under-recover.

Q. WHAT IS YOUR UNDERSTANDING AS TO HOW RATING AGENCIES VIEW SITUATIONS IN WHICH A UTILITY UNDER-RECOVERS ITS ENERGY COSTS?

A. I would encourage the Commission to read Schedule WLG-1, a S&P report published March 22, 2006 titled "Fuel and Purchased Power Cost Recovery in the Wake of Volatile Gas and Power Markets – U.S. Electric Utilities to Watch," specifically pages 3 and 5. Clearly, S&P believes that the total recovery of fuel and purchased power costs are imperative. I would encourage the Commission to also read Schedule WLG-2, a companion S&P report published March 23, 2006 titled "Downgrade Potential Across Credit Grade and Sectors," specifically page 11. In hindsight, this was the shot across the Company's bow as S&P downgraded Empire on May 17, 2006 (see Schedule WLG-3 "Research Update: Empire Electric Downgraded to 'BBB-"on Expected Tight Financials") citing "To strengthen Empire's cash flow during its planned capital spending for generation and environmental compliance, [Iatan 2, Iatan 1 and Asbury environmental – contemplated by the regulatory plan –in Case No. EO-2005-0263, as well as Plum Point] constructive rate relief will be essential and should include recovery of fuel and purchased power on a timely basis." Similar language appears in reports from Fitch and Moody's rating services as well as the sell-side equity analysts that cover Empire. I frankly do not know how it could be much clearer: debt and equity analysts believe the total recovery of fuel and purchased power expense on a timely basis is critical to maintain ratings that, in turn, provide for the lowest costs for capital, the very capital required to build base-load generation to serve our customers.

Q. WHAT OTHER INFORMATION WOULD YOU LIKE THE COMMISSION TO CONSIDER?

A. I would like the Commission to read certain sections of its Staff's report in Case No. GW-2006-0110, which I have attached to my testimony as ScheduleWLG-4, and consider the relevance in the instant situation – a regulated utility seeking to timely recover its prudently incurred costs necessary to deliver reliable service to its customers.

On page 24 of the report it is said "gas-fired generation plays an important and necessary role in peaking and intermediate generation. Coal-fired generation, for example, is not an appropriate or efficient method to meet peak demand for electricity which occurs in the summer months. The concerns expressed above should not be interpreted as a blanket condemnation of gas-fired generation."

Specifically, on page 28 of the report it is said "Without some mechanism to address this fuel volatility, like the current PGA process, LDCs would be subject to significant swings in over- and under-collections of actual natural gas cost compared to an embedded natural gas rate. This situation could result in frequent earnings complaints and emergency rate relief cases and could result in significant credit risk to the LDCs. If this situation were not addressed, it could result in pre-payment requirements from natural gas suppliers and other types of credit-related payments that could ultimately impact the delivered price and availability of natural gas to LDCs and their customers."

And finally, on page 36 it is said "these task forces are attempting to ameliorate circumstances for end-use customers that result from market prices that are, to a large degree, beyond the control of any parties to this proceeding."

Q. DO YOU HAVE ANY FINAL COMMENTS?

A. Yes. In summary, Empire seeks the timely recovery of its energy costs. If this does not happen as a result of this case, this may adversely impact the Company's credit ratings and increase its cost of capital.

Q. DOES THIS CONCLUDE YOUR SUPPLEMENTAL DIRECT TESTIMONY?

A. Yes, it does.