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Witness: W. Scott Keith
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Sponsoring Party: Empire District
Case No. ER-2006-0315

**Before the Public Service Commission
of the State of Missouri**

Surrebuttal Testimony

of

W. Scott Keith

August 2006

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OF
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1 **INTRODUCTION**

2 **Q. STATE YOUR NAME AND ADDRESS PLEASE.**

3 A. My name is W. Scott Keith and my business address is 602 Joplin Street, Joplin,
4 Missouri.

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

6 A. I am presently employed by The Empire District Electric Co. ("Empire" or "the
7 Company") as the Director of Planning and Regulatory. I have held this position
8 since August 1, 2005. Prior to joining Empire I was Director of Electric
9 Regulatory Matters in Kansas and Colorado for Aquila, Inc. from 1995 to July
10 2005.

11 **Q. ARE YOU THE SAME W. SCOTT KEITH THAT EARLIER PREPARED**
12 **AND FILED DIRECT AND REBUTTAL TESTIMONY IN THIS RATE**
13 **CASE BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION**
14 **("COMMISSION") ON BEHALF OF EMPIRE?**

15 A. Yes.

16 **PURPOSE**

17 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

18 A. My surrebuttal testimony will discuss the off-system sales issues that have been
19 raised by two rebuttal witnesses - Janis Fischer of the Commission Staff ("Staff")

1 and Ralph Smith testifying on this topic on behalf of the Office of the Public
2 Counsel ("OPC").

3 **OFF-SYSTEM SALES**

4 **Q. WHAT HAVE THESE TWO WITNESSES PROPOSED REGARDING OFF-**
5 **SYSTEM SALES?**

6 A. Essentially, Staff has recommended that the ongoing Missouri retail revenue
7 requirement reflect the level of actual off-system sales for the 12 months ending
8 March 31, 2006. This position is discussed by Staff witness Janis Fischer
9 beginning at page 4, line 14 of her rebuttal testimony. OPC witness Ralph Smith
10 has recommended that a five-year average of off-system sales for twelve-month
11 periods ending March 31, 2001 through 2006 be used in the determination of the
12 ongoing Missouri retail revenue requirement. This is discussed by Mr. Smith
13 beginning at page 6, line 1 of his rebuttal testimony.

14 **Q. PLEASE COMPARE THE OFF-SYSTEM SALES RATE TREATMENT**
15 **RECOMMENDED BY EMPIRE WITH THOSE BEING RECOMMENDED**
16 **BY STAFF AND THE OPC.**

17 A. The Staff's recommendation concerning off-system sales has essentially not
18 changed from that contained in the Staff's direct testimony. The Staff recommends
19 that the off-system sales results for the twelve-month period ending March 31,
20 2006 be used in the determination of Empire's overall Missouri revenue
21 requirement. The OPC has changed its recommendation slightly by recommending
22 that the average off-system sales results of the last five-year periods ending March
23 31, 2006 be used in the determination of Empire's overall Missouri revenue

1 requirement. Empire's recommendation has not changed. We recommend that an
2 average of the last five years of off-system sales be used in the determination of the
3 Company's revenue requirement. This average should be calculated after removing
4 the impact of the off-system sales that were sourced from a unique non-recurring
5 transaction with AEP.

6 **Q. DO YOU AGREE WITH EITHER THE STAFF OR OPC**
7 **RECOMMENDATIONS CONCERNING OFF-SYSTEM SALES?**

8 A. No.

9 **Q. WHY DO YOU DISAGREE WITH THE POSTION TAKEN BY THE**
10 **STAFF?**

11 A. As I stated in my rebuttal testimony, the Staff's off-system sales recommendation is
12 inconsistent with the historical treatment of this issue in Missouri. In addition, the
13 Staff's recommendation uses the off-system sales results from a single year to
14 establish rates that may very well be in place for a number of years.

15 **Q. PLEASE EXPLAIN.**

16 A. As indicated in my rebuttal testimony, off-system sales fluctuate substantially from
17 year-to-year and are driven by market forces beyond the control of Empire, such as
18 weather and plant outages. In addition to the fluctuations in overall sales levels,
19 the makeup of the resources that are used to make these off-system sales have
20 fluctuated dramatically over the last five years. For example, the vast majority,
21 approximately *__* percent, of the off-system sales in 2001 were associated with
22 the purchase and resale of hydro-electric power. By contrast, these transactions
23 only make up *__* percent of this activity by 2006. The most significant change in

1 the composition of off-system sales that has taken place over the last five to six
2 years is associated with the purchase of electricity on the open market and its resale
3 in the open market. In 2002, this activity, driven almost exclusively by the AEP
4 transaction, accounted for *__* percent of Empire's total off-system sales. By
5 2006, the purchase and resale of energy had declined to only *_* percent of the
6 overall off-system sales. I have attached a depiction of the supply resources that
7 have been used to make off-system sales since 2001 as Surrebuttal Schedule WSK-
8 1. By its very nature, the Staff's approach indicates that, in addition to other
9 factors such as weather and fuel prices, the supply resources used to make off-
10 system sales during the twelve-months ended March 31, 2006 represent a normal
11 pattern of activity. As shown by Surrebuttal Schedule WSK-1, this is not the case.
12 The composition of the supply resources used by Empire to make off-system sales
13 has varied significantly over the last five to six years, with the last year or so being
14 supported by Empire generation resources. The Staff's approach fails to account
15 for these fluctuations and consequently its recommendation is distorted.

16 **Q. HOW DO YOU PROPOSE TO RESOLVE THESE DISTORTIONS?**

17 A. The use of an average of the off-system sales activity over the last five to six years
18 would eliminate the distortion that is inherent in the Staff's recommendation.

19 **Q. PLEASE EXPLAIN.**

20 A. In addition to smoothing out the variations in the resources used to make the sales,
21 the use of an average would smooth out other factors like weather, market prices
22 and fuel prices.

23 **Q. ARE THERE OTHER PROBLEMS ASSOCIATED WITH THE STAFF'S**

**RECOMMENDED USE OF A SINGLE YEAR TO ESTABLISH AN
ONGOING LEVEL OF OFF-SYSTEM SALES?**

A. Yes. In addition to fixing the composition of the resources used to make the sales, the use of a single year of activity in off-system sales also fixes the market price of off-system sales to that occurring during a single twelve-month period and the gross profit margin earned by resource type.

Q. WHY IS THIS A PROBLEM?

A. Just as the composition of the resources used to make the off-system sales has changed over the last five to six years so has the revenue earned on each resource and the level of gross profit earned from each resource. The relationship of each of these factors over the last five to six years is displayed on Surrebuttal Schedules WSK-2, WSK-3 and WSK-5.

**Q. PLEASE DESCRIBE SURREBUTTAL SCHEDULE WSK-5 IN MORE
DETAIL.**

A. Surrebuttal Schedule WSK-5 displays the average gross profit earned on off-system sales by supply resource since 2001. For example, Empire earned slightly over *__* per megawatt-hour ("Mwh") on its off-system sales supported by Empire generation during 2001. The gross profit on this same resource declined to *__* per Mwh in 2002. More recently the level of earnings on this resource climbed to over *___* per Mwh, an all time high for the period displayed. The Staff's approach would lock this all time high margin level into the Empire retail rates until the next Missouri electric rate case.

Q. WHAT FACTORS HAVE INFLUENCED THE GROSS PROFIT MARGIN

1 **EMPIRE HAS BEEN ABLE TO EARN ON OFF-SYSTEM SALES,**
2 **ESPECIALLY FROM ITS OWN GENERATING UNITS?**

3 A. There are three major factors influencing the level of off-system sales and gross
4 profit margins Empire has experience during the last couple of years. Those factors
5 are weather extremes in the Midwest, forced conservation at coal units that are
6 dependent upon the Powder River Basin ("PRB") for coal deliveries, and high
7 natural gas prices. Each of these factors has contributed to an increase in the
8 opportunity to make off-system sales for Empire and has influenced the prices in
9 the wholesale market.

10 **Q. HOW WOULD YOU CHARACTERIZE THE FACTORS DRIVING OFF-**
11 **SYSTEM SALES?**

12 A. They are not normal.

13 **Q. PLEASE EXPLAIN.**

14 A. For example, both the Staff and Empire made adjustments to actual test year sales
15 levels to reflect the fact that the weather in the Empire service territory was
16 abnormal and actual sales were abnormally high. The PRB coal delivery problems
17 do not represent normal operating conditions. The OPC has presented testimony in
18 this rate case describing the PRB problem as a nonrecurring event (Smith Direct pg
19 12). Finally, natural gas prices have varied significantly during the test year.
20 Neither the Staff nor the OPC considers the high price that natural gas reached in
21 the summer and fall of 2005 to be representative of ongoing natural gas prices.

22 **Q. DID THE STAFF ATTEMPT TO NORMALIZE OR ADJUST THE TEST**
23 **YEAR OFF-SYSTEM SALES FOR THESE ABNORMALITIES?**

1 A. No. In fact Staff's witness Fischer noted the PRB coal delivery problems at page 5
2 of her rebuttal testimony, but indicated that this PRB delivery problem supported
3 the use of the twelve-months ending March 31, 2006 off-system sales level in this
4 case.

5 **Q. DO YOU AGREE WITH STAFF'S ASSERTION THAT THE PRB**
6 **DELIVERY PROBLEMS SUPPORT THE USE OF A SINGLE YEAR OF**
7 **OFF-SYSTEM SALES ACTIVITY?**

8 A. No. As pointed out by OPC's witness Smith, the PRB delivery problems are
9 abnormal, and the Staff and Empire have each eliminated the impact of PRB coal
10 conservation from the production simulation models put forth in this rate case. If
11 the PRB delivery problems are the subject of normalization in the fuel cost runs
12 put forth by the Staff and Empire, which they are, there is no reasonable basis to
13 turn this abnormality around and use it as support for a higher level of off-system
14 sales in another part of the case.

15 **Q. HAVE YOU REVIEWED THE REBUTTAL TESTIMONY FILED BY MR.**
16 **SMITH ON BEHALF OF OPC RELATED TO OFF-SYSTEM SALES?**

17 A. Yes.

18 **Q. WHAT HAS THE OPC USED AS A BASIS FOR ITS RECOMMENDATION**
19 **FOR OFF-SYSTEM SALES?**

20 A. The OPC has recommended that a five-year average of Empire's historical off-
21 system sales be used in this rate case. This calculation is discussed at page 6 of Mr.
22 Smith's rebuttal testimony. Essentially, Mr. Smith has updated his five-year
23 average to represent the twelve-months ended March 31, 2006.

1 **Q. DO YOU AGREE WITH THE OPC'S RECOMMENDATION ON OFF-**
2 **SYSTEM SALES?**

3 A. No. In addition to containing a small error in the calculation of the average off-
4 system sales profit margin, the OPC has not adjusted Empire's historical off-system
5 sales levels to remove an unusual transaction that took place with AEP. This is the
6 same area of disagreement Empire had with Mr. Smith's earlier calculation. My
7 rebuttal testimony described this calculation in detail and explained that the
8 transaction was unusual and significant, not expected to occur again and that the
9 profit margin earned on the AEP transaction did not include all of the costs
10 associated with the transaction and this resulted in an overstatement of the profit
11 margin.

12 **Q. HOW UNUSUAL OR SIGNIFICANT TO EMPIRE WAS THE AEP**
13 **TRANSACTION?**

14 A. This transaction was quite significant in terms of the profit margin earned by
15 Empire during 2002 and 2003, and greatly expanded the scope of Empire's off-
16 system sales activity during 2002 and 2003. This is displayed in the Surrebuttal
17 Schedules I have attached to my testimony. In 2002 and 2003, the purchase and
18 resale of energy, the vast majority of which was purchased from AEP, contributed
19 *____* and *____*, respectively, of total off-system sales gross profit. After the
20 AEP transaction expired, the gross profit contribution from this sort of activity had
21 declined to *__* by 2005 and 2006. This situation is depicted on Surrebuttal
22 Schedule WSK-3. In addition, the AEP transaction greatly expanded the scope of
23 Empire's activity during 2002 and 2003 with sales levels rising from slightly over

1 *_____* Mwh in 2001 to over *_____* Mwh in 2002 and over *_____*

2 Mwh in 2003. By 2004, overall off-system sales had declined to slightly over

3 *_____* Mwh without the AEP energy. This is displayed on Surrebuttal

4 Schedule WSK-4.

5 **Q. WHAT DOES THE COMPANY RECOMMEND BE USED TO ESTABLISH**

6 **AN ONGOING LEVEL OF OFF-SYSTEM SALES FOR PURPOSES OF**

7 **THIS RATE CASE?**

8 A. Empire recommends that a five-year average of the off-system sales be used to

9 establish the overall ongoing off-system sales level for purposes of this rate case.

10 However, prior to calculating the five-year average, the off-system sales made with

11 energy sourced from the AEP purchase should either be eliminated entirely or, at

12 the very least, the gross profit on those sales be reduced to reflect the fixed fees

13 associated with the transaction. These fixed fees were setout in my rebuttal

14 testimony.

15 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

16 A. Yes.