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

INITIAL POSTHEARING BRIEF

OF

INDUSTRIAL INTERVENORS

Stuart W. Conrad (MBE #23966)
David L. Woodsmall (MBE #40747)
3100 Broadway, Suite 1209
Kansas City, MO 64111
(573) 635-2700 voice
(573) 635-6998 facsimile
E-mail: dwoodsmall@fcplaw.com

ATTORNEYS FOR INDUSTRIAL INTERVENORS

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COMES NOW Praxair, Inc., Explorer Pipeline Inc., and General Mills, Inc., with the support and backing of Wal-Mart Stores and Enbridge Pipelines, Inc. (collectively referred to as the "Industrial Intervenors"), pursuant to the Commission's May 29, 2008 Order Adopting Proposed Filing Dates, and submits its Initial Posthearing Brief on the issues set forth below. The Industrial Intervenors submit this brief addressing the issues and subissues involving Return on Equity, Fuel Cost Recovery and Off-System Sales Margins. The Commission has recently scheduled a true-up hearing to occur on June 19 and 20, 2008. We reserve the right to address additional issues, including those that arise in the context of the true-up, in the context of the Reply / True-Up Brief scheduled to be filed on July 3, 2008.

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I. INTRODUCTION

In recent years, inflation has hit numerous aspects of our daily lives. Nowhere, however, has inflation been more evident than in the electric rates of Empire ratepayers. With the current requested increase, electric rates have increased over 51% in the last seven years in southwest Missouri.

	Increase Authorized (Requested)	Date Authorized (Requested)	% Increase
ER-2008-0093	$34,725,203	October 1, 2007	10.11%
ER-2006-0315	$29,369,397	January 1, 2007	9.96%
ER-2004-0570	$25,705,500	March 27, 2005	9.96%
ER-2002-0424	$11,000,000	December 1, 2002	4.97%
ER-2001-0299	$17,100,000	October 2, 2001	8.40%
TOTAL			**51.49%**

While the pinch of increased electric rates is felt by all customers, the impact is acutely felt by small and large commercial and industrial customers that can see their entire profit margin eliminated in one swift decision by the Commission.[1] These commercial and industrial customers are the drivers of economic development of which the Commission, as a division of the Department of Economic Development, should be acutely mindful. As Mr. Brubaker notes:

> These companies have experienced significant increases in their cost of power purchased from Empire in the last several years. From October 2001 to July 2007, Empire's rates have increased by over 40%. This increase has been relatively level across all classes of customers. These intervenors are keenly aware of the cost of power and its effect on their operations, and are concerned that the increases which the Commission grant to Empire be no more than what is necessary to cover prudently incurred costs, and to maintain investment grade credit quality.[2]

Certain proposals advanced by Empire in this case makes it abundantly clear, however, that rates will no longer be limited to that level necessary to cover prudently

[1] Concerns with the rapid increase in Empire's rates were routinely expressed by ratepayers at the local public hearings.
[2] Ex. 500, page 2.

incurred costs and ensure investment grade credit quality. Rather, rates to these Missouri customers will be inflated for the benefit of Empire's shareholders scattered around the nation.[3]

Among the aspects of Empire's positions in this case that make this realization abundantly clear are the following:

(1) Empire's request, through a witness previously deemed to lack credibility, for a return on equity of 11.6% - the highest in the nation among all electric utilities. Based upon a national average return on equity of 10.3%, this requested return greatly exceeds the Commission's zone of reasonableness and should be summarily rejected.

(2) The rapid proliferation of tracking / adjustment mechanisms to guarantee recovery of certain expenses while still allowing for the possibility of an inflated return on equity through uncapped revenues. In addition, to the fuel adjustment clause requested in this case, Empire is also requesting a tracking mechanism for tree trimming and vegetation management. This is in addition to Empire's current expense trackers for pension and OPEB costs. These tracking mechanisms would eliminate any risk of Empire not recovering these expenses. On the other hand, while capping its exposure to expense items, Empire seeks to leave revenues uncapped. For instance, Empire seeks to eliminate off-system sales revenues from the fuel adjustment clause and to solely profit from the rapid increase in its wholesale revenues.

(3) Empire's ratemaking hypocrisy whereby it advances different accounting treatments merely based upon the difference between expenses and revenues. For

[3] The fact that Empire is more interested in the return of profits to its shareholders is understood by the fact that Empire has consistently paid out a dividend in excess of its earnings. See, Exhibit 310 where Empire paid a first quarter dividend of 32 cents a share while earnings were only 15 cents per share. The fact that Empire pays out such an inflated dividend leaves little cash behind in the form of retained earnings for the construction of necessary improvements.

instance, where an expense item is increasing, Empire's seek to establish recovery at the test year level.[4] On the other hand, where a revenue item is increasing, Empire's seeks to blunt the impact of that increase by suggesting a five year average for that revenue item.[5]

In this case, the Industrial Intervenors ask the Commission to consider its role in stimulating economic development in southwest Missouri. Such development will only be spurred by electric rates that are only as high as needed to cover necessary costs while providing a reasonable, not inflated, return to the shareholders. With this goal in mind, the Commission should consider whether its decisions will be used by Empire's to meet this goal or, instead, to further their agenda of returning monopoly profits to its shareholders.

II. RETURN ON COMMON EQUITY

A. INTRODUCTION

It is well established that public utility commissions have several basic objectives. Foremost among these objectives is to ensure adequate earnings for the utility while preventing excessive (monopoly) profits.[6] Absent regulatory controls, the utility will inevitably seek to extract monopoly profits from the many (the ratepayers of Missouri) for the benefit of the few (the shareholders scattered across the nation).

The attempt to extract monopoly profits in this case is best seen in the Company's request for an inflated return on equity. Rather than seeking that level of return that is "sufficient to ensure confidence in the financial soundness of the utility,"[7] Empire seeks to bolster its corporate profits. The Supreme Court has pointed out, however, that the

[4] See, Empire's treatment for tree-trimming and vegetation management at Tr. 233.
[5] See, Empire's treatment for off-system sales margins.
[6] Phillips, Charles F. Jr., *The Economics of Regulation*, Rev. ed. (1969) at page 124.
[7] *Bluefield Water Works and Improvement Co. v. Public Service Comm'n*, 262 U.S. 679, 692-693 (1923).

utility has no "right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures."[8]

In this case, Empire requests a profit (the return on equity) of 11.6%. In support of this request, Empire presents the testimony of Dr. Vander Weide. As this brief demonstrates, Dr. Vander Weide has consistently sought, on behalf of his utility clients, a return on equity that is the highest in the nation. That trend continues in this case. The Commission has previously recognized Dr. Vander Weide's requests to be so high as to undercut his credibility. At a time when the average electric utility is authorized a return of 10.3%, Vander Weide asserts that Empire should be authorized a return that is 130 basis points higher. Given the Commission's recent use of the "zone of reasonableness," Vander Weide's testimony should be summarily rejected.

In contrast, the Industrial Intervenors presented the testimony of Michael Gorman. Consistent with his analysis in the recent AmerenUE and Aquila rate proceedings, Mr. Gorman has prepared a return on equity analysis which ensures sufficient and comparable earnings while avoiding concerns of monopoly profits. Specifically, Mr. Gorman has utilized: (1) a discounted cash flow; (2) a risk premium; and (3) a capital asset pricing model analysis in his determination of a just and reasonable return on equity. The ultimate result of each of these models leads to a recommended return on equity of 10.0%.

MODEL	RESULT
Two-Stage DCF	9.46% (Ex. 501, page 24)
Risk Premium	9.94% (Ex. 501, page 27)
CAPM	10.34% (Ex. 501, page 32)
Average	10.00% (Ex. 501, page 32)

[8] *Id.*

In an effort to show the reasonableness of his methodology, Mr. Gorman also replicated Dr. Vander Weide's analyses after removing the obvious flaws in Vander Weide's methodology. The results buttress the reasonableness of Gorman's return on equity recommendation.[9]

MODEL	VANDER WEIDE RESULT	ADJUSTED VANDER WEIDE RESULT
DCF	11.3%	9.00%
RISK PREMIUM	11.0%	10.42%
CAPM	12.5%	10.46%
AVERAGE	11.6%	9.96%

In this case, the Commission should utilize its "zone of reasonableness", the national and state average authorized return on equity, its previous findings of the relative levels of credibility of the witnesses, and the inherent reasonableness of Mr. Gorman's recommendation in finding that Empire is authorized a return on equity of 10.0%.

B. ZONE OF REASONABLENESS

In recent years the Commission has sought to assess the reasonableness of a witness' return on equity recommendation by comparing that recommendation to the national average authorized return on equity for the same time period. As the Commission noticed, "the national average is a good indicator of the capital market in which [the utility] will have to compete for the equity needed to finance its operations."[10] The Commission recognized, however, that it is not appropriate to simply adopt the national average return on equity,[11] because "if all commissions took that approach, returns on equity would never change, despite changing economic facts, leading to unjust

[9] Ex. 504, page 4.
[10] *In re: AmerenUE's electric rate increase*, Case No. ER-2007-0002, Report and Order, page 38 (issued May 22, 2007).
[11] *Id.*

results."[12] Rather, the Commission utilized the national average return on equity by creating a "zone of reasonableness" around that national average. "The zone of reasonableness has been described as a range 100 basis points above and 100 basis points below the national average return on equity."[13]

The implication of a recommendation falling outside this zone of reasonableness is unclear. In one case, the Commission found that "a recommendation greatly varying from the national norm ***will be viewed with skepticism***,"[14] suggesting that either high or low boundaries should not be transgressed. However, the low end appears to be more of a barrier than the upper. The Commission ***summarily rejected*** a consumer-sponsored recommendation that was below the bottom end of the zone of reasonableness.[15] "Because the return on equity recommended by DOE falls outside the 'zone of reasonableness,' the Commission will discard it and find that it merits no further discussion."[16] It is uncertain whether transgressions of the upper boundary, particularly when recommended by a utility, will be subject to similar treatment.

In the case at hand, evidence was elicited which indicated that the national average return on equity for 2007 was 10.36% and the average for the first quarter of 2008 was 10.32%.[17] Therefore, the "zone of reasonableness" to be utilized in this matter is approximately 9.35% - 11.35%. As such, of the return on equity recommendations advanced in this proceeding, two are safely within the "zone,"[18] while Empire's

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[12] *Id.*
[13] *Id.* at page 39.
[14] *Id.* (emphasis added).
[15] See, *In re: KCPL's electric rate increase*, Case No. ER-2006-0314, Report and Order, page 21 (issued December 21, 2006).
[16] *Id.* at pages 21-22.
[17] Exhibits 229 and 230.
[18] Industrial Intervenor Witness Gorman recommends a return on equity of 10.0% (Exhibit 501, page 2) and Staff Witness Barnes recommends a return on equity of 10.26% (Exhibit 219, page 2).

recommendation is significantly in excess of the Commission's zone of reasonableness.[19] If the standard used in the recent KCPL rate case is applied, Empire's recommended return on equity should be summarily rejected. At a minimum it should be treated with great "skepticism."

Recognizing the inflated nature of its request relative to the Commission's zone of reasonableness, Empire now disavows the zone of reasonableness test[20] or suggests that it be modified to consider only return on equity recommendations for integrated electric companies.[21] Empire posits that integrated electric companies, including Empire, are more risky and therefore deserve a higher return on equity.[22] The evidence indicates, however, that the classification of an electric utility as either integrated or wires-only, does not provide an accurate assessment of the utility's risk. As Mr. Gorman indicated, there are several examples of wires-only electric utilities which have a higher risk than Empire operating as an integrated utility.[23] Given that the risk of an electric utility is not dependent on its classification as either an integrated or wires-only utility, it is not appropriate to distinguish between such utilities when calculating the national average return on equity. Rather, the national average return on equity should include all electric

[19] Empire Witness Vander Weide recommends a return on equity of 11.6% (Exhibit 28, page 40).
[20] Tr. 442 ("After having gone through several cases in which you all have utilized this -- this tool and having read some of your decisions discussing it, I'm not really certain how helpful this tool has been").
[21] *Id.* ("If you're going to utilize the zone of reasonableness as a tool in this case, you should focus on returns allowed for integrated electric utilities such as Empire.").
[22] Tr. 477-478.
[23] In response to a question from Commissioner Jarrett, Mr. Gorman noted that "it's too simplistic to differentiate the risk of a regulated utility company simply by categorizing it as an integrated utility company or a transmission and distribution utility company. Integrated utility companies can have lower risks than T&D utility companies or they can have higher risk depending on which integrated utility company is at issue and the T&D companies you're comparing it to." (Tr. 799-800). As an example, Mr. Gorman points to Ameren's Illinois utilities which have a "higher risk" because of concerns as to whether "they can fully recover their purchased power cost that they're required to buy to serve smaller customers in their jurisdiction." (Tr. 800).

utilities. That national average return on equity contains the return on equity for all types of electric utilities with all measures of risks including integrated utilities such as Empire.

Nevertheless, if the Commission finds it appropriate to consider only integrated electric utilities, it would be useful to consider the average authorized return on equity received by those integrated electric utilities operating in Empire's own backyard. After all, the Supreme Court directs the Commission to consider the returns "generally being made at the same time and ***in the same general part of the country***."[24] In May of 2007, the Commission authorized Aquila to earn a return on equity of 10.25%.[25] In that same month, the Commission authorized AmerenUE to earn a return on equity of 10.2%.[26] Finally, in December of 2007, the Commission authorized KCPL to earn a return on equity of 10.75%.[27] Recognizing that each of these utilities operates in Missouri as integrated electric utilities,[28] and that any concerns as to difference in risk resulting from the different nature of electric utilities is eliminated, the statewide average authorized return on equity for the last year is 10.4%.[29]

UTILITY	RETURN ON EQUITY
Aquila	10.25%
AmerenUE	10.20%
KCPL	10.75%
Average	**10.40%**

Therefore, a zone of reasonableness based upon integrated electric utilities operating in the "same general part of the country" would extend from 9.4% to 11.4%. Under such a

[24] *Bluefield Water Works and Improvement Co. v. Public Service Comm'n*, 262 U.S. 679, 692 (1923) (emphasis added).
[25] *In re: Aquila's electric rate increase*, Case No. ER-2007-0004, Report and Order, page 63 (issued May 17, 2007).
[26] *In re: AmerenUE's electric rate increase*, Case No. ER-2007-0002, Report and Order, page 44 (issued May 22, 2007).
[27] *In re: KCPL's electric rate increase*, Case No. ER-2007-0291, Report and Order, page 29 (issued December 6, 2007).
[28] Tr. 487.
[29] Tr. 488.

scenario, Empire's recommendation remains well outside the zone of reasonableness and should be either summarily rejected or treated with great skepticism.

C. CREDIBILITY OF WITNESSES

In addition to the Commission's use of the "zone of reasonableness," another tool at the Commission's disposal is to review previous Commission findings as to a witness' credibility. In the recent AmerenUE electric rate proceeding, the Commission considered the testimony of both current Empire witness Vander Weide and Industrial Intervenor witness Gorman. In that case, the Commission made the following findings regarding Empire's witness Vander Weide, his recommendation and his credibility.

> ***When the Commission steps back, the first pattern that emerges is the realization that the rate of return advocated by the experts who testified for AmerenUE is too high. James Vander Weide advocates a return on equity of 12.2 percent.*** . . . Yet, Vander Weide acknowledged that, so far as he knew, if this Commission allowed AmerenUE a return on equity of 12.2 percent, or even 12.0 percent, it would be the highest return on equity allowed to any integrated electric utility in the country. . . . ***Such efforts call into question the credibility of these witnesses.*** Indeed, Vander Weide came close to acknowledging that his proposed return on equity was extreme when at the hearing he indicated an eleven percent return on equity, in line with the amounts that the Commission has allowed Kansas City Power & Light and The Empire District Electric Company in recent rate cases, "would be a benchmark that the financial community would look at."[30]

In contrast to Vander Weide's recommendation that "would be the highest return on equity" in the country, the Commission clearly appreciated the "balanced" approach provided by Industrial Intervenor witness Gorman.

> ***In particular, the Commission accepts as credible the testimony of MIEC's witness, Michael Gorman***, who explains that AmerenUE's proposed adjustment for financial risk is an incomplete assessment of AmerenUE's overall risk because it ignores the difference in operation risk between AmerenUE and comparable companies. . . . ***Of the witnesses***

[30] *In re: AmerenUE's electric rate increase*, Case No. ER-2007-0002, Report and Order, pages 40-41 (issued May 22, 2007).

> ***who testified in this case, Michael Gorman, the witness for MIEC, does the best job of presenting the balanced analysis that the Commission seeks.***[31]

The Commission's appreciation for the "balanced" approach provided by Mr. Gorman was not limited solely to the *AmerenUE* rate proceeding. In another proceeding decided five days earlier, the Commission had another opportunity to consider the recommendations of Mr. Gorman. Again, recognizing that the recommendation advanced by the Company was "too high," the Commission instead relied upon the recommendation of Mr. Gorman. "Michael Gorman, the witness for SIEUA, AG-P and FEA, did the best job of presenting the balanced analysis the Commission seeks."[32]

The Missouri Commission is not the only public utility commission that has relied upon the credibility of Mr. Gorman. In a recent Illinois rate proceeding, the Illinois Commerce Commission expressly pointed out Mr. Gorman's credibility.

> Having addressed the significant contested issues that relate to cost of common equity it appears to the Commission, as discussed above, that there are significant shortcomings in the analyses of Ms. McShane, Mr. Cuthbert, and Mr. Bodmer. On the other hand, the Commission believes that with the exception of his bond yield plus risk premium test, Mr. Gorman's analyses are largely free of any significant problems as are Ms. Freetly's.[33]

This case presents a comparable situation to that faced by the Commission in *AmerenUE* proceeding. Faced with the dueling opinions of Mr. Vander Weide and Mr. Gorman, the Commission should first be struck by the fact that Mr. Vander Weide recommends an 11.6% return on equity that would again be the highest in the nation.[34]

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[31] *Id.* at pages 40-42.
[32] *In re: Aquila's electric rate increase*, Case No. ER-2007-0004, Report and Order, pages 59-62 (issued May 17, 2007).
[33] *In re: AmerenCILCO, Ameren CIPS and AmerenIP electric rate increase*, Case Nos. 06-0070, 06-0071 and 06-0072, Order at page 148 (issued November 21, 2006).
[34] Exhibits 229 and 230.

Second, the Commission should again realize the "balanced" approach presented by Mr. Gorman and relied upon by the Commission in both the *AmerenUE* and *Aquila* rate proceedings. Given the obvious disparity in credibility between Mr. Vander Weide and Mr. Gorman, the Commission should again rely upon the recommendation advanced by Mr. Gorman.

D. PROBLEMS INHERENT IN EMPIRE'S METHODOLOGY

Beyond a recommended return on equity that substantially exceeds the Commission's zone of reasonableness and a supporting witness the Commission has previously found to lack credibility, Empire's methodology for calculating its requested return on equity is fundamentally flawed. As Mr. Gorman explains, the DCF, risk premium and CAPM methodologies, were all used by Vander Weide in a manner that leads to an "excessive" return on equity.[35] When employed in a reasonable manner, each of Vander Weide's methodologies will result in a return on equity that supports the 10.0% advanced by Mr. Gorman.[36]

Furthermore, any questions regarding differences between the proxy groups employed by Mr. Gorman and Mr. Vander Weide are dispelled when one recognizes that both Mr. Gorman and Mr. Vander Weide's methodologies, if properly applied, both support the 10.0% recommendation advanced by Mr. Gorman.[37]

[35] Ex. 504, page 2.
[36] *Id.* at page 4.
[37] *Id.* at page 2 ("I also show that Dr. Vander Weide's proxy group has a market cost of common equity within the range of 9.5% to 10.5%, with a midpoint of 10.0%.").

1. Discounted Cash Flow (DCF) Model

As Mr. Gorman notes, the Constant Growth DCF methodology is fundamentally flawed for several reasons.[38] Foremost among these concerns is the fact that, because the Constant Growth DCF does not allow for the consideration of different growth rates at different points in time, it must utilize a single growth rate. In his analysis, Dr. Vander Weide relies on a growth rate that is unreasonable in that it exceeds the growth rate of the gross domestic product for an infinite period of time.[39]

The fundamental notion underlying the DCF model is that it provides a present value calculation of an infinite string of dividend payments. In this way, the DCF model is perpetual in nature.[40] This perpetual string of dividend payments is based upon the current dividend amount that is, then, presumed to grow at the same constant rate as the company's earnings. Given the ready availability of the current dividend, the perpetual string of dividends payments is dependent solely on the assumed growth in the Company's earnings.

The obvious limitation underlying the Constant Growth DCF is that, unlike reality, it does not allow for the consideration of different growth rates at different points of time. In its Constant Growth DCF analysis, Empire utilized a growth rate of 6.89%.[41] Given the current projected GDP growth rate of approximately 4.8%,[42] the electric utility proxy group growth rate significantly exceeds that of the gross domestic product. While

[38] *Id.* At pages 4-7. In addition to the use of an inflated growth rate, Vander Weide's DCF recommendation is also skewed by his improper use of the quarterly version of the DCF and use of a market weighted growth rate for his proxy group instead of an simple average growth rate. Mr. Gorman points out the flaws in both of these shortcomings at pages 5-6 of Exhibit 504.
[39] Based upon his use of an inflated growth rate, Vander Weide concludes a DCF equity recommendation of 11.3% (Ex. 28, page 26), well in excess of the national average return on equity (Ex. 229 and 230).
[40] Ex. 28, page 16 ("The DCF method assumes that the current market price of a firm's stock is equal to the discounted value of ***all*** expected [dividends]."). (emphasis added).
[41] Ex. 504, page 6.
[42] *Id.*

a specific industry sector may experience a growth rate that exceeds the GDP for a ***short*** period of time, it cannot exceed the GDP growth rate for any extended period of time, let alone the perpetual time period assumed by the DCF model.[43]

The problem with a growth rate that exceeds that of the GDP is readily apparent and has been the subject of much academic research. An industry growth rate that exceeds the GDP growth rate, if viewed in the perpetual time frame assumed by the DCF model, assumes that the specific industry sector will eventually encompass the entirety of the U.S. economy. For this reason, in the long term, GDP growth represents the "ceiling, or high end, sustainable growth rate for a utility over an indefinite period of time."[44] Academics, therefore, note that "[e]xpected growth rates vary somewhat among companies, but dividends for mature firms are often expected to grow in the future at about the same rate as nominal gross domestic product."[45]

In the case at hand, analysts predict a ***short-term*** electric utility growth rate that exceeds that of the GDP. This short-term growth rate is based upon the near term addition of large capital projects (generation, transmission, distribution and environmental emissions control equipment) to rate base.[46] That said, while analysts foresee this inflated short-term growth for electric utilities, the use of such inflated

[43] Ex. 501, pages 19-23.
[44] *Id.* At page 19.
[45] *Id.* At page 21 (citing to Brigham, Eugene and Houston, Joel F., *Fundamentals of Financial Management*, at page 298). See also, Ibbotson Associates' *Stocks, Bonds, Bills and Inflation*, at page 92, wherein the authors found that "earnings and dividends have historically grown in tandem with the overall economy."
[46] *Id.* at pages 21-22.

growth rates cannot be found to be consistent with the perpetual nature of the constant growth DCF model.[47]

These inflated growth rates present the Commission with two options: (1) reject the use of the inflated short-term growth rates or (2) utilize such growth estimates in the context of a multi-stage DCF methodology that reflects a more reasonable second stage growth estimate.

> The results of [the] constant growth DCF model are unreasonably high because it reflects a growth rate that is not sustainable over an indefinite period of time, as required by this DCF model. However, the growth rate is based on consensus analysts' growth rate projections, so it is a reasonable short-term reflection of rational investment expectations, but a poor reflection of rational long-term expectations. The constant growth DCF model requires a rational long-term expectation. The limitation on the constant growth DCF model is that it cannot reflect a rational expectation that a period of abnormally high/low short-term growth can be followed by a change in growth to a rate that is more reflective of long-term sustainable growth. A two-stage growth DCF model can capture this expectation.[48]

In his analysis, Mr. Gorman recognized the obvious limitation of the constant growth DCF model and eschewed it in favor of the two-stage DCF model which allowed him to utilize the short-term inflated growth rates while still preserving the rational nature of the DCF model. As Gorman notes, "a two-stage growth can capture the rational expection of abnormally high growth experienced in the next three to five years, followed by a more normalized long-term sustainable growth thereafter."[49] Utilizing a short-term growth rate consistent with analysts' expectations and a long-term rate proxied by the

[47] *Id.* ("This indicates that rate base growth will drive abnormal earnings growth over the next three to five years. Afterwards, the relatively high level of capital expenditures and related increase in rate base and earnings will slow to a lower sustainable level.").
[48] *Id.*
[49] Ex. 504, page 7.

consensus growth in the gross domestic product, Mr. Gorman arrived at a DCF recommendation of 9.0% for Vander Weide's proxy group.[50]

2. Risk Premium Model

Similar to his handling of the DCF model, Dr. Vander Weide also implements the risk premium model in a manner that supports his overall 11.6% return on equity recommendation. In his rebuttal, Mr. Gorman points out numerous flaws in Vander Weide's risk premium model.[51]

As formulated, the risk premium model seeks to recognize the higher return on equity demanded by ***equity*** holders as compared to ***bond*** holders.[52] By comparing the return on equity demanded by equity holders in each of the proxy companies and comparing that return to the return given to utility bond holders, one can estimate the "risk premium" of holding equity securities versus debt securities.[53]

In its testimony, Empire presents two risk premium analyses. ***First***, Empire uses an *ex-ante* risk premium. In this approach, Empire leverages the inflationary methods contained in its DCF model to extract a similar boost in its risk premium recommendation. Specifically, Vander Weide performs a DCF analysis on each of the comparable companies in his proxy group. Like his DCF analysis, discussed *supra*, Vander Weide relies on a growth rate assumption for each proxy company that exceeds the growth in GDP. Vander Weide derives a preliminary risk premium by comparing the DCF calculation for the proxy group to the interest rate on A-rated utility bonds.[54] Vander Weide then increases this preliminary "risk premium" to account for the claimed

[50] *Id.*.
[51] *Id.* at pages 7-11.
[52] Ex. 28, page 26. See also, Ex. 501, page 24.
[53] *Id.*
[54] Ex. 28, page 27.

relationship between risk premium and interest rates.[55] Finally, Vander Weide adds his adjusted risk premium to an outdated, and inflated, yield for A-rated utility bonds.

As Mr. Gorman indicates, Vander Weide's risk premium analysis suffers from the same flaw as his DCF analysis. "By inflating the DCF return [for the proxy companies], he has inflated the market risk premium."[56] Demonstrating the inflated nature of the DCF analysis performed on the proxy group, Gorman compared Vander Weide's DCF for the proxy group to the average authorized return on equity for each time period. As Gorman demonstrates, a comparison to the average authorized return on equity indicates that Dr. Vander Weide's DCF returns are about 77 basis points greater than the industry average authorized returns."[57] Finally, Gorman notes that the current yield for A-rated utility bonds is 15 basis points lower than the yield utilized by Vander Weide.[58] By accounting for each of these flaws, Gorman demonstrates that Vander Weide's analysis yields a risk premium return on equity of 10.3%.[59]

Second, Empire conducts an *ex-post* risk premium analysis. Under this analysis, Vander Weide compared both the historical return on: (1) the S&P utility stock index and (2) the S&P 500, versus the return on A-rated utility bonds.[60] Vander Weide then adds this risk premium (4.45% to 5.10%) to an outdated yield for A-rated utility bonds.[61]

As Mr. Gorman indicates, the risk premium developed by comparing the S&P 500 to bond yields is irrelevant in that "it does not produce an appropriate risk-adjusted return

[55] *Id.* at page 28.
[56] Ex. 504, page 8.
[57] *Id.* at page 9.
[58] *Id.*
[59] *Id.* at page 10.
[60] Ex. 28, page 29.
[61] *Id.* at page 30; Ex. 504, page 10.

for Empire."[62] There is no evidence indicating that the risk associated with an equity investment in the S&P 500 is comparable to the risk of investment in Empire. As Gorman notes, Vander Weide's CAPM analysis, and the use of a beta that is less than 1.0 "is an implicit admission that Empire has a lower risk than the overall market."[63] Similarly, the *ex-post* risk premium analysis based upon the S&P utility stock index is flawed in that it "includes companies that may not be risk comparable to Empire."[64]

In his rebuttal testimony, Gorman adjusts for the flaws in Vander Weide's risk premium analysis. Based upon Vander Weide's risk premium methodologies and the adjustments made by Gorman, Vander Weide's risk premium studies "indicate a return in the range of 10.3% to 10.55%" with a midpoint of 10.42%.[65]

3. Capital Asset Pricing Model (CAPM)

While it is well established that equity shareholders require a risk premium compared to the return of bondholders, the Capital Asset Pricing Model recognizes that certain equity securities require a larger risk premium than other equity securities. Therefore, when compared against the overall market risk premium, certain equity securities require a larger return (more risky companies, $\beta > 1.0$), while other equity securities require a smaller return (less risky companies, $\beta < 1.0$). As Vander Weide notes, "the equity beta [β] is a measure of the company's risk relative to the market as a whole."[66] It is well established that utility equity securities contain less risk than the risk associated with the overall market and, therefore, have a beta coefficient less than 1.0.

[62] Ex. 504, page 10.
[63] *Id.*
[64] *Id.*
[65] *Id.* at page 11.
[66] Ex. 28, page 36.

While noting that Empire's CAPM analysis suffers from outdated and inflated estimates for both: (1) the utility proxy group's risk (β) coefficient and (2) the risk-free return on government security, Mr. Gorman points out that the ultimate CAPM return on equity recommendation is excessive primarily as a result of an inflated market risk premium.[67]

There are several flaws in Dr. Vander Weide's historical market risk premium. ***First***, in calculating his market risk premium, Vander Weide compares the income return on the risk-free government security and the total return on market equity investments.[68] By only considering the income return for the risk-free government security, Vander Weide considers the payment of cash coupon yields, but fails to consider bond price changes over the expected holding period for the bond. Just as equity holders anticipate an increase in the market price of their security, in addition to any dividend payments, bond holders also anticipate an increase in the market price of their security in addition to the coupon payments. "Hence, [Vander Weide's] development of an equity risk premium is simply based on an unrealistic premise and does not capture rational expectations."[69]

Second, Vander Weide's comparison between the income return for the risk-free government security and the total return for the market equity investments also suffers from a temporal mismatch. As Gorman notes, "[t]he income return [on the government security] is a forward looking expected return if the Treasury bond is held to maturity."[70] In contrast, Vander Weide's total return for market equity investments "is a backward-

[67] Ex. 504, page 12.
[68] *Id.*
[69] *Id.* at page 13.
[70] *Id.* at page 12.

looking historical review."[71] Therefore, Vander Weide's "market risk premium is based on the mismatch of a forward-looking expected income return on Treasuries, and historical actual achieved total returns on market equity securities."[72]

In an effort to correct the flaws contained in Vander Weide's CAPM analysis, Gorman utilized published estimates of the risk premium between market equity securities and Treasury bonds for a 70 year period.[73] Used in conjunction with an updated estimate of the risk-free return for government securities and the utility proxy group's risk (β) coefficient, Gorman suggests that Vander Weide's CAPM analysis actually yields a return on equity of 10.46%.[74]

4. Conclusion

As demonstrated, Dr. Vander Weide's return on equity analysis is consistent with that of a utility attempting to extract monopoly profits. In comparison to a national average return on equity of 10.3%, and a statewide average return on equity of 10.4%, Vander Weide recommends that Empire be authorized a return of 11.6%. By correcting the flaws in each of Vander Weide's analyses, a more reasonable return on equity can be calculated. This corrected return on equity is consistent with proper financial methodologies, is consistent with national and state average authorized returns, and, more importantly, is consistent with the dictates of the United States Supreme Court.

[71] *Id.* at page 13.
[72] *Id.*
[73] *Id.* (citing to *Morningstar Stocks, Bonds, Bills and Inflation*, 2008 Yearbook at page 31).
[74] *Id.* at page 17.

Dr. Vander Weide's Return on Common Equity Summary
With Appropriate Adjustment

Description	Dr. Vander Weide's Return (1)	Adjusted Results (2)
DCF	11.3%	9.00%
Risk Premium	11.0%	10.42%
CAPM	12.5%	10.46%
Average	11.6%	9.96%

E. PROBLEMS INHERENT IN "ON-THE-FLY" ANALYSES

The Commission has repeatedly recognized the difficulty of conducting a return on equity analysis. For this reason, the Commission has publicly expressed the need for expert witnesses to provide a "balanced" return on equity analysis. In the recent *AmerenUE* rate proceeding, the Commission notes that "[i]n order to obtain guidance about the appropriate rate of return on equity, the Commission considers the testimony of ***expert*** witnesses."[75] In fact, noting the difficulty of the return on equity research and analysis, the Commission has routinely discussed the nature of a witness' credentials in considering the return on equity recommendation. In contrast to the obvious expertise of the Industrial Intervenors' witness Gorman, as repeatedly recognized by the Commission in its recent decisions, there is no evidence to support a finding that any single Commissioner is qualified to advance an expert opinion on the issue of return on equity. While it may be permissible, therefore, for a commissioner to seek to clarify their understanding of a witnesses' testimony, it is inappropriate for them to do so in a manner that becomes advocacy for one side or another. It has been said that

[75] *In re: AmerenUE electric rate increase*, Case No. ER-2007-0002, Report and Order, page 37 (issued May 22, 2007).

> Whatever special necessity for enforcing the law in all its rigor there may be in a particular quarter of the country, the rules by which and the manner in which the administration of justice should be conducted are the same everywhere, and argumentative matter of this sort should not be thrown into the scales by the judicial officer who holds them.[76]

And it has also been said that a judge

> [M]ay ask questions and has the prerogative of commenting directly on witnesses and their testimony. Woodring v. United States, 311 F.2d 417, 421 (8 Cir. 1963). It is only when a judge becomes an advocate for one party that he oversteps the bounds of propriety in directing and governing the conduct of the trial. Franano v. United States, 310 F.2d 533 (8 Cir. 1962.) A court should show no bias toward either party or even tend to become an advocate for either party.[77]

Though one may disagree with the conclusions reached, the technical aspects of a rate of return analysis require study and employment of particular disciplines and training. Indeed, witnesses for the Commission Staff have occasionally been encouraged in public agenda sessions to seek additional training in the field so that they would be able to present "better" testimony.

The need for such expertise and training becomes apparent when one looks for the flaws inherent in one commissioners' effort to do a return on equity analysis on the fly. While possibly not apparent to a lay person, the flaws are immediately apparent to a witness with the credentials of Mr. Gorman. As Mr. Gorman points out:

> Q. You were asked to do many, many calculations by Chairman Davis. Do any of Chairman Davis's mix-and-match calculations change your view to an appropriate ROE for Empire?
>
> A. They do not. And the reason is, many of those calculations were done only changing one factor. They didn't completely update all the factors that went into the return on equity study.

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[76] *Starr v. United States*, 153 U.S. 614, 628 (U.S. 1894).

[77] *Kramer v. United States*, 408 F.2d 837, 841 (8th Cir. Mo. 1969). This line may have been crossed in this proceeding. During the hearing, one commissioner gave the appearance of having become an advocate for a specific position, at one point drawing an objection from counsel for not allowing the witness to answer the questions while other witnesses had not been similarly interrupted. Tr. 831.

> As an example, the average bond ratings for both treasury and utility bonds would change if I went from a six-month average in 2007 to a full calendar year average. The Chairman had me change simply the average authorized return on equity for the six months to the annual average. That didn't produce the same risk premium implied through authorized returns on equity for the full calendar year.
>
> He reviewed the calculation of the internal growth rate using Empire data as a payout ratio assumption of 80 percent in a -- in a long-term growth rate implicit in that analysis which suggested an earned return on equity of around 25 percent.
>
> Well, the fact is, it -- maintaining a 5 percent growth rate for a company probably couldn't be done at an 80 percent payout ratio. The more of your earnings you pay out, the lower your growth rate is going to be.
>
> And like a savings account, if you're earning 10 percent on a $100 deposit in your savings account, the end of the first -- you have a $100 deposit at the end of the first year, you have $10 of earnings. If you reinvest that $10 back into your account, you have $110 the second year.
>
> If you earn 10 percent on that $110 deposit the next year, you have a hundred -- you have $11 income. Your income grew by 10 percent in that year because you had 100 percent retention of all earnings. If you would not have returned – retained any of that interest earnings, the balance would have stayed at $100, your earnings would stay at $10 and your growth rate would be zero.
>
> So there's a direct correlation in your earnings growth and your retention payout ratio, retention ratio and your payout ratio. You can't hold one constant and let the other one float. They interrelate to each other. So that conclusion produced an illogical result because the underlying assumptions that need to go into interpreting those assumptions were not reasonable.[78]

Ultimately, despite the extensive bench questioning, nothing modified Mr. Gorman's opinion or his belief as to an appropriate return on equity for Empire. Further, despite the illogical assumptions advanced as part of the "on-the-fly" return on equity analysis, it only served to highlight the unreasonable nature of the return on equity recommendations advanced by Dr. Vander Weide.

[78] Tr. 851-853.

Q. Were any of the methodologies suggested by Chairman Davis' calculation consistent with your methodologies?

A. Well, the mathematics were consistent but the underlying matching of the time period of the data was not because in many cases that was inconsistent.

Q. Did any of the calculations that Chairman Davis had you perform ever end up supporting the 11.6 ROE recommended by Dr. Vander Weide?

A. No, sir, didn't come close to it.[79]

E. PROBLEMS INHERENT IN STAFF'S METHODOLOGY

In its testimony, Staff recommends a return on equity of 9.72% to 10.8%. Staff's return on equity analysis is based upon a CAPM analysis as well as a constant growth DCF analysis. Staff's CAPM analysis results in a return on equity below 10.0%.[80] Staff's constant growth DCF analysis, however, since it relies on a broad range of growth estimates, delivers a return on equity range of 9.70% to 10.85%.[81] The growth rate (5.55%) associated with the low end of that return on equity[82] appears to be only slightly higher than the projected nominal GDP growth over the next five years (5.0%).[83] As such, the low end of Staff's range (9.70%), because it relies on a growth rate that slightly exceeds GDP growth, constitutes a conservative estimate.

Similar to Vander Weide's constant growth DCF analysis, however, the growth rate (6.70%) underlying the high end of Staff's DCF range of 10.8% is significantly above the projected GDP growth rate. Recognizing that the DCF growth rate cannot exceed the GDP growth for any extended period of time, the GDP growth rate constitutes

[79] Tr. 853-854.
[80] Ex. 204, Schedule 18.
[81] Ex. 218, page 2.
[82] Ex. 204, Schedule 17.
[83] Ex. 504, page 6.

a ceiling on the DCF growth rate. As such, for the same reason that Vander Weide's DCF analysis is unreliable,[84] the high end of Staff's recommended range is similarly unreliable and should be rejected.

G. EFFECT OF A FUEL ADJUSTMENT CLAUSE ON THE AUTHORIZED RETURN ON EQUITY

When it enacted SB179, the General Assembly recognized the effect that an automatic adjustment clause had on a utility's risk profile. As such, the General Assembly instructed the Commission to consider this reduction in business risk when it authorized a return on equity.

> The Commission may take into account any change in business risk to the corporation resulting from implementation of the adjustment mechanism in setting the corporation's allowed return in any rate proceeding, in addition to any other changes in business risk experienced by the corporation.[85]

The fact that a fuel adjustment clause will reduce Empire's business risk is unquestioned. As Empire's CEO responds:

> Q. Would you agree that the fuel adjustment clause as authorized by SB 179 would decrease Empire's risk?
>
> A. Yes, I would.[86]

Despite the fact that Empire's CEO recognizes the reduction in business risk associated with the implementation of a fuel adjustment clause, Empire's consultants suggest that no reduction in the authorized return on equity is appropriate. Those consultants posit, since most of the proxy companies have a fuel adjustment clause, that a

[84] See, Section II(D)(1), pages 15 through 17 of this brief for the discussion surrounding the unreasonableness of company growth rates that exceed the GDP growth rate.
[85] Section 386.266.7
[86] Tr. 230.

fuel adjustment clause would merely reduce Empire's risk to a level consistent with those proxy companies.

Empire's consultants miss the method by which proxy companies are selected and the reason that those companies are considered "comparable companies." The companies that make up the Empire proxy group were selected because, based on a total company risk profile, they are comparable to Empire. Therefore, while any particular risk element may be different between a proxy company and Empire, on a total company risk profile, that company is ***currently*** comparable to Empire.

For instance, while certain proxy companies may have higher risk associated with the effect of nuclear operations, that risk is implicit in the proxy company's bond rating.[87] Despite the increased operating risk associated with these nuclear operations, there are offsetting risk factors that make the total company risk comparable to that of Empire.

Similarly, while certain proxy companies may have higher risk associated with deregulated operations, that risk is implicit in the proxy company's bond rating.[88] Despite the increased business risk associated with these deregulated operations, there are enough offsetting risk factors that make the total company risk profile comparable to that of Empire.

In the same way, Empire's current total risk profile is comparable to the comparable company group. This Empire total risk profile consists of certain items of lower risk (no nuclear operations, no exposure to hurricanes, no deregulated operations) as well as items of higher risk (exposure to natural gas generation and ***no Missouri fuel adjustment clause***).

[87] Tr. 485.
[88] Tr. 486.

Any Commission change to Empire's total risk profile (i.e., the implementation of a fuel adjustment clause) would decrease Empire's risk profile vis-à-vis the proxy company group. As Mr. Gorman points out:

> My proxy group and that of Staff witness Mr. Barnes were both selected based on a comparison of Empire's current total investment risks relative to those of the proxy group. Empire's current investment risk does not include the operating risk reduction created by implementing a fuel adjustment mechanism.
>
> Regulatory mechanisms are an important assessment made by credit analysts in assigned the operating risk of a utility company, which goes into its overall credit rating. Specifically, Standard & Poor's (S&P) notes that the regulatory mechanisms are an important factor in determining the overall business risk assessment of a utility company. In assigning a utility's business profile score, S&P reviews the utility's business risk using the following categories: management risk, regulatory risk, market risk, operations and competitive position risk. Regulatory risk includes responsiveness of the regulator to adjust rates to meet the utility's changed cost of service.
>
> Empire's current regulatory mechanisms do not include a fuel adjustment clause; therefore, it is beyond dispute that its current total investment risk and bond rating does not reflect the risk reduction (or transfer to customers of risk) of fuel cost recovery. Importantly, if a fuel adjustment mechanism is implemented for Empire, its operating risk will be reduced, and a lower return on equity would be appropriate.
>
> This is not to say that only downward return on equity adjustments are appropriate. If the Commission decided to make a change to another aspect of the Company that caused a material increase in risk from the current status quo, then an upward adjustment to the recommended return on equity would be appropriate.[89]

Given Empire's decreased risk profile, the Commission is faced with options: (1) conduct a new return on equity analysis using a proxy group consisting of a risk profile comparable to Empire's new risk profile including the new fuel adjustment clause or (2) make an isolated adjustment to account for Empire's diminished risk relative to that of the proxy group. Rather than conduct an entirely new return on equity analysis for

[89] Ex. 506, pages 3-4.

Empire, Mr. Gorman estimated the commensurate adjustment to return on equity associated with Empire's reduced risk profile.

> I am estimating a return on equity that is based on Empire's existing operating and financial risk. If the Commission implements regulatory mechanisms that reduce Empire's operating risk, then my return on equity would compensate Empire for risks included in that rate of return that it no longer is assuming. As such, it may be necessary to reduce the authorized return on equity if the Commission implements a fuel adjustment mechanism that meaningfully shifts a portion of fuel cost recovery risk from Empire to Empire's ratepayers.[90]

Ultimately, depending on the amount of sharing included in any fuel adjustment clause, the implementation of a fuel adjustment clause for Empire in this case could be worth as much as 50 basis points.[91]

III. FUEL COST RECOVERY

A. BACKGROUND AND INTRODUCTION

In 1979, the Missouri Supreme Court issued a decision in which it discussed the legality of the fuel adjustment clause.[92] The Court recognized that, in a rate case proceeding, the Commission is required to consider "all relevant factors." Thus, utility rates are not increased simply because a single cost item has increased. Rather, using the "all relevant factors" standard, an increase in one factor may be offset by "compensating economies" or decreases in other factors.[93] Only after considering all the relevant factors should the Commission make a decision to increase or decrease a utility's rates. Recognizing that a fuel adjustment clause would, however, allow for a rate change based solely on a change in one factor (fuel) without allowing for any consideration of

[90] Ex. 501, page 3.
[91] *Id.* at page 4.
[92] *State ex rel. Utility Consumers Council of Missouri v. Public Service Commission*, 585 S.W.2d 41 (Mo. 1979).
[93] *Id.*

"compensating economies" or decreases in other factors, the Court noted that a fuel adjustment clause represents a "**radical departure** from the usual practice."[94]

While finding the fuel adjustment clause to be an illegal departure from the mandate to consider "all relevant factors," the Supreme Court also pointed out that it constitutes poor ratemaking. In particular, the Court noted that the fuel adjustment clause would likely cause the utility to depart from current fuel cost minimization practices. "***[U]tilities would lose any incentive to keep down fuel costs where they know such costs can be fully and automatically passed on to the consumer.***"[95] The Missouri Commission has also recognized this fundamental flaw in the fuel adjustment clause. "[U]nder such a proposal, management would not be encouraged to bargain for the lowest coal rates possible when it would know any increase would be immediately 'flowed through' to customers."[96]

Other jurisdictions have pointed out other flaws inherent in automatic adjustment mechanisms including: (1) that adjustment mechanisms constitute an unlawful delegation to the utility of the commission's authority to regulate rates;[97] (2) that adjustment mechanisms deny customers the right to know their utility rates with certainty in advance;[98] (3) that adjustment mechanisms deny the public the opportunity to be heard prior to any utility rate increase;[99] and (4) that automatic adjustment mechanisms add

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[94] *Id* (emphasis added).
[95] *Id* (citing to Foy, *Cost Adjustment in Utility Rate Schedules*, 13 Vanderbilt L.Rev. 663,664 (1959-1960); Trigg, *Escalator Clauses in Public Utility Rate Schedules*, 106 U.Pa.L.Rev. 964, 969-973 (1957-1958); Martin, *The Fuel Adjustment Clause and Its Role in the Regulatory Process*, 47 Miss.L.J. 302, 309 (1976) (emphasis added).
[96] *Re Union Electric Co.*, 92 P.U.R. 3d 254, 262 (1971).
[97] *Re Rockford Electric Co.*, 1917F P.U.R. 196 (Illinois Commerce Commission); *Jones v. Montpelier Light and Power Co.*, 1921D P.U.R. 145 (Vermont Public Service Commission).
[98] Section 393.140(11) RSMo.
[99] *Great Falls Gas Company*, 29 P.U.R.3d 237 (Montana Public Service Commission).

another level of complexity to current regulation that cannot be accounted for with current staffing levels.[100]

While Commission authority to employ a properly designed fuel adjustment clause has been provided through the enactment of Senate Bill 179 (Section 386.266 RSMo), the fact remains, as recognized by the Missouri Supreme Court, that fuel adjustment mechanisms constitute poor ratemaking and eliminate the utility's incentive to minimize fuel costs. In fact, in its recent decision in the *AmerenUE* rate case, the Commission recognized that a fuel adjustment clause can lead to a higher than authorized return, an improper matching of revenues and expenses, and the elimination of the incentives inherent in regulatory lag.

> A fuel adjustment clause is a powerful regulatory tool to be used with careful consideration. If a fuel adjustment clause is allowed in an inappropriate situation, the customers who pay for utility service can be forced to pay rates that are higher than they should be. . . .
>
> A fuel adjustment clause should be used cautiously because it runs contrary to some of the basic principles of traditional utility regulation. One such principle is the matching of expenses and revenues. . . . The increased or decreased income in one area may be balanced by decreased costs or increased revenue in another area.
>
> In a traditional rate case, without a fuel adjustment clause, the Commission examines all the revenue and costs of the utility during a particular period known as a test year. The Commission then matches the revenue and costs, arriving at an amount the utility needs to recover from its ratepayers if it is to earn a reasonable return on its investment. If a fuel adjustment clause, or other tracking mechanism, is established, then the utility would be able to pass on increased costs in one area, in this case fuel and purchased power, without an examination of all the other areas in which its costs may have decreased or its revenues increased. As a result, ratepayers could be required to pay increased rates while the company enjoys increased profits.

[100] *The Fuel Adjustment Clause and its Role in the Regulatory Process*, 47 Mississippi Law Journal 302, 312.

> Inclusion of a fuel adjustment clause also affects the operation of regulatory lag. Regulatory lag results because a rate case test year, at least in Missouri, is based on a historical test year, usually ending about the time the utility files for a rate increase. Since a rate case takes eleven months to complete, a utility will always be about eleven months behind. Of course, utilities do no particularly like regulatory lag when their costs are increasing, but regulatory lag can also favor the utility when their costs are decreasing. The good effect of regulatory lag is that it provides the utility with a strong incentive to maximize its income and minimize its costs. If, however, a fuel adjustment clause is in place, the utility has less financial incentive to minimize its fuel costs because those costs will be automatically recovered from ratepayers. Efforts can be made to design a fuel adjustment clause in a manner that maintains some incentive; for example, the Missouri statute authorizing a fuel adjustment clause requires the utility to file a new rate case every four years and requires the Commission to review the prudence of the company's purchasing decisions every 18 months. But regulatory reviews are only a partial substitute for the direct incentives that can result from a utility's quest for profits.[101]

While some may argue that the deficiencies of a fuel adjustment clause may be remedied through the existence of mandatory prudence review, those reviews are generally deemed to be ineffective in analyzing the multitude of energy generation and procurement decisions that underlie the utility's total fuel cost. As Industrial Intervenor Witness Brubaker notes:

> Of course, utilities are held to the prudency standard, but it is very difficult to conduct a detailed audit of all of the decisions that go into a utility's procurement of fuel and purchased power, the maintenance of its generating fleet, and other factors that influence the level of these costs. The complexity of auditing the utility's generation function pales in comparison to the more limited analysis required for the Purchased Gas Adjustment (PGA) filings of the gas utilities. The number of decisions required to be investigated in the case of a PGA is relatively small. However, in the case of an electric utility, there are hourly transactions involving purchases and sales, decisions respecting acquisition of various kinds of fuel supplies in different markets, preventive maintenance practices, speed and cost of recovering from forced outages and similar decisions and actions. Thus, a rigorous audit of electric utility generation

[101] *In re: AmerenUE's electric rate increase*, Case No. ER-2007-0002, Report and Order, pages 17-18 (issued May 22, 2007).

and purchased power costs is much more difficult to accomplish than a PGA audit.[102]

With the multitude of evils in mind, SB179 gives the Commission broad latitude to "approve, modify, or reject" a fuel adjustment mechanism.[103] Therefore, in the event that the Commission decides to implement a fuel adjustment clause for Empire, it should carefully structure the fuel adjustment clause in a manner that eliminates the deficiencies that the Missouri Supreme Court found inherent in an automatic adjustment mechanism.

In the initial portion of this section of the brief, the Industrial Intervenors explain that the issue of the structure of a fuel adjustment clause is largely irrelevant in that Empire has bargained away their option to request such a mechanism. In the second portion, this brief recognizes the inherent deficiency that automatic adjustment mechanisms cause the utility to "***lose any incentive to keep down fuel costs where they know such costs can be fully and automatically passed on to the consumer.***" As such, this brief discusses an adjustment mechanism that preserves some of the utility's incentive to minimize fuel costs while providing the utility some protection from the volatility of the fuel and purchased power market. Finally, in furtherance of this effort to maintain proper incentives, this brief identifies certain fuel and purchased power items that should be excluded from any automatic adjustment mechanism.

B. IS EMPIRE BARRED FROM REQUESTING A FUEL ADJUSTMENT CLAUSE?

Prior to the implementation of SB179, Empire filed a rate increase in 2004.[104] In the context of that case, and despite the fact that fuel adjustment clauses were still unlawful, the parties nevertheless agreed to the implementation of an interim energy

[102] Ex. 500, page 3.
[103] Section 386.266.4 RSMo.
[104] Case No. ER-2004-0570.

charge ("IEC"). In consideration for the ratepayers' agreement to implement the IEC, Empire agreed not to seek the implementation of a fuel adjustment clause for the duration of the IEC.[105]

In its next rate proceeding, and immediately following the enactment of SB179, Empire sought to renege on its agreement and implement a fuel adjustment clause. While the Commission claimed that it had the authority to prematurely cancel the IEC, the Commission found that Empire could ***not*** seek a fuel adjustment clause while the IEC was still effective. "The Commission clarifies that The Empire District Electric Company, pursuant to the Stipulation and Agreement, may not make any request for an energy cost recovery rider [fuel adjustment clause] while the existing interim energy charge is effect."[106]

Therefore, while the Commission found that Empire could not seek the implementation of a fuel adjustment clause, it did find that Empire could seek the premature termination of the IEC, thus opening the door for Empire to seek the implementation of a fuel adjustment clause in its next case.

On December 29, 2006, the Commission issued its Order Granting Expedited Treatment and Approving Tariffs.[107] By that Order, the Commission sought to approve certain rate schedules and cancel those rate schedules preceding the new tariffs. For

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[105] Case No. ER-2004-0570, *Non-Unanimous Stipulation and Agreement Regarding Fuel and Purchased Power Expense*, filed February 22, 2005 at page 12. ("In consideration of the implementation of the IEC in this case and the agreement of the Parties to waive their respective rights to judicial review or to otherwise challenge a Commission order in this case authorizing and approving the subject IEC, for the duration of the IEC approved in this case Empire agrees to forego any right it may have to request the use of, or t o us, any other procedure or remedy available under current Missouri statute or subsequently enacted Missouri statute, in the form of a fuel adjustment clause, a natural gas recovery mechanism, or other energy related adjustment mechanism to which the Company would otherwise be entitled.").

[106] Case No. ER-2006-0315, *Order Clarifying Continued Applicability of the Interim Energy Charge*, issued May 2, 2006, at page 4.

[107] Case No. ER-2006-0315, *Order Granting Expedited Treatment and Approving Tariffs*, issued December 29, 2006.

instance, relevant to the instant discussion, the Commission sought to approve the following rate schedule:

P.S.C. Mo. No. 5, Section 4, 5th Revised Sheet No. 17

and cancel:

P.S.C. Mo. No. 5, Section 4, 4th Revised Sheet No. 17.[108]

By this order approving tariffs, the Commission sought, at the request of Empire, to prematurely terminate the IEC.

Immediately following the issuance of the Commission's December 29, 2006 Order Granting Expedited Treatment and Approving Tariffs, the Office of the Public Counsel filed its Petition for Writ of Mandamus with the Missouri Supreme Court. In that petition, Public Counsel asked the Supreme Court to find that the Commission had abused its discretion by making its December 29, 2006 Order effective in such a manner as to preclude the possibility of parties filing an Application for Rehearing. In its October 30, 2007 decision in *State ex rel. Office of Public Counsel v. Public Service Commission*, the Supreme Court found that the Commission had abused its authority in issuing its December 29, 2006 Order Granting Expedited Treatment and Approving Tariffs.[109] Given this abuse of discretion, the Supreme Court ordered the Commission to vacate its December 29, 2006 Order.[110]

With the vacation of the December 29, 2006 Order, the updated tariffs were never approved. Therefore, the ER-2004-0570 tariffs, including the IEC tariff, were necessarily still in effect. As such, on October 1, 2007, the date that Empire filed its tariffs to

[108] *Id.* at page 5.
[109] *State ex rel. Office of the Public Counsel v. Public Service Commission*, 236 S.W.3d 632, 637 (Mo. 2007)
[110] *Id.*

implement a fuel adjustment clause, the IEC tariff was still in effect. Given the express provisions of the ER-2004-0570 Stipulation and Agreement, as recognized by the Commission, Empire was precluded, on such a date, from seeking to implement a fuel adjustment clause.

C. IF AUTHORIZED, HOW SHOULD A FUEL ADJUSTMENT MECHANISM BE STRUCTURED?

Given the problems inherent in an automatic adjustment clause, as recognized by the Missouri Supreme Court, it is incumbent upon the Commission to structure a fuel adjustment clause that maintains the proper incentives for the utility to minimize its fuel and purchased power costs. Rather than a complete pass-through of all fuel and purchased power costs, the Commission should provide an incentive, through a sharing mechanism, for Empire to keep fuel costs as low as possible. As Mr. Brubaker points out:

> If some form of FAC is permitted, then an appropriate way to provide the utility with a greater incentive to manage its costs is to include a sharing mechanism of some type, which requires the utility to retain some portion of any cost increases that may be experienced relative to the base costs in the FAC. Similarly, the utility would be permitted to retain a portion of any cost decrease that may be experienced. By making the utility responsible for a share of increased costs, there is added incentive (compared to 100% pass through) for the utility to focus on management of these costs.[111]

Despite Empire's claims to the contrary, the notion of implementing a sharing mechanism in the context of a fuel adjustment clause is not unusual. Recognizing the incentive a sharing mechanism places on a utility to minimize its fuel and purchased power costs, many states have implemented sharing mechanisms in the context of the fuel adjustment clause.

[111] Ex. 500, pages 3-4.

For instance, the Washington Utilities and Transportation Commission has implemented a sharing mechanism in the context of the fuel adjustment clause for Puget Sound Energy. As the Washington Commission notes, the fuel adjustment mechanism "would account for a sharing of costs and benefits that are graduated over four levels of power cost variances, with an overall cap of $40 million (+/-) over the four year period July 1, 2002 through June 30, 2006."[112] Under the Puget Sound fuel adjustment clause, the utility is required to absorb all variances within a dead band, up to $20 million annually. Thereafter, fuel cost variances are shared to varying degrees up to a total absorbed cost of $40 million annually.[113]

Additionally, the Wyoming Commission has implemented a sharing mechanism in the fuel adjustment clause of Rocky Mountain Power.[114] Similar to the sharing mechanism designed for Puget Energy, the Rocky Mountain Power fuel adjustment clause creates a dead band in which the utility is required to absorb all fuel and purchased power variances.[115] Thereafter, the Company is permitted to recover between 70% and 90% of all variances, depending on the exact point on the sharing grid.[116] Importantly, unlike Puget Sound, there is no cap on the amount that may be absorbed by the utility.[117]

Still again, Avista Corporation operates under a FAC sharing mechanism which provides for a dead band in which the utility is requires to absorb all costs, a certain amount of 50/50 sharing with customers, followed by an unlimited amount of sharing in which customers absorb 90% of all variances. Again, under this mechanism, there is no

[112] Ex. 32, page 12.
[113] *Id.* at pages 12-13.
[114] *Id*. at pages 16-28.
[115] *Id.* at page 18.
[116] *Id.*
[117] *Id.*

cap on the total amount of fuel variances that may be absorbed by the utility.[118] Sharing mechanisms associated with fuel adjustment clauses have also been implemented for Montana-Dakota Utilities, Idaho Power Company and Portland General Electric Company.[119]

In this case, drawing from approaches used by these other public utility commissions, Industrial Intervenor Witness Brubaker proposed a mechanism to share increases and decreases in fuel and purchased power costs between shareholders and ratepayers. Specifically, Brubaker proposes two versions of a fuel adjustment clause sharing grid differentiated by a dead band in the first proposal. Graphically represented in Schedule 2 of Exhibit 502, Brubaker describes his first proposal as follows:

> Structurally, I propose that there be a ±$1,200,000 deadband around the base point in the FAC. Within this band, Empire would retain 100% of the variations in costs. This deadband gives the utility an incentive to manage costs and also adds stability to the rates because small changes or deviations from the base point would not trigger changes in the level of rates. The $1,200,000 annual variation is about 1% of fuel costs and translates into approximately 0.20 percentage points (20 basis points) rate of return on common equity.
>
> Outside the deadband, I propose that for up to the next ±$6,000,000 (5% of fuel costs) of change in net costs beyond the ±$1,200,000 deadband, there be a sharing of 90% to customers and 10% to stockholders. At the full ±$6,000,000 in this band, the 10% to stockholders amounts to $600,000 or approximately 0.1% or 10 basis points in return on equity. Considering both the deadband and this first $6,000,000 band, the total dollars to stockholders would be $1,800,000, and the cumulative impact on return equity would be 30 basis points.
>
> Beyond this initial ±$6,000,000 deviation, the next $6,000,000 (an additional 5% of fuel costs) would be split 80% to customers and 20% to stockholders, and at the full ±$6,000,000 in this band would represent $1,200,000 or 20 basis points return on equity for stockholders. At this point, considering the deadband and both sharing bands, the amount to

[118] *Id.* at page 3, 36-42.
[119] *Id.*

> stockholders would be $3 million and the impact on return equity would be 50 basis points.
>
> Beyond this $13,200,000 (deadband plus two sharing bands), there would be a full flow through to customers of any additional change in net costs. The cumulative impact at a $13,200,000 deviation from the base is $3,000,000 to stockholders or 50 basis points return on equity.[120]

The benefits of this sharing mechanism should be obvious. ***First***, it provides the utility "an incentive to controls costs and to perform in a superior manner."[121] ***Second***, through the use of the dead band, it provides ratepayers with some "stability [in] rates because small changes or deviations from the base level would not trigger changes in the level of rates."[122] ***Third***, since the utility will be invested in its decision-making, it serves to diminish the reliance on an after-the-fact prudence review. The fuel adjustment clause proposed by Mr. Brubaker minimizes the inherent deficiencies in the fuel adjustment mechanism that were recognized by the Missouri Supreme Court.

In his surrebuttal, in response to suggestions raised by Staff, Mr. Brubaker provided an alternative mechanism by which he eliminated the dead band and increased the bands for sharing of costs between ratepayers and shareholders. Graphically represented on Schedule 1 of Exhibit 505, Brubaker describes his alternative proposal as follows:

> This alternative sharing mechanism maintains the same $3 million cap on absorptions by Empire of increases in cost, and retention by Empire of the benefit of decreases in costs. It differs in that I have eliminated the dead band which previously required Empire to absorb the first ± $1.2 million deviation from the base. By taking those dead band dollars and spreading them out over a broader range of cost changes, an incentive to control costs can be maintained over a much broader range.[123]

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[120] Ex. 502, pages 8-9 and Schedule 2.
[121] *Id.* at page 9.
[122] *Id.* at page 8.
[123] Ex. 505, page 14.

In contrast to this tempered proposals advanced by Mr. Brubaker, Empire suggests a fuel adjustment clause whereby 95% of all variations in fuel and purchased power are passed through to ratepayers. When asked for the justification for their proposal, Empire merely notes that it was mimicking the fuel adjustment clause adopted by Aquila.[124]

> From the response to MPSC Staff Data Request No. 169, it is evident that the 95% / 5% structure is simply based on the outcome of a recent Aquila Networks, Missouri PSC Rate Order (Case No. ER-2007-0004), and not an analysis of the incentives present in this mechanism or the impact on the utility's return on equity of the proposed sharing of the deviations in the level of fuel and purchased power costs from the base.[125]

That mechanism, which was adopted by the Commission without the support of any expert witness, provides for a minimal degree of sharing, but not enough to implement the incentives necessary for a utility to minimize costs. Based upon certain scenarios of future increased costs, the 95% sharing mechanism "does not provide a sufficient incentive to Empire to control costs."[126] As Brubaker notes, at the minimal sharing threshold proposed by Empire, "the price signal to the utility is very weak. The price signal needs to be strong enough to be meaningful."[127] The clarion call, then, for the Commission in structuring an adjustment mechanism is that the "mechanism implemented provide greater incentives for the utility to control costs and take other actions which will reduce the level of charges to customers. . . . A more structured sharing mechanism, which would provide greater incentives to the utility [as compared to the 95% sharing proposed by Empire], would be more appropriate.[128]

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[124] The Aquila case remains on appeal and no final decision has been reached on that matter.
[125] Ex. 502, page 4.
[126] *Id.* at page 6.
[127] *Id.* at page 7.
[128] *Id.* at pages 6-7.

D. WHAT COSTS SHOULD FLOW THROUGH A PROPERLY STRUCTURED FUEL ADJUSTMENT MECHANISM?

As the Commission has recognized, "a fuel adjustment clause should be used cautiously because it runs contrary to some of the basic principles of traditional utility regulation."[129] Foremost among these basis principles is the notion of regulatory lag and its positive effect on the Company's incentive to minimize costs. As the Commission has found:

> The good effect of regulatory lag is that it provides the utility with a strong incentive to maximize its income and minimize its costs. If, however, a fuel adjustment clause is in place, the utility has less financial incentive to minimize its fuel costs because those costs will be automatically recovered from ratepayers.[130]

If, then, the Commission finds it necessary to implement a fuel adjustment clause, in order "to preserve the financial health of the utility,"[131] then the Commission should be careful to segregate those costs that should pass through the adjustment mechanism. By only allowing certain costs to pass through the adjustment mechanism, the Commission can ensure that all other costs realize the positive effects of regulatory lag and the strong incentive for the utility to minimize that particular cost. It is important to note, however, that by excluding such costs from recovery in the fuel adjustment clause, the Commission is ***not*** denying recovery of those costs. Such costs are quantified and may be recovered through base rates. Only variances in such costs, to the extent they occur between rate cases, will be denied automatic adjustment. Instead, like all other expense and revenue items, the variance in those costs will wait until the next rate case for quantification and recovery.

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[129] *In re: AmerenUE's electric rate increase*, Case No. ER-2007-0002, Report and Order, page 17 (issued May 22, 2007).
[130] *Id.* at page 18.
[131] *Id.* at page 19.

Given their desire to avoid regulatory lag and the pressures that it may place on its management to make thorough and thoughtful decisions, Empire seeks to apply a broad brush approach to the costs that get applied to the fuel adjustment clause. In essence, as explained in the introduction, Empire seeks to cram as many expenses into a tracker mechanism as possible while still allowing for uncapped revenues.[132] The Commission should peer through Empire's self-serving suggestions and, instead, narrowly identify those expense items which should be removed from the scrutiny of regulatory lag.

The Commission may easily determine the types of costs that should flow through a fuel adjustment mechanism by considering the standard utilized for granting a fuel adjustment clause. As noted in the *AmerenUE* rate decision, it would necessarily be those fuel items which are volatile enough to threaten "the financial health of the utility." Mr. Brubaker has reduced this to a more workable definition.

> In addition to the requirement that the cost be prudent, costs flowed through the FAC should generally be those that are variable with the level of kWh generated, are volatile and / or difficult to predict or control. In addition, the magnitude of the costs should be significant to the utility.[133]

The logic of Brubaker's criteria is obvious, expenses which are not variable, volatile or difficult to predict or control are capable of identification and recovery through base rates. In fact, when considering the types of costs that should flow through a fuel adjustment clause, the Commission has previously concluded that Aquila "will only be allowed to flow ***variable*** fuel and purchased power costs, including variable transportation costs, through its fuel adjustment clause."[134] The need to eliminate fixed

[132] Ex. 505, page 4.
[133] *Id.* page 7.
[134] *In re: Aquila's electric rate increase*, Case No. ER-2007-0004, Report and Order, pages 42-43 (issued May 17, 2007).

costs from consideration in the fuel adjustment clause is also dictated by a need to prevent discriminatory treatment of high load factor customers.

> Predominantly, FAC's are designed to recover changes in variable costs; that is, costs that vary on a kWh basis. In addition to the reasons I have previously mentioned, costs passed through the fuel clause are on a per kWh basis (adjusted for losses) and inclusion of demand-related costs in an FAC would burden high load factor customers because they would be required to pay a disproportionately large share of such costs. It is preferable, and more typical, to include these costs in base rates.[135]

With this in mind, Mr. Brubaker has identified several cost items, contained in Empire's proposed fuel adjustment clause, which should ***not*** be recovered in an adjustment mechanism. For example, unit train costs and natural gas transportation demand charges are fixed costs and therefore do not vary with the level of kWh generated.[136] Additionally, fuel handling costs should not be recovered through the adjustment mechanism. Such costs are primarily labor costs. "Labor costs are neither volatile nor outside the control of the utility. There is no reason to distinguish labor costs associated with fuel handling from any other labor costs that are incurred."[137] Furthermore, given the Commission's authority to implement an environmental cost recovery mechanism (ECRM), emission allowances should not be recovered through the fuel adjustment mechanism. The General Assembly was very careful to limit the automatic annual recovery of environmental expenses to 2 ½%.[138] The effort to move emission costs from the ECRM to the fuel adjustment clause is a blatant end-around the cap contained in SB179.[139]

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[135] Ex. 505, page 10.
[136] *Id.* at pages 7 and 8.
[137] *Id.*
[138] Section 386.266.2.
[139] Despite the fact that Empire does not yet have an ECRM in place, this will not preclude Empire's recovery of such costs because Empire "does not expect to incur any SO_2 costs for several years." Ex. 505, page 8.

Finally, the Commission should limit the extent to which the fuel adjustment clause can be used to recover regional transmission organization (RTO) costs. Under these RTO arrangements, "a myriad of additional charges that bring significant expenses may evolve if the market formalizes and takes on more roles."[140] Until such time as these future charges are defined with greater certainty, they should not receive FAC treatment.[141] Instead, the fuel adjustment clause should be limited "to inclusion of those charges (and revenues) that currently are being applied in the SPP market."[142]

There is support in Missouri as well as from other jurisdictions for Mr. Brubaker's criteria for consideration of costs to be included in the fuel adjustment clause. For instance, in the recent Aquila rate decision, the Commission agreed with the parties and denied fuel adjustment clause treatment of unit train lease, depreciation, and maintenance costs. Furthermore, the Commission excluded fuel handling costs as well as natural gas reservation and demand costs from inclusion in the fuel adjustment clause.[143] Looking to another jurisdiction, the Louisiana Public Service Commission has recently denied the extension of the fuel adjustment clause to include fuel handling costs, unit train costs and natural gas demand charges.[144]

Finally, it should be recognized that Empire has sought to ***exclude*** off-system sales revenues from treatment in the fuel adjustment clause. Such a position is consistent with Empire's "continued effort to gain guaranteed recovery for its ***expense*** items while still allowing for the possibility of inflated returns because of uncapped ***revenues***.[145] In

[140] Ex. 505, page 18.
[141] *Id.*
[142] *Id.*
[143] *Id.* at page 9.
[144] *Id.* at page 11.
[145] *Id.* at page 4.

essence, while complaining of the volatility in fuel costs, Empire is willing to suffer that volatility so long as they are able to pocket the profits from wholesale transactions.

As Mr. Brubaker notes, the complexity of identifying and auditing the costs associated with off-system sales makes identification of fuel costs used for native load sales versus those used for off-system sales virtually impossible. As such, both the expenses and the revenues associated with off-system sales should flow through the adjustment mechanism. Belatedly, given the logic of the parties and the obvious motivations underlying their initial position, Empire agreed to recognize both the costs and revenues associated with off-system sales in the fuel adjustment clause.

IV. OFF-SYSTEM SALES MARGINS

The issue of off-system sales demonstrates the hypocrisy with which Empire approaches different items based upon the effect that the approach will have on the Company's bottom line. When faced with an increasing ***expense*** item, Empire seeks to maximize its recovery and proposes to utilize the test year amount for ratemaking purpose. When faced with a ***revenue*** item that has exhibited a similar increase; Empire ignores the test year amount in favor of a 5 year average.

In the last four years, Empire has realized increasing margins from the sale of off-system capacity and energy.[146]

Calendar Year	Net Sales Margins
2003	$3,016,910
2004	$1,687,445
2005	$3,502,169
2006	$3,441,831
2007	$5,955,336

[146] Ex. 209, page 3.

Despite the increasing nature of its off-system sales margins, Empire proposes to utilize a 5 year average for the quantification of off-system sales margins to include in rates.[147] In support of its 5 year average, Empire simply notes that the Commission ordered a 5 year average in the last case. Empire's reliance on the Commission's decision in the last case ignores a fundamental aspect of ratemaking – the Commission must make decisions which reflect changes in facts. Therefore, when faced with a string of off-system sales figures that do not display any recognizable trend, the Commission was justified in using that 5 year average. In this case, however, a definite increasing trend has developed. As such, the utilization of a 5 year average, such as that asserted by Empire, would ignore the fact that off-system sales margins are increasing. In light of these increasing margins, it is ludicrous to think that the off-system sales margins for the period in which rates are in effect will significantly decrease.

Similarly, Staff proposes to utilize a level of off-system sales margins that is "derived by multiplying the January through June 2007 OSS margin amounts by two."[148] Again, Staff's proposed level of off-system sales margins fails to reflect the likely reality that off-system sales margins for the period that rates are in effect will exceed test year levels. Most importantly, Staff's proposed level of off-system sales fails to recognize the existence of the recently executed BPU capacity contract. Under that capacity agreement, which took effect in June of 2007, "BPU has a commitment to make capacity payments to Empire of $1.3 million" for the summer of 2007 and 2008.[149] Staff's

[147] Ex. 4, pages 7-8.
[148] Ex. 209, page 2.
[149] Ex. 303, page 3.

adjustment fails to recognize approximately $1.0 million of capacity payments associated with this recently executed contract.[150]

In lieu of the positions advanced by Empire and Staff, the Industrial Intervenors urge the Commission to adopt the position advanced by OPC Witness Kind. In his testimony, OPC witness Kind points out that, while the 2007 level of off-system sales margins represented an increase over the previous year, it "better reflects the amount of margins that the Company will be making on its off-system sales in the near future."[151] In fact, relying upon Empire's 2007 Annual Report (SEC Form 10-K), Kind points out that Empire has several opportunities which will allow it to further increase off-system sales margins. First, Kind points out that the recent development of the Southwest Power Pool Energy Imbalance Services market will lead to an increased number of energy transactions.[152] Second, Kind notes the existence of the bilateral sale contract with the Kansas City Board of Public Utilities ("BPU") which "has increased off-system sales revenues by $1.8 million."[153] Under this contract, "BPU has a commitment to make capacity payments to Empire of $1.3 million again in 2008."[154] Finally, Kind notes that the recent addition of the Riverton 12 combustion turbine will further increase Empire's opportunities for sales into the SPP EIS market.[155]

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[150] *Id.*
[151] *Id.*.
[152] *Id.* at page 3 (citing to Empire's 2007 10-K) ("Revenues less expenses increased during 2007 as compared to 2006 primarily due to sales facilitated by the SPP Energy Imbalance Services (EIS) market that began on February 1, 2007.") and page 5.
[153] *Id.* at page 3.
[154] *Id.* at page 4. Kind notes that since this is a capacity contract, the $1.3 million in payments consists entirely of margin. "This $1.3 million in off-system sales revenues results in $1.3 million margins from off-system sales because Empire does not need to provide any energy to BPU in order to receive these capacity payments.") *Id.*
[155] *Id.* at page 5 ("The addition of the Riverton 12 150 MW V84.3A2 combustion turbine to Empire's portfolio of supply side resources has also permitted the Company to make additional capacity sales that would not be possible without it.").

In this case, the Commission should see through Empire's ratemaking hypocrisy and establish rates that are reflective of the period of time in which the rates will be in effect. Relevant to off-system sales margins, it has been shown that Empire has numerous opportunities that will allow it to not only meet the test year level of off-system sales, but to exceed that level. For this reason, the Commission should utilize the test year level of off-system sales margins as a conservative estimate of going-forward rates. Furthermore, it is important that the Commission then order that this margin be utilized for the calculation of the base cost per MWhr in the fuel adjustment clause. For future calculations of the fuel adjustment factor, the net fuel cost should be determined by taking total fuel and purchased power costs eligible to be included in the fuel clause calculation, for both native load and off-system sales, and subtract total revenues derived from off-system sales.[156]

V. CONCLUSION

The Industrial Intervenors respectfully request that the Commission issue its Order with findings consistent with the positions advanced in this brief.

[156] The proper use of off-system sales margins is reflected in the calculations on Schedule 3 of Exhibit 502.

Respectfully submitted,

Stuart W. Conrad, MBE #23966
David L. Woodsmall, MBE #40747
3100 Broadway, Suite 1209
Kansas City, Missouri 64111
(573) 635-2700
Facsimile: (573) 635-6998
Internet: dwoodsmall@fcplaw.com

ATTORNEYS FOR INDUSTRIAL INTERVENORS

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the foregoing pleading by email, facsimile or First Class United States Mail to all parties by their attorneys of record as provided by the Secretary of the Commission.

David L. Woodsmall

Dated: June 18, 2008