BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of The Empire District Electric Company to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its Missouri Service Area.	)))))	Case No. ER-2006-0315

PREHEARING BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

INTRODUCTION

On February 1, 2006, The Empire District Electric Company filed with the Commission tariff sheets designed to implement a general electric rate increase for service it provides to its Missouri customers. In an order issued April 4, 2006, the Commission established August 30, 2006 as the deadline for prehearing briefs. The Commission later extended that deadline until August 31, 2006.

This brief only addresses in detail issues raised and supported by the testimony of Public Counsel witnesses. Public Counsel also supports the positions of other parties on several issues and that support is mentioned herein.

ISSUES

REVENUE REQUIREMENT

Rate of Return Issues

1. Return on Common Equity: What return on common equity should be used for determining Empire's rate of return?

The appropriate return on equity is 9.65 percent.

The United States Supreme Court established the framework for determining return on equity for a regulated public utility in the Hope decision:

> [T]he return to the equity owner should be commensurate with the returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. [1]

Thus the three standards for determining an appropriate return on equity are: 1) earnings must be comparable to returns on other investments having corresponding risks; 2) earnings must be sufficient to assure confidence in the financial integrity of the enterprise; and 3) earnings must be sufficient to allow the utility to attract capital.

The Commission has long recognized that the Discounted Cash Flow (DCF) method is the best way to calculate return on equity for a regulated utility. Public Counsel witness King explains how the DCF method works:

> [T]he return that any investor expects from the purchase of a stock consists of two components. The first is the immediate cash flow in the form of a dividend. The second is the prospect for future growth in dividends. The sum of the rates of these two flows, present and future, equals the return that investors require. Investors adjust the price they are willing to pay for the stock until the sum of the dividend yield and the annual rate of expected future growth in dividends equals the rate of return they expect from other investments of comparable risk. The DCF test thus determines what the investing community requires from the Company in terms of present and future dividends relative to the current market price.

Mr. King's comparable group of firms used in the DCF analysis is superior to that used by Empire witness VanderWeide because Empire failed to eliminate inappropriate firms from his comparable group. Public Counsel witness King started with the same firms, but then removed four companies that are primarily engaged in gas distribution, one company that is principally

[1] Federal Power Commission et. al vs. Hope Natural Gas Company, 320 U.S. 592, at 601 (1944).

involved in non-utility, non-electric activities, and one which is so heavily leveraged that it cannot be considered a healthy company for comparison purposes.

Empire's reliance on the risk premium approach and the CAPM approach is unwarranted; both of these methods of calculating the cost of equity are flawed.

King Direct Testimony, pp. 1-3, 5-6, 11-31
King Rebuttal Testimony, pp. 2-14
King Surrebuttal Testimony, pp. 1-12

2. <u>Capital Structure:</u> What capital structure should be used for determining Empire's rate of return?

The appropriate capital structure consists of 51.64% long-term debt and 48.36% common equity. No short-term debt should be recognized in the capital structure for ratemaking purposes.

King Direct Testimony, pp. 1-11; Schedule CWK-1
King Rebuttal Testimony, pp. 1-2; Schedule CWK-1(revised)

a. Should the unamortized expenses and discounts be reduced from the total principal amount of long-term debt and trust preferred stock outstanding for determining Empire's capital structure for ratemaking purposes?

Public Counsel witness, Mr. Charles King, has included long-term debt in his determination of Empire's capital structure at its gross amount as this is the amount that Empire owes back to its bondholders. Reducing the long-term debt amount for issuance expense drives up the equity ratio and consequently the cost of capital.

Revenue Issue

3. <u>Off-system Sales:</u> What amount should be included in Empire's revenue requirement for off-system sales?

The amount should be the five-year unadjusted average of off-system sales. This is the most reasonable approach and consistent with prior Commission treatment of similar issues. The five year average is also within $50,000, or 2% of the test year actual off-system sales margin.

Smith Direct Testimony, pp. 14-16
Smith Rebuttal Testimony, p. 6
Smith Surrebuttal Testimony, pp. 3-6

Regulatory Plan Amortizations

4. Regulatory Plan Amortizations: Should Empire's revenue requirement include regulatory plan amortizations? If so, (i) how should Empire's off-balance sheet obligations be valued for purposes of the amortizations and (ii) should the amortized amount be subject to an income tax gross-up?

Empire's revenue requirement should include an amortization amount. Empire's interpretation of the Regulatory Plan provisions concerning amortization is incorrect and unduly narrow.

The off-balance sheet obligations should include only the operating lease costs for Empire's Unit Trains along with two purchased power contracts. Public Counsel witness Robertson calculated the value of these obligations by first determining the individual discounted present value of all three obligations as of March 31, 2006. He then calculated and included an operating lease depreciation adjustment based on Standard & Poor's method of calculating depreciation adjustments. Finally, the March 31, 2006 discounted present values of the two purchased power contracts were further adjusted by a risk factor ratio of 10% to arrive at their debt-equivalent values. This ratio is the lowest one used by Standard & Poor's and is consistent with the extremely low likelihood of Empire defaulting on the contracts.

The amortization should not be grossed up for taxes. It represents an expense which is to be treated as a reduction of current plant in service, and is additional depreciation on Empire's existing plant. The additional depreciation requires a straight line tax depreciation deduction be reflected in the determination of the Company's cost of service in the instant case. This position is consistent with the ratemaking treatment afforded any increase in depreciation.

Robertson Direct Testimony, pp. 6-8
Robertson Rebuttal, pp. 18-30
Robertson Surrebuttal, pp. 1-12; Schedule TJR-1

Expense Issues

5. Fuel and Purchased Power Expense: What is the appropriate level of on-system fuel and purchased power expense Empire should be allowed to recover in rates?

If the Commission decides to base Empire's fuel and purchased power costs on a test year adjusted amount (rather than holding Empire to the terms of the IEC), then the allowed amount for such costs should be based on normal conditions. Any nonrecurring costs related to temporary Powder River Basin coal delivery problems should be excluded from the normalized amount. In addition, Empire's proposed fuel and purchase power costs should be adjusted downward to reflect the decline in natural gas prices since November 1, 2005.

Smith Direct Testimony, pp. 7-14, 17-20
Smith Rebuttal Testimony, pp. 2-6
Smith Surrebuttal Testimony, pp. 1-3

6. Fuel and Purchased Power Expense Recovery Method: What method should be used for recovery by Empire of its fuel and purchased power expense?

In this brief, Public Counsel addresses the simpler version of this issue because of time constraints. Public Counsel supports the positions of Praxair/Explorer on the more detailed version of this issue. The answer to this simple question is obvious and unavoidable: Empire should recover fuel and purchased power expense pursuant to the terms of the IEC it agreed to in Case No. ER-2004-0570.

In that case, the parties entered into an agreement that the Commission approved. That agreement created an interim energy charge that was to last for three years. The Commission, as well as the parties,[2] recognized that the agreement was for a three-year term. The Commission, in its order approving the agreement, stated:

> On February 22, 2005, Empire, the Public Counsel, Praxair, Inc., and Explorer Pipeline Company jointly filed a Nonunanimous Stipulation and Agreement Regarding Fuel and Purchased Power Expense. No party filed a timely objection or request for hearing with respect to this Nonunanimous Stipulation and Agreement. The Stipulation and Agreement provides that a certain specified amount of Revenue Requirement shall be collected in Empire's permanent rates with respect to its Missouri jurisdictional fixed and variable fuel and purchased power costs and that an additional specified amount of Revenue Requirement for such costs shall be collected on an interim basis, subject to true-up and refund, through a surcharge referred to as an Interim Energy Charge ("IEC"). **The IEC shall be in effect for three years.** [Emphasis added.]

The agreement clearly prohibits Empire from requesting the recovery of additional variable fuel costs for the duration of the three year period. Section 4 of the agreement provides:

> 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 to use, 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 cost recovery mechanism, or other energy related adjustment mechanism to which the Company would otherwise be entitled. Empire also agrees not to request an Accounting Authority Order or other regulatory mechanism to accumulate and or recover any amount of variable fuel and purchased power cost that exceeds the IEC ceiling.

[2] Empire at that time also agreed that the term would be three years. It was only later, when the operation of the IEC was not favorable to Empire, that Empire looked for a loophole to get out of its agreement.

Public Counsel witness Meisenheimer explains why Public Counsel was willing to enter into the IEC agreement:

> In large part, Public Counsel joined in the Stipulation in ER-2004-0570 because the terms of the Stipulation cap until 2008, at specific dollar levels, the exposure to upward price volatility that consumers face associated with fuel and purchased power costs. In addition, the provisions of the Stipulation allow for downward but not upward rate adjustments based on true-up and prohibit Empire from requesting an AAO or other regulatory mechanism to accumulate and or recover amounts in excess of the IEC ceiling. In joining as a signatory party, Public Counsel believed that these three elements of the Stipulation and Agreement would provide consumers with price protection and price certainty.
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> …
>
> Ultimately, Public Counsel agreed to a Stipulation because it contained no "catastrophic" out clause to cover unexpected or anomalous changes in the natural gas commodity market, no upward rate adjustment based on true-up and no provision to rebase, at a later time, the level of fuel and purchased power recovered in base rates or through the IEC. It would be patently unfair to consumers to now allow Empire to unilaterally override the terms of the Stipulation and Agreement by allowing any such additional recovery during the 3 year period covered by the IEC.
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> *Meisenheimer Direct (Revenue Requirement) Testimony, pp. 3-12*

7. <u>Gain from unwinding forward natural gas contract:</u> Should Empire's gain from unwinding a forward natural gas contract during the test year offset test year fuel and purchased power expense? If so, should the entire gain be an offset in the test year, or should it be amortized and only a portion of the gain be applied as an offset in the test year?

Public Counsel supports the Staff position on this issue.

8. <u>Incentive Compensation:</u> Are all the costs of Empire's incentive compensation plan an expense Empire should recover from Empire's ratepayers? If not, what costs should be recovered?

Public Counsel supports the Staff position on this issue.

9. <u>Low Income Assistance Program</u>: Should Empire's Experimental Low-Income Program (ELIP) be continued with changes? If so, what should those changes be, should the Customer Program Collaborative (CPC) determine those changes and have oversight responsibility respecting the program, and how should the cost of

the program be included in Empire's cost-of-service for collection from ratepayers? What should be done with unspent ELIP funds?

The parties have reached an agreement in principle to resolve this issue by unanimously asking the Commission to approve an amendment to the agreement in which this program was established. That amendment is expected to be filed in Case No. ER-2002-0424 (the case in which the program was created) within a few days.

10. Unspent Funding of Current Energy Efficiency and Affordability Programs: What should be done with unspent funds from the current energy efficiency and low-income weatherization programs? What should be the amortization amount respecting the demand side management (DSM) regulatory asset account?

The parties have reached an agreement in principle to resolve this issue by unanimously asking the Commission to approve an amendment to the agreement in which these programs were established. That amendment is expected to be filed in Case No. ER-2002-0424 (the case in which the program was created) within a few days.

CLASS COST OF SERVICE/RATE DESIGN

11. Rate Design/Cost-of-Service: How should any revenue increase for Empire that results from this case be implemented in rates?

The Commission should enforce the agreement reached by the parties and approved by the Commission in Case No. ER-2004-0570 and require Empire to abide by it. The levels of fuel and purchased power (F&PP) expense in this case should be limited to an annual recovery in base rates of $102,994,356 and an additional amount of $8,249,000 recovered through the IEC. If the Commission enforces the previous agreement and limits the Company to these levels of recovery, any increase should be distributed among the various customer classes based on an equal percent of current class revenues excluding the proportion of variable fuel cost reflected in current revenues. If the Commission eliminates the IEC and allows the Company to recover additional fuel cost in this case, class increases should be based on a composite of a variable fuel related adjustment and a non-variable fuel related adjustment. This approach is the most reasonable one proposed in this case and best preserves the balance struck between classes in the agreement in ER-2004-0570.

Empire's proposed increase is largely associated with increased variable fuel cost. If the Commission allows Empire to back out of its three-year IEC agreement, and approves an increase in base rates driven by increases in fuel costs, it should not spread these costs on an equal percentage basis. Doing so would force residential customers and small commercial customers to bear more of the increase than if the increased revenue requirement associated with variable fuel cost recovery was allocated appropriately based on kWhs.

Meisenheimer Direct (Rate Design) Testimony, pp. 1-8
Meisenheimer Rebuttal Testimony, pp. 1-5

a. A sub-issue: What level of revenue credits should be recognized for purposes of allocating any revenue requirement increase?

Public Counsel supports the Staff position on this issue.

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OFFICE OF THE Public Counsel

/s/ Lewis R. Mills, Jr.

By:______________________________

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CERTIFICATE OF SERVICE

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