Exhibit No.
Issue: Fuel Adjustment Clause
Witness: H. Edwin Overcast
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Sponsoring Party: Empire District Electric Co.
Case No. ER-2008-0093
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Before the Public Service Commission
Of the State of Missouri

Surrebuttal Testimony

of

H. Edwin Overcast

April 2008

**SURREBUTTAL TESTIMONY
OF
H. EDWIN OVERCAST
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2008-0093**

Q. ARE YOU THE SAME H. EDWIN OVERCAST THAT PRESENTED DIRECT AND REBUTTAL TESTIMONY IN THIS CASE BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION") ON BEHALF OF THE EMPIRE DISTRICT ELECTRIC COMPANY ("EMPIRE" OR "COMPANY")?

A. Yes.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. I am addressing issues related to the rebuttal testimony of the Commission Staff ("Staff") and the Office of Public Counsel ("OPC"). Specifically, I will discuss the Staff's position that their proposal provides an incentive for Empire to control fuel costs. In addition, I will respond to the OPC testimony that unique conditions suggest that Empire does not need a fuel adjustment clause ("FAC") and the suggestion that disallowance of prudently incurred costs in an amount even larger than proposed by the Staff represents a reasonable opportunity for Empire to earn its allowed return. Finally, I will comment on the Staff's proposed distribution facilities charge.

Q. WHAT DOES THE STAFF RECOMMEND AS THE "INCENTIVE PLAN" PORTION OF THEIR FAC PROPOSAL?

A. The Staff supports a proposal that limits Empire to recovery of only 70% of any cost increases above the base fuel and purchased power cost approved in this case and requires that Empire return to customers only 70% of any cost decreases it has in this area.

Q. IN THIS REGARD DOES THE STAFF'S FAC PROPOSAL OR ANY OF THE OTHER FAC PROPOSALS MADE IN THIS CASE REPRESENT A TRUE INCENTIVE PROPOSAL?

A. No.

Q. PLEASE EXPLAIN.

A. The purpose of any incentive is to produce a desired result relative to the effort of the principal who presumably acts to avoid penalties and to receive rewards. No party to this proceeding has proposed any FAC "incentive" that provides Empire with the opportunity to control its fuel costs. The options available to Empire to limit fuel costs to the level of the test year (normalized sales for the twelve months ended June 30, 2007 and estimated fuel and purchased power prices for 2008) and avoid the certain loss of five percent (the Empire proposal), 30% (the Staff proposal), 40% (the OPC proposal) and a variable percent ranging from 100% to about 10% depending on the amount of the increase (the Industrial proposal) do not exist.

Q. WHY?

A. Empire has no ability to limit the production of electricity to the test year levels and normal growth alone increases the Rate Effective Period costs even if fuel and purchased power prices remain unchanged. In addition, Empire has no ability to control the weather events that impact customer usage. Furthermore, Empire has no control over spot prices for fuel and purchased power since these prices are determined in the market. Beyond the current price hedges that Empire has in place, Empire has no control over the market prices for the hedge positions they take. More importantly, if Empire's credit position slips further Empire may not be able to find counterparties that will take the credit risk for a fixed price contract or Empire may be required to provide credit that will increase Empire's costs. It is fair to conclude that the Staff proposal is not an incentive at all but represents a penalty provision that confiscates return on equity dollars on the theory that Empire will be imprudent for thirty percent of its fuel costs despite no evidence of any imprudence. Providing a reasonable opportunity for Empire to earn the allowed return and equitable treatment of prudently incurred costs requires full recovery not an automatic disallowance. Despite the Aquila precedent and Empire's voluntary willingness to follow that precedent that includes a five percent dead band, Empire needs a full tracking clause to have a reasonable and sufficient opportunity to earn its return.

Q. DOES EMPIRE HAVE ITS WEATHER NORMALIZED VOLUME OF GAS HEDGED FOR THE RATE EFFECTIVE PERIOD?

A. No. While much of the gas supply for 2008 has been hedged, only 55 percent of the volumes have been hedged for 2009 and eight months of the Rate Effective Period occur in 2009. Importantly, the hedged position is based on normal weather and thus does not protect from the adverse costs associated with weather that is not normal.

Q. WHAT DOES THE MARKET EXPECT REGARDING GAS PRICES COMPARED TO THE COST USED IN THE STAFF REPORT?

A. The Staff has used a weighted average hedged gas price of $6.853 per MMBtu for 2008. This is the price used in the base cost for the FAC. Based on the NYMEX closing futures price as of April 21, 2008, the market price for gas deliveries in May of 2008 closed at $10.733 per MMBtu. Later months of 2008 settled at prices above $11.00 per MMBtu. For 2009, prices have settled in the range of $9.75 to $12.023. These prices are well above the value that Staff includes in the base cost of fuel and further illustrate the fundamental problem with the proposals that include disallowance of a portion of costs increases. One additional point related to higher gas costs is that the cost of purchased power in part will likely reflect these higher gas prices as well.

Q. DOES THE STAFF PROVIDE ANY EVIDENCE THAT EMPIRE HAS BEEN IMPRUDENT IN ITS FUEL AND PURCHASED POWER PRACTICES IN THE PAST?

A. No. There is no evidence that Empire has been imprudent. On the contrary, there is ample evidence that Empire has and continues to manage its fuel and purchased power costs prudently. The assumption that allowing full recovery of a cost will somehow cause Empire to behave imprudently is not justified because Empire earns no additional profit through such behavior. There are no benefits to Empire from imprudent purchases of fuel and purchased power because no shareholder return dollars result from any purchase of fuel or energy, and the fuel clause mechanism represents a significant asymmetric risk. The risk is asymmetric because Empire recovers its cost if it is prudent and faces disallowances if it is not. **The net result is that Empire has no earnings impact from prudent behavior and loses earning if they are not prudent.** This is a powerful incentive for management to minimize fuel costs within the constraints of the information available at the time the decisions are made.

Q. HOW DOES THE STAFF PROPOSAL IMPACT EMPIRE RELATIVE TO FUTURE COSTS?

A. Under the Staff proposal, the cost penalty that Empire would incur fails to provide a reasonable opportunity for Empire to earn the allowed return. Failure to earn the allowed return further weakens Empire's financial metrics and potentially then competitiveness in the capital market. If Empire falls below the current BBB- bond rating, the ability to finance its capital plan and to do so at reasonable capital costs will become problematic. The result will be higher costs for customers in the future.

Q. DOES THE STAFF'S VIEW THAT "EMPIRE SHOULD BE HELD RESPONSIBLE (I.E., OVER/UNDER RECOVERY) FOR A PERCENTAGE OF THE ADJUSTMENT TO THE BASE FUEL RATE" REPRESENT SOUND REGULATORY POLICY?

A. No. Forcing a utility to absorb an arbitrary amount of costs that for all intent and purpose represent costs beyond the control of the utility represents an implicit tax on either customers or shareholders for the benefit of the other party, shareholders or customers, based on the outcome of a series of random, market-based outcomes. There is no logic in regulatory policy to support such a random outcome. Further, as I explained in my rebuttal testimony, the Staff proposal imposes an asymmetric risk to shareholders in the current environment for which the Staff offers no compensation. This violates the principle that return is the compensation for taking risk.

Q. HAVE YOU REVIEWED THE TESTIMONY OF OPC WITNESS MR. KIND RELATIVE TO THE FAC?

A. Yes.

Q. DOES OPC ADDRESS POLICY REASONS THAT OPC BELIEVES SHOULD RESULT IN THE COMMISSION DENYING THE EMPIRE FAC REQUEST?

A. Yes. OPC argues that there are four unique circumstances that make rejection of the FAC appropriate as follows:

1. The limited time that the rates would be effective
2. The new rates in this case will be based on the fuel cost estimates for 2008
3. Empire has protected itself against fuel cost changes through long-term contracts and hedging
4. Empire will be purchasing wind energy in 2009.

None of these provides a reasonable basis for rejecting the proposed FAC as will be discussed below.

Q. PLEASE COMMENT ON THE LIMITED PERIOD THE RATES ARE EFFECTIVE AS A REASON TO REJECT THE FAC.

A. As a practical matter, Empire has demonstrated that the FAC is needed regardless of the expected number of months the current rates will be effective. For all the reasons contained in my direct testimony, fuel costs are and will be unpredictable in the Rate Effective Period and beyond. Simply put, the estimate of fuel costs for normalized sales for a test period even using the expected costs for a later period cannot adequately or reasonably determine the actual fuel costs going forward. A fuel clause is necessary to permit Empire an opportunity to earn the allowed return and to protect customers from paying rates that permit Empire to earn more than the just and reasonable return in the unlikely event of lower costs. Rejecting the fuel clause because the rates may apply only for a short duration is not a valid argument.

Q. PLEASE COMMENT ON THE IMPACT OF USING ESTIMATED 2008 PRICES AS THE BASIS FOR REJECTING THE CLAUSE.

A. The 2008 fuel prices represent an estimate or forecast of future costs. Fuel prices are only one component of the cost of fuel and purchased power as I have demonstrated in my direct testimony. Many factors contribute to the actual costs for any future period including unit availability (scheduled maintenance, unit deratings and forced outage rates), weather, load growth, unit operation relative to the heat rate curve and others. The purpose of an FAC is to mitigate the risk of over or under recovery of fuel costs. This mitigation benefits customers as well as the utility. If, for example, fuel prices fell dramatically (albeit an unlikely occurrence) customers would be burdened with excess costs. If fuel prices increase (the expected trend) Empire would have no chance of earning the allowed return. Even though Empire uses prices that are known for 2008, this only represents four months of the Rate Effective Period with eight months occurring in 2009 when prices are expected to be different. With an FAC, customers will pay only the actual fuel costs and purchased power related costs. If those costs are less than the 2008 estimate included in base rates, then there will be a credit to the rates. This rationale does not support rejection of the FAC.

Q. PLEASE COMMENT ON THE PROPOSITION THAT EMPIRE HAS PROTECTED ITSELF FROM FUEL COST CHANGES THROUGH CONTRACTS AND HEDGES AS A REASON TO REJECT THE FAC.

A. The statement is factually incorrect. Even during 2008, Empire does not have contracts or hedges for all of its fuel supply. Empire began 2008 with 1,200,000 MMBtu of gas un-hedged in a normal weather, normal coal unit outage year. Additionally, Empire had budgeted to purchase over 600,000 MWh's of non-contract spot purchased power which tends to follow the price of natural gas. The non-contract spot purchased power alone represents over 10% of Empire's energy sources based on the 2008 budget. MPSC Staff includes a similar amount of non-contract spot purchased energy in their determination of costs for Empire. Certainly by 2009, the situation is even further from factual. Empire has only 4,700,000 MMBtu of natural gas hedged out of an expected burn of 8,500,000 MMBtu based on the budget forecast.

In addition, some contracts such as coal transportation have quarterly adjustment mechanisms to track fuel costs. Even in 2008, natural gas hedges continue to have volume risks based on weather and risks based on plant outages. Further, there is coal price risk for the amount of coal not purchased going forward in 2009. These risks are not small given the recent increases in coal prices and the expectations for further increases. Schedule HEO- SR1 provides evidence of the sharp increase in coal prices since the time that this case was filed. In addition to rising coal prices, natural gas prices are up as well. This is discussed in detail above and demonstrates that Empire is exposed to substantial price increases for fuel and purchased power in the Rate Effective Period. As a result of both factual and practical errors, this position cannot be used to reject the proposed FAC.

Q. PLEASE COMMENT ON THE PURCHASE OF WIND ENERGY AS A COST MITIGATING FACTOR IN 2009 AS A REASON TO REJECT THE FAC.

A. The availability of wind energy as an additional source of power presents risks related to the impact on fuel costs not contemplated at all in the testimony of Mr. Kind. Wind energy is much like run of the river hydro in that when the wind blows the power is must take. This means that Empire must be prepared to manage the variability of wind generation through the operation of the remainder of its thermal system and participation in the SPP energy imbalance market. While it is true that most wind energy will replace gas fired generation or spot purchased power, it does not significantly reduce our exposure to the variability in the costs of natural gas and the spot purchased power that is generated from natural gas units. The Meridian Way wind farm is projected to add about 350,000 MWh's of generation to Empire's system. Empire's system is predicted to grow on a normalized basis 154,266 MWh's between 2008 and 2009. This leaves only 195,734 MWh's or 3% of our energy supply in a normal weather year as a potential for reduced exposure to natural gas or non-contract spot purchased power. The wind is also variable by nature and will almost assuredly afford output that is not equal to 350,000 MWh's.

An extreme weather year, an unexpected coal unit outage, or higher priced natural gas and non-contract spot purchased power cause cost impacts much larger than any impacts of the new Meridian Way contract. These issues will be worked out by system dispatchers as they come to have a better understanding of the operating characteristics of the wind generation units. The addition of wind energy in 2009 is actually a sound reason for approving the FAC to permit both the Empire and its customers to mitigate the impact of wind energy on the system.

Q. WHAT RECOMMENDATION DOES OPC MAKE REGARDING THE AMOUNT OF THE ADJUSTMENT APPLIED TO FUEL COSTS ABOVE THE BASE COST?

A. OPC recommends that Empire recover only 60% of prudently incurred costs above the base level of fuel costs and that if fuel costs are lower, Empire refund only sixty percent of the reduction to base costs to customers.

Q. HOW DO YOU RESPOND?

A. The OPC recommends an even larger disallowance of costs for Empire when the costs are above the base and a bigger loss for customers if fuel costs are below the base than the disallowance recommended by the Staff. Having discussed in detail all the reasons that such a proposal fails to provide a sufficient and reasonable opportunity to earn the allowed return, it is sufficient to conclude that every argument against the Staff proposal applies with even greater force to the OPC recommendation.

Q. DOES THE OPC PROVIDE EVIDENCE THAT EMPIRE HAS OR WILL BE IMPRUDENT?

A. No, and without such evidence Empire is entitled to the recovery of its costs. Further, customers are entitled to know that Empire will not be unjustly enriched in the event of lower costs. A full recovery FAC strikes the balance between customers and shareholders so long as costs are prudently incurred. Failure to strike this balance through mitigation by using a full tracking FAC ultimately raises costs for consumers through higher cost debt and equity. Consequently, the OPC proposal to share cost changes above the base amount by recovering or keeping 60 percent should be rejected.

Q. DOES THE OPC RECOMMENDATION PROVIDE EMPIRE A SUFFICIENT OPPORTUNITY TO EARN ITS ALLOWED RETURN?

A. No. The OPC proposal results in a disallowance of prudently incurred costs for fuel and purchased power simply as the result of changes in the growth of electric sales, during abnormal weather, unit performance and when prices for fuel and purchased power rise. Given the current state of markets for coal, the price volatility of natural gas, expected growth and the fact that low cost coal units run at extremely high capacity factors, a reasonable conclusion would be that the probability of higher fuel costs exceeds the probability of lower fuel costs by a substantial amount. The OPC proposal virtually assures that Empire has no chance to earn its allowed return. Further, OPC does not propose to compensate Empire for this asymmetric risk.

Q. HOW SHOULD ACCOUNT 509, EMISSION REVENUE AND COST, BE TREATED?

A. As I indicated in my rebuttal testimony, this cost should be included in the FAC. Mr. Keith also discusses this issue in his surrebuttal testimony as well.

Q. DOES EMPIRE SUPPORT THE STAFF PROPOSAL FOR A SEPARATE DISTRIBUTION FACILITIES CHARGE FOR DEMAND BILLED GENERAL SERVICE CUSTOMERS?

A. Yes. Empire supports implementation of the Staff proposal of separate distribution facilities charges for rates GP, TEB and LP. Empire will develop appropriate billing determinants using test year demands to support the application of this charge as well as the elimination of the ratchet in the remaining demand charge as proposed by Staff.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.