Exhibit No.
Issue: Fuel Adjustment Clause, Rate Design, ROE
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

Rebuttal Testimony

of

H. Edwin Overcast

April 2008

REBUTTAL 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 FILED DIRECT TESTIMONY ON THE BEHALF OF THE EMPIRE DISTRICT ELECTRIC COMPANY ("EMPIRE") IN THIS CASE BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. This testimony responds to various positions taken by Commission staff witnesses and Mr. Brubaker and Mr. Gorman on behalf of certain industrial customers as well as certain rate design issues raised by the parties.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. My testimony consists of four sections 1- Regulatory Principles; 2- Proposed Changes to the Fuel Clause; 3- ROE and Risk; and 4- Rate Design Changes.

Regulatory Principles

Q. WHY IS IT NECESSARY TO DISCUSS REGULATORY PRINCIPLES IN LIGHT OF THE TESTIMONY OF OTHER PARTIES?

A. Certain recommendations of the other parties, as contained in their direct testimonies, violate fundamental regulatory principles based on an incomplete view of the elements of ratemaking. As a result, it is necessary to provide this testimony as background to remove any confusion that may exist.

Q. WHAT REGULATORY PRINCIPLES WILL YOU DISCUSS?

A. First, the concept that a utility has a right to recover prudently incurred expenses, and no more, requires analysis since both the Staff and Mr. Brubaker propose two potential fuel adjustment clause ("FAC") outcomes inconsistent with this principle, namely: (1) Empire be denied a portion of prudently incurred costs when fuel costs increase regardless of the reason or Empire's potential to control those costs and (2) Empire be allowed to retain the revenue built into base rates when the fuel costs decline regardless of the reason or Empire's potential to control the costs. Second, the form of costs, either variable or fixed, demand or commodity charges, associated with fuel costs when prudently incurred should not be disallowed following the above principle. Third, there is no benefit to Empire from inefficient or imprudent action relative to the cost of fuel and purchased power and such an assumption by the Staff and Mr. Brubaker violates the principle that disallowance of an expense must be based on competent evidence not speculation. Finally, the testimony of both the Staff and Mr. Brubaker violate the principle that regulation must provide the utility with a reasonable opportunity to earn the allowed return.

Q. PLEASE DISCUSS THE PRINCIPLE OF RECOVERY OF PRUDENTLY INCURRED EXPENSES.

A. Expenses, in contrast to the return on equity, represent facts to be determined. In the case of fuel costs, most regulators recognize that the amount of fuel expense for any twelve month test year will not necessarily be a good prediction of actual expenses in a future period for all the reasons discussed in my direct testimony and other reasons as well. The use of an FAC is a way to permit the recovery of prudently incurred expenses in rates without the regulatory expense of constant, pancaked rate filings and without the creation of unreasonable gains or losses from expense over or under recovery. Without the reasonable opportunity to recover actual, prudently incurred expenses, the concept of an allowance of a return on investment over and above expenses loses all meaning. Further, this principle also limits the over recovery of expenses. That is, a regulatory mechanism that results in excess payments by consumers over and above the prudent level of expenses is not in the public interest.

Q. DOES THE FORM OF AN EXPENSE HAVE A BEARING ON THE ALLOWED RECOVERY OF COST?

A. No.

Q. PLEASE EXPLAIN.

A. The form of the payment - fixed or variable, demand or commodity - has no bearing on the recovery of the cost if the costs are prudent. For example, in the case of demand charges approved by the FERC to recover pipeline transportation costs, the rates change only if approved by the FERC. Thus the pass through of these costs as an approved wholesale rate should be automatic. Further, pass through of increases or decreases in such costs avoid complex accounting issues in future periods when final rates are approved at the FERC and refunds occur. Without full pass through, the refund amounts must be allocated between customers and shareholders based on who absorbed the costs originally. Empire has no control over the timing of such demand charge increases or of the ultimate resolution of the increase. FERC approval amounts to a finding that the costs recovered from a federal rate must be prudent. Mr. Brubaker's recommendation that natural gas pipeline demand or reservations charges be excluded from the FAC should be rejected by the Commission.

Q. PLEASE DISCUSS THE CONCEPT OF ASSUMING IMPROVIDENT BEHAVIOR RELATED TO FUEL COSTS AS A BASIS FOR DISALLOWING A PORTION OF FUEL COSTS.

A. Both the Staff and Mr. Brubaker assume that the existence of a fuel clause designed to allow recovery of variable and unpredictable fuel costs will cause Empire to be imprudent or wasteful in the purchase of fuel and power. The test of imprudence and wasteful spending, however, does not rely on assumptions, but on facts and evidence.

Q. PLEASE EXPLAIN.

A. Commission's base decisions on evidence as opposed to speculation and in our system individuals and utilities are entitled to a presumption that they have acted appropriately and that their incurred expenses are reasonable. The notion that Empire has an incentive to be wasteful in its acquisition of fuel and purchased power is not supported by any evidence, further there is no benefit to Empire from being inefficient in any event. In fact, the existence of fuel clause audits, complaint proceedings, prudence reviews and the loss of base revenues resulting from the price response to increased power costs are all deterrents to wasteful and imprudent practices. Since there is no gain and only potential for loss from a number of sources, a rational company will manage its business efficiently rather than take the chance of a significant loss. By assuming that the utility behaves inefficiently the FAC would not be designed to reasonably provide the utility with a sufficient opportunity to earn a fair return on equity as required of the Commission by the Missouri statute.

Q. PLEASE DISCUSS THE OPPORTUNITY TO EARN THE ALLOWED RETURN AS IT RELATES TO THE FAC PROPOSALS OF MR. BRUBAKER AND THE STAFF.

A. Both the proposals related to energy cost recovery have a much greater chance of reducing the dollars available for return than for providing additional dollars for return. As I discussed in my direct testimony, failure to provide a reasonable opportunity to earn the allowed return may result from any number of factors. However, when the proposed fuel adjustment clause provisions result in a significant under recovery of prudently incurred fuel costs, as proposed by the Staff and Mr. Brubaker, no reasonable opportunity of earning the allowed return is provided. The reasons that both the Staff and Brubaker proposal have a higher probability of lower earnings include the impact of system growth on fuel costs, full use of low cost capacity, and the trend toward rising costs for fuel and purchased power over time. Since both proposals from the Staff and Mr. Brubaker cause Empire to absorb a significant portion of increased costs out of the equity return, there is no reasonable opportunity for the Company to earn the allowed return. It is axiomatic that if a utility is prevented from recovering its prudently incurred costs, there is no reasonable opportunity to earn a fair return provided by the Commission. The dollars that provide the return exist only after all the bills are paid.

Proposed Changes to the Fuel Clause

Q. HAVE YOU REVIEWED THE CHANGES TO THE FUEL CLAUSE PROPOSED BY THE STAFF AND MR. BRUBAKER?

A. Yes.

Q. DO THE PROPOSALS BY MR. BRUBAKER AND THE STAFF PROVIDE SYMMETRY RELATIVE TO COST RECOVERY AND RETURN?

A. No. While the "sharing" proposals presented by Mr. Brubaker and the Staff have the appearance of mathematical symmetry, neither proposal, as I discuss below, actually is symmetric. To be symmetric requires that the probability of the outcomes, positive or negative, be normally distributed around the base fuel costs used in the FAC. This is not the case. In fact, the Empire proposal which is designed to match the Aquila FAC approved earlier by the Commission to absorb or to keep five percent of the changes in fuel costs is not symmetric either. Since I believe that 100% recovery of prudently incurred fuel costs represents the correct basis for a reasonable FAC that provides a sufficient opportunity to earn a reasonable return, there is no need for designing a fuel cost system that randomly rewards or penalizes the utility based on fuel prices, weather, purchased power prices and other variables beyond the reasonable control of the utility. The fact that Empire is willing to forego 5% of its prudently incurred fuel costs should be seen for what it is – simply an attempt to match the FAC which this Commission previously approved for Aquila.

Q. PLEASE DISCUSS YOUR CONCLUSIONS REGARDING THE PROPOSALS BY MR. BRUBAKER AND THE STAFF.

A. I believe that the “sharing” mechanisms proposed by Mr. Brubaker and by the Staff fail the tests of sound regulatory policy and should be rejected. I believe that the recommendation of Mr. Brubaker, to exclude pipeline transportation demand charges, fails to reflect sound regulatory policy in the case of natural gas. It is appropriate to pass through any fuel and purchased power related costs that receive Federal regulatory approval. Finally, emissions related costs should be passed through the fuel and purchased power costs as proposed by Empire and the Staff.

Q. PLEASE EXPLAIN WHY THE “SHARING” MECHANISMS PROPOSED BY THE STAFF AND MR. BRUBAKER SHOULD BE REJECTED.

A. Both “sharing” mechanisms violate regulatory principles in a number of ways. First, the rationale for the mechanisms assumes that the Company has an incentive to be inefficient or improvident in its fuel and purchased power practices. No evidence is provided to support the assumption. Second, the “sharing” mechanisms result in two possible outcomes that are not just and reasonable. Either the Company fails to recover all prudently incurred expenses or consumers pay more than the actual expenses. Both outcomes are inconsistent with the public interest. Third, both sharing mechanisms fail to provide the Company with a reasonable and sufficient opportunity to earn the allowed return.

As proposed, the "sharing" mechanisms do not provide an incentive to be efficient because regardless of prudent and efficient behavior in the procurement of fuel and purchased power Empire is prohibited from recovering all of its energy costs.

Q. PLEASE EXPLAIN THE PROBLEMS ASSOCIATED WITH THE USE OF A "SHARING" OF COSTS AS AN INCENTIVE MECHANISM AS PROPOSED BY MR. BRUBAKER.

A. To fully understand the problems presented with Mr. Brubaker's incentive plan requires that there be a full understanding of the elements of the fuel clause. The fuel clause calculation is based on the following assumptions:

1. The base cost is determined using the normalized Mwh sales for the test year ended June 30, 2007.
2. The base cost represents a forecast of fuel costs for calendar year 2008.
3. All of the available Mwhs of production from the least cost plants are included in the base rates already.
4. Most of the rate effective period occurs in 2009 when forecast fuel costs will exceed the fuel costs used to calculate the base costs in this case.

The result of customer and sales growth is to increase energy costs above the base even with no increase in fuel or purchased power costs. If the forecast of fuel prices is accurate, the costs will be even higher since that compounds the growth effect by raising all costs. (Given the dynamics of the markets that determine fuel prices, forecast prices and actual prices are likely to be different although the trend in prices has been an upward trend over the last few years.) It is reasonable to conclude that the actual cost for the Rate Effective Period has a greater probability of being higher than the base cost. For example, the EIA AEO (Annual Energy Outlook) 2008 provides a forecast of coal prices for electric generation as illustrated in the following table.

Coal Price Forecast in
2006 Dollars per Short Ton Delivered

2007	2008	2009	2010
$33.78	$35.44	$35.68	$35.98

Thus, Mr. Brubaker's system is neither symmetric nor reasonable since it requires that Empire absorb costs that are otherwise just and reasonable. Simply, a sharing mechanism that penalizes prudent and efficient behavior because of factors beyond Empire's reasonable control is not an incentive mechanism at all. Further, if Empire through good fortune and extraordinary effort is able to procure fuel and purchased power below market prices but at prices still in excess of the costs in base rates because of growth or overall price increases, Empire is still penalized by the sharing mechanism recommended by Mr. Brubaker.

Q. HAS EMPIRE ESTIMATED THE AMOUNT BY WHICH THE RATE EFFECTIVE PERIOD COSTS WILL EXCEED THE BASE PERIOD FUEL COSTS?

A. Yes. At my request, Empire reran its system dispatch model for the test period assuming only the forecast level of growth for calendar year 2008. Prices for fuel and purchased power remained the same. The use of growth for 2008 is extremely conservative since it represents only a few months of the Rate Effective Period. The following table provides the results of the analysis.

Change in Base Fuel Costs for 2008 Volume

	2007 Test Year	Test Year with 2008 Load Growth	Differences
MWH	5,425,392	5,638,379	212,987
Annual Energy Costs	$172,032,185	$182,438,191	$10,406,006
Unit Cost	$31.71	$32.36	$0.65
Revenue at Base Rate		$178,792,998	

The increase of about $3.7 million after base rate recovery is a total system number, the Missouri jurisdiction accounts for about 82.3% of the total company or about $3.0 million in additional costs. Under Mr. Brubaker's incentive mechanism, Empire absorbs the $1.2 million of dead band costs, $0.18 million in the second band for a total of $1.38 million dollars of prudently incurred costs, assuming no change in the price of fuel and purchased power. There is no real incentive in a plan that guarantees a loss and provides no opportunity for management to change the situation regardless of how well they manage the business. The Brubaker proposal results in rates that are unjust and unreasonable by failing to provide an opportunity to earn the allowed return even in the absence of forecast fuel price increases. In addition, at $1.38 million, the results of Mr. Brubaker's proposed disallowance would represent over four percent of the Staff recommended earnings in this case using the Staff midpoint. (See Schedule 21 of Staff Report and Staff Accounting Schedule 1) This loss results solely from the growth in weather normalized sales for 2008 and ignores the additional growth for eight months of 2009 included in the Rate Effective Period. It also ignores the potential for increased fuel costs as forecast for coal and a variety of other factors likely to lead to increased total fuel and purchased power costs.

Q. DOES THE STAFF "SHARING" PROPOSAL SUFFER FROM SIMILAR SHORTCOMINGS?

A. Yes. Under the Staff proposal, Empire is allowed to recover only seventy percent of the change in fuel costs. Using the above example, the Staff would disallow 30% of prudently incurred costs or $0.9 million dollars. The Staff disallowance albeit smaller than the disallowance under Mr. Brubaker's proposal initially, provides no cap and offers no opportunity to avoid even greater overall losses. Further, as with Mr. Brubaker's proposal, the Staff proposal penalizes prudent and efficient behavior because of factors beyond Empire's reasonable control and is not an incentive mechanism at all. Thus, the Staff proposal produces rates that are unjust and unreasonable because they fail to allow Empire reasonable opportunities to earn the allowed return and represent a potential downside of around 2.65 percent of Staff's recommended equity return. The Staff "sharing" proposal is particularly odd given the fact that the Staff acknowledges, at page 61 of its cost of service report, that natural gas and spot purchased power costs are outside of Empire's control and that the change in energy costs that the Staff proposal would penalize Empire for are directly related to those two cost categories. Sharing cost increases that are prudent and result from factors beyond Empire's control provides no incentive and amounts to an earnings penalty.

Q. WHY IS THE EXCLUSION OF PIPELINE DEMAND CHARGES FROM FUEL PRICES PROPOSED BY MR. BRUBAKER INAPPROPRIATE?

A. The demand charges associated with fuel costs represent natural gas pipeline demand charges that are part of the transportation and storage tariffs of suppliers. The FERC regulates pipeline charges including proposed increases to such charges. Empire has no control over the filing made to change such charges or the timing under which the charges take effect. The effective date may be as little as 31 days after filing subject to refund at the end of the case. Refusing to allow the pass through of costs approved by the FERC represents a critical failure related to fuel cost recovery. If the FERC determines the charges to be reasonable and the Commission has already approved recovery of the costs in base rates that cost should pass through the fuel clause without the expense of a new rate case.

Q. HAVE YOU REVIEWED THE TESTIMONY OF MR. BRUBAKER CONCERNING THE PASS THROUGH OF EMISSIONS COST THROUGH THE FAC?

A. Yes and I do not agree with Mr. Brubaker's recommendation that emissions costs be excluded.

Q. WHY SHOULD EMISSIONS COSTS BE PASSED THROUGH THE FAC?

A. Emissions costs represent implied taxes on the use of a particular fuel and generally vary with the amount of fuel consumed. The costs result from legislative mandates beyond the control of Empire. Failure to pass through such costs represents an attempt to shift this tax from consumption that causes the tax to the ownership of the asset from the time the cost is incurred until the next subsequent rate case. This is inconsistent with sound rate determination and proper price signals for consumers that, as the Staff notes, are an important feature

feature for rates.

ROE and Risk

Q. DOES APPROVAL OF THE PROPOSED FUEL ADJUSTMENT MEAN THAT THE ROE PROPOSED BY MR. GORMAN AND THE STAFF NEEDS TO BE REDUCED?

A. No. On the contrary given the “comparable” companies used by both Mr. Gorman and the Staff and the proposed fuel clauses that are recommended by Mr. Brubaker and the Staff there is reason to believe that even with the fuel adjustment clause Empire should earn a higher return, not lower. Even with the approval of the Empire FAC proposal, the appropriate ROE should be at least as high as recommended by Empire witness Dr, Vander Weide.

Q. WHY DO YOU CONCLUDE THAT EMPIRE REQUIRES A HIGHER RETURN THAN PROPOSED BY MR. GORMAN AND THE STAFF?

A. The rationale for a higher return may be found in an analysis of the different set of comparable companies used by Mr. Gorman and the Staff. I have prepared a set of schedules containing information about the comparable companies. Rebuttal Schedule HEO-1 provides information relative to the treatment of fuel costs for the companies used by Mr. Gorman. Reviewing that schedule, we find that twelve of the fifteen companies have full tracking fuel adjustment clauses. For the three companies that do not have a full tracking clause- Ameren, Avista and PNM Resources, Avista uses deferred accounting treatment for fuel costs in excess of those in base rates and has an opportunity to recover these costs after hearing and Ameren and PNM have fuel clause recovery in one jurisdiction for each company. For Ameren, 61.5 percent of revenue is subject to a jurisdiction with a fuel clause based on data from 2006. For PNM Resources, under 29 percent of revenue is earned in the jurisdiction without a fuel adjustment clause. These facts suggest that Mr. Gorman has used comparable companies for whom full recovery of fuel costs is the basis for investors' expectations regarding return. In addition, certain of the utilities in the sample have adjustment clauses that go beyond fuel cost recovery.

Q. ARE THERE OTHER ISSUES THAT SUGGEST THE ESTIMATED RETURN FOR MR. GORMAN'S COMPARABLE COMPANIES IS LOW WHEN COMPARED TO EMPIRE?

A. Yes. Rebuttal Schedule HEO-2 provides other information about the regulatory models used for the comparable companies that impact their ability to earn the allowed return. As that table shows, many of the utilities have the opportunity to use a future test year or to have a test year that is closer in time to the Rate Effective Period than available to Empire. During periods when costs are rising this reduces the probability that these companies will fail to earn the allowed return. Interestingly, even in periods when fuel costs have fallen, Empire has failed to earn the allowed return suggesting that risk factors other than fuel costs have a negative impact on the opportunity to earn the allowed return.

Q. WHAT IS THE BASIS FOR YOUR CONCLUSIONS REGARDING THE STAFF'S COMPARABLE COMPANIES?

A. Rebuttal Schedule HEO-3 provides the status of fuel adjustment clauses for the Staff's comparable companies. 14 of the 16 companies used in their estimate of capital cost have full tracking fuel clauses. As discussed above, the two companies without full protection on fuel costs both have substantial fuel cost recovery from a portion of their customer base. This means that investor expectations of the sample include an expectation of fuel cost recovery in terms of the required equity return. In addition, many of the Staff's comparable companies have other forms of adjustments that improve the opportunity to earn the allowed return relative to Empire.

Q. ARE THERE OTHER ISSUES THAT SUGGEST THAT THE STAFF'S COMPARABLE COMPANIES BIAS THE RETURN ESTIMATE BELOW A REASONABLE LEVEL?

A. Yes. Rebuttal Schedule HEO-4 shows that many of these companies have regulatory models that provide a reasonable opportunity to earn the allowed return. These comparable companies have test years that permit costs to be determined closer to the Rate Effective Period and or coincide with the Rate Effective Period.

Rate Design Changes

Q. DOES EMPIRE OPPOSE THE PROPOSED STAFF RATE DESIGN CHANGES RELATED TO THE IMPLEMENTATION OF A FACILITIES CHARGE?

A. No. Empire supports the use of a facilities charge as part of its rates applicable to demand billed customers as proposed by the Staff so long as the implementation of the proposal does not cause a revenue shortfall during the Rate Effective Period.

Q. HOW MIGHT THE PROPOSAL RESULT IN A REVENUE SHORTFALL DURING THE RATE EFFECTIVE PERIOD?

A. Since this is a new rate provision, it is necessary to estimate the facilities charge billing demand units. It is also necessary to assure that the estimate accounts for the initialization of the charge and the potential elasticity response to the ratchet effect proposed. Both of these issues require a detailed analysis of the monthly demands of the Empire customers. If the proposed estimated billing determinant is too high relative to the actual facilities demand during the Rate Effective Period the expected revenue will be lower for Empire than authorized. If it is higher, although a much less likely outcome, the revenue will also be higher.

Q. DOES THIS NEW RATE DESIGN INCREASE OR DECREASE RISK?

A. As proposed by the Staff without a detailed analysis of the facilities demand billing determinants, the Staff proposal represents a factor that increases risk for Empire.

Q. WHY IS EMPIRE AT RISK UNDER THE STAFF'S ESTIMATE OF PROPOSED BILLING DETERMINANTS?

A. Staff has used the an estimate of maximum demand from the test year to calculate the billing determinants as if the facilities charge had been in effect for the twelve months of the test year and at least eleven months prior to the test year. When

Empire begins applying the new facilities charge, it will begin with the first month of the Rate Effective Period. The full effect of the ratchet on revenues will not result until Empire has completed the rate year. For customers whose demand peak is in the summer, the demand determinant estimate used by the Staff will not be effective for most of the Rate Effective Period. This means that the Staff revenues from the facilities charge are overstated by the difference between the average winter peak demand and the summer peak demand. Even the winter peaking customers will likely have several months when their facilities charge revenue is below the level contained in the Staff estimate. Without a method to protect the Empire revenues from this start-up issue, the proposed rate does not allow Empire a reasonable opportunity to earn the allowed return.

Q. IS THERE A REASONABLE WAY TO ALLOW EMPIRE TO RECOVER THE REVENUE SHORTFALL RESULTING FROM IMPLEMENTATION OF THE FACILITIES CHARGE?

A. Yes. There are several options that would permit Empire to recover the revenue shortfall. The most direct method is to permit an adjustment clause applicable to the customers subject to the facilities charge that recovers the monthly shortfall in revenue with a one month lag. To the extent that the facilities charge revenue per month is less than the allowed revenue per month, the revenue shortfall would be divided by the actual facilities demand for the month and added to the charge for the subsequent month until the facilities charge revenue for the month excluding the adjustment portion equaled the monthly allowed revenue when the adjustment would no longer apply. Since this method minimizes the cash flow impact this is the preferred method for protecting Empire from an unnecessary risk.

Q. DOES THIS COMPLETE YOUR TESTIMONY?

A. Yes.