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

REPLY / TRUE-UP BRIEF

OF

INDUSTRIAL INTEVENORS

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ATTORNEYS FOR INDUSTRIAL INTERVENORS

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COME NOW Praxair, Inc., Explorer Pipeline Inc., and General Mills, Inc., with the support 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 submit their Reply / True-Up Posthearing Brief on the issues set forth below. The Industrial Intervenors submit this brief addressing the issues and sub-issues involving Return on Equity, Fuel Cost Recovery and Off-System Sales Margins.

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I. INTRODUCTION

In their Initial Brief, Industrial Intervenors anticipated many of the arguments that were raised in the Initial Briefs. Rather than repeat those arguments, the Industrial Intervenors will utilize this Reply Brief to respond to the more egregious claims raised by Empire in its Initial Brief.

II. RETURN ON COMMON EQUITY

A. INTRODUCTION

In their Initial Brief, the Industrial Intervenors pointed out several noticeable flaws in Empire's 11.6% return on equity recommendation. ***First***, the Industrial Intervenors noted that Empire's request is significantly outside the Commission's zone of reasonableness.[1] Given the Commission's previous findings regarding return on equity recommendations that fall outside the zone of reasonableness, Empire's ROE recommendation should be summarily rejected. ***Second***, the Industrial Intervenors pointed out that the Commission has previously found Empire's witness to be lacking in credibility.[2] Given this lack of credibility, the Commission should similarly disregard Empire's return on equity recommendation. ***Third***, the Industrial Intervenors provided expert analysis showing that Empire's return on equity recommendation is flawed. Scrutinizing the DCF, risk premium and CAPM analysis of Empire's uncredible witness, Mr. Gorman finds that Empire's recommendation leads to an "excessive" return on equity.[3]

Empire, in large part, now discards its own recommendation. Recognizing the excessive nature and diminished validity of its return on equity recommendation, Empire

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[1] Industrial Intervenors' Initial Brief, filed June 18, 2008, at pages 8-12.
[2] *Id.* at pages 12-14.
[3] *Id.* at pages 14-23.

instead attempts to leverage a return on equity decision equal to that granted in Empire's last rate proceeding.[4] The Commission should not allow a utility to recommend a return on equity, known to be inflated, with the intention of leveraging the reasonable recommendations advanced by the other parties. Allowing the use of a knowingly inflated return on equity recommendation in this way makes a mockery of the Commission's rules for prefiling of testimony. In addition, it is an open violation of the Commission's zone of reasonableness standard. As the Commission indicated when faced with a consumer-sponsored return on equity recommendation it found too low for the zone of reasonableness, such a recommendation should be "discarded."[5] Once discarded, "it merits no further discussion." It represents the epitome of arbitrariness for the Commission to "discard" a consumer-sponsored return on equity recommendation that is too low, as judged by the zone of reasonableness, yet utilize a utility-sponsored return on equity recommendation that is too high as judged by that same zone of reasonableness.

B. EMPIRE'S RECOMMENDATION IS INCONSISTENT WITH THE COURT ENUNCIATED PARAMETERS

In its Initial Brief, Empire posits that "the Commission should give the greatest weight to the testimony of Empire witnesses Dr. Vander Weide and Dr. Overcast, as their recommendations fit squarely within the ratemaking parameters enunciated by the

[4] Empire Initial Brief, filed June 18, 2008, at page 8. ("At the hearing in this matter, Staff witness Barnes clarified his recommendation and testified that he would be in agreement with an award of 10.8 percent. Industrial witness Gorman said he would not take issue with an award of 10.3 percent. (Tr. 514, 797-798). Interestingly, if the Commission considers Dr. Vander Weide's 11.6 percent recommendation, the high side of the Staff's range (10.8), and the high end of the Industrials' range (10.3), a simple average yields an ROE of 10.9 percent – the ROE authorized in Empire's last case.).

[5] *In re: Kansas City Power & Light*, Case No. ER-2006-0315, Report and Order, issued December 21, 2006, at pages 21-22.

courts."[6] Noticeably, Empire fails to provide any support for its claim that the Empire return on equity recommendation is consistent with these court enunciated ratemaking parameters. To the contrary, the United States Supreme Court has repeatedly found that a utility has no right "to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures."[7] Despite its claim that its recommendation "fits squarely within the ratemaking parameters enunciated by the courts," the evidence shows that Empire is actually seeking a return consistent with "highly profitable or speculative ventures;" a return that violates the standards enunciated by the Supreme Court.

Specifically, Empire recommends that it be awarded a return on 11.6%. The evidence indicates that Empire's recommendation would result in the ***<u>highest</u>*** return on equity in the nation.[8] Furthermore, it would represent the highest return on equity in over three years.[9] Such a recommendation does not fit with the Supreme Court's enunciated standard.

C. EFFECT OF CONSTRUCTION RISK

Empire the argues that it should be granted an excessive return on equity because it faces "substantial risks" associated with its construction program.[10] Like its return on equity recommendation, Empire also exaggerates the risk associated with its construction program. The evidence indicates that, during its construction program, Empire's cash flow is stabilized, and risk mitigated, ***through the implementation of a regulatory plan amortization.***[11] Despite its claim of "substantial" risk, the evidence reveals that the

[6] Empire Initial Brief, at page 6.
[7] *Bluefield Water Works and Improvement Co. v. Public Service Commission,* 262 U.S. 679, 692 (1923).
[8] Ex. 229 and Ex. 230.
[9] *Id.*
[10] Empire Initial Brief at page 10. See also, page 9.
[11] Ex. 501, page 6 ("Hence, the combination of traditional regulation and Empire's Regulatory Plan [including the regulatory amortizations] will benefit and mitigate the construction risk to both equity

amount of the regulatory amortization necessary to maintain Empire's credit rating is ***decreasing***.[12] As Staff Witness Oligschlaeger points out, "this result indicates that a portion of the RPA rate component authorized by the Commission in Empire's previous rate proceeding, ER-2006-0315, is ***no longer required*** to support the Company's investment-grade credit ratings."[13] Thus, whatever risk Empire experiences associated with its construction program, has ***decreased*** significantly since its last rate case.

Moreover, construction risk is not unique to Empire. To the contrary, analysts widely recognize the ongoing construction program throughout all the electric industry. As the Edison Electric Institute notes:

> U.S. electricity demand is growing slowly but steadily and reserve margins are shrinking in many power markets nationwide. The utility industry is in the early stages of a ***sizeable*** long-term capital investment cycle that includes rising spending on emissions control equipment, transmission and distribution upgrades and, over the longer term, a new round of baseload generation. Much of this will likely be built in regulated rate base.
>
> EEI's spring 2007 study of industry capital spending based on 10K data and discussions with companies indicated that the industry is projecting $73.1 billion of capital expenditures in 2007 – a 21.1% rise from the $60.3 billion spent in 2006 and 51.1% above the $48.4 billion in 2005. Based on current projections, industry capex should reach at least $75 billion in 2008 and $75.5 billion in 2009.[14]

Given that construction risk is inherent in the entire electric industry, that risk is reflected in the comparable company group used to calculate return on equity. It would be duplicative to reflect that risk in the comparable company group and simultaneously

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investors and debt investors by allowing for AFUDC earnings and cash flow enhancement during major construction programs.").

[12] Ex. 233, pages 9-13.

[13] *Id.* at page 10 (emphasis added).

[14] Ex. 501, pages 21-22.

single out that risk as support for an exaggerated return on equity. The construction risk is already reflected in the return on equity recommendation.

In addition to the fact that construction risk is ubiquitous in the electric industry, it is also a risk that has previously been considered by this Commission. In its Report and Order in the latest Aquila rate proceeding, the Commission authorized Aquila a return on equity of 10.25%.[15] Included in Aquila's 10.25% return on equity is an explicit reflection of Aquila's construction risk.[16] Thus, while Empire claims that it should be authorized an 11.6% return on equity to account for construction risk, it is unable to show that its construction risk is higher than that experienced by Aquila who was authorized a return of 10.25%. Given that Aquila does not share in the same regulatory plan amortization mechanism currently enjoyed by Empire, Aquila experiences significantly more construction risk than Empire. As such, based upon construction risk, Empire should receive a return on equity that is lower than the 10.25% awarded to Aquila.

D. EFFECT OF A FUEL ADJUSTMENT CLAUSE

Finally, Empire continues to claim that it should be authorized the 11.6% return on equity even if it is authorized to implement a fuel adjustment clause.[17] Empire reaches this conclusion by attempting to isolate an individual risk item of the comparable company group. Without looking at other compensating items of risk, Empire posits that since most of the companies in the proxy group have a fuel adjustment clause, the "cost of equity recommendations of all witnesses on this topic already include the lower risk of having a fuel adjustment mechanism."[18] Empire is wrong.

[15] Case No. ER-2007-0004, Report and Order, issued May 17, 2007, at page 63.
[16] *Id.* at page 62.
[17] Empire Initial Brief at pages 11-13.
[18] *Id.* at page 13.

The General Assembly recognized that the implementation of a fuel adjustment clause would have an obvious effect on a utility's risk.[19] Further, as expressly recognized by its Chief Executive Officer, the implementation of a fuel adjustment clause ***will*** reduce Empire's risk.

Q. Would you agree that the fuel adjustment clause as authorized by SB 179 would decrease Empire's risk?

A. Yes, I would.[20]

Finally, the focus on a single item of risk, without consideration of all other compensating risks, ignores the point of using a comparable company group. 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.

Thus, while certain proxy companies may have higher risk associated with nuclear operations, that risk is implicit in the proxy company's total risk profile.[21] Similarly, while certain proxy companies may have higher risk associated with deregulated operations, that risk is implicit in the proxy company's total risk profile.[22] Given that Empire does not have nuclear or deregulated operations, Empire's return on equity is not adjusted downward to account for the absence of these risks. Rather, given the fact that the comparable companies have a similar total company risk profile, it is obvious that there must be offsetting risk factors that make Empire's total company risk comparable to that of the proxy companies.

[19] Section 386.255.7
[20] Tr. 230.
[21] Tr. 485.
[22] Tr. 486.

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***). 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.
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> 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.[23]

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

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 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.[24]

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.[25]

E. CONCLUSION

In its testimony, the Industrial Intervenors assert that Empire should be authorized a 10.0% return on equity. This recommendation is consistent with the national average return on equity authorizations and the Commission's zone of reasonableness. This recommendation is supported by the proper application of the DCF, risk premium and CAPM models applied to a large number of comparable companies. Finally, and most importantly, this recommendation is designed to support Empire's credit rating and

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[24] Ex. 501, page 3.
[25] *Id.* at page 4.

continued financial integrity. As Mr. Gorman points out, after analyzing the credit metrics that result from his return on equity recommendation, "my proposed rate of return produces credit metrics that support the target credit metrics included in Empire's regulatory plan."[26] Realizing that his proposed return on equity would deliver metrics well in excess of those necessary to maintain Empire's credit rating or financial integrity, Dr. Vander Weide refrained from making a similar analysis. Clearly, Vander Weide's recommendation is excessive and should be rejected.

[26] Ex. 501, page 35.

III. FUEL COST RECOVERY

A. INTRODUCTION

In the List of Issues, the Office of the Public Counsel and the Industrial Intervenors have asserted that the Commission is barred, because of the continued existence of the Interim Energy Clause, from implementing a fuel adjustment clause for Empire. Further support for this argument was provided in the Industrial Intervenors' Initial Brief.[27] Not surprisingly, Empire has taken a contrary view.[28] As Public Counsel notes in its Initial Brief:

> The existing interim energy charge embodied in those tariffs was in effect when this case was filed, and Empire was prohibited from requesting a fuel adjustment clause in this case. The Commission clearly disagrees, as evidenced by the pleadings and briefs it filed in SC89176. Although confident that a decision in SC89176 will prove Public Counsel right, Public Counsel is equally confident that the Commission will not change its position in this case without a court order. Accordingly, this brief will not further elaborate on the arguments that the Commission has already rejected on this issue.[29]

The Industrial Intervenors share Public Counsel's confidence that the courts will ultimately determine that the IEC was in effect when this case was filed and that Empire was contractually barred from seeking a fuel adjustment clause while the IEC was in effect. Nevertheless, the Industrial Intervenors also believe that this Commission is not likely to suddenly see the light. As such, this brief will not further elaborate on the arguments that the Commission has already rejected on this issue. Rather, this brief will focus entirely on the appropriate structure for a fuel adjustment clause in the event the Commission does find it appropriate to authorize such a mechanism.

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[27] Industrial Intervenors' Initial Brief at pages 34-37.
[28] Empire Initial Brief at pages 34-36.
[29] Public Counsel Initial Brief at page 35.

B. HOW SHOULD A FUEL ADJUSTMENT CLAUSE BE STRUCTURED?

Much like its position on return on equity, where it attempts to use its inflated recommendation to leverage a higher average return on equity, Empire has also largely abandoned its request regarding the appropriate structure for a fuel adjustment clause. Initially, Empire sought to implement a fuel adjustment clause which would flow through 95% of all variations in fuel and purchased power costs.[30] As Empire admitted, this structure was designed to reflect the outcome of the Commission's decision in Case No. ER-2007-0004 and was not based on any "analysis of the incentives present in this mechanism."[31]

Now, however, Empire urges the Commission to reject its initial proposal in lieu of a mechanism which "provides for recovery of 100%" of fuel and purchased power cost variations.[32] Despite the statutory urging that any fuel adjustment clause be "designed to provide the electrical corporation with incentives to improve the efficiency and cost-effectiveness of its fuel and purchased power activities,"[33] Empire argues for abandonment of the sharing mechanism merely based on the notion that "we spent it, therefore it must be prudent."

In their Initial Brief, the Industrial Intervenors pointed out the numerous flaws inherent in the fuel adjustment mechanism. These flaws were recognized by the Missouri Supreme Court when it characterized the adjustment mechanism as a "radical departure from the usual process."[34] The Supreme Court noted that the fuel adjustment clause

[30] Ex. 2, page 21.
[31] Ex. 502, page 4.
[32] Empire Initial Brief at pages 33 and 38.
[33] Section 386.266.1
[34] *State ex rel. Utility Consumers Council of Missouri v. Public Service Commission*, 585 S.W.2d 41 (Mo. 1979).

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.***"[35]

In its Report and Order in the last Aquila rate proceeding, the Commission expressly found that any fuel adjustment clause should "retain some incentive for Company efficiency."[36] More specifically, the Commission found:

> While the Commission believes Aquila should be given the opportunity to recover its prudently incurred fuel costs, it also agrees with Mr. Johnstone and Ms. Brockway that: (1) after-the-fact prudence reviews alone are insufficient to assure Aquila will continue to take reasonable steps to keep its fuel and purchased power costs down; and (2) the easiest way to ensure a utility retains the incentive to keep fuel and purchased power costs down is to allow less than 100% pass through of those costs. Accordingly, it is not appropriate to allow Aquila to pass 100% of its fuel and purchased power costs, above those included in its base rates, through its fuel adjustment clause.[37]

Despite the clarity of the Commission's order, Empire failed to provide any support for the notion that its new 100% recovery clause will satisfy: (1) the statutory focus on fuel and purchased power cost-effectiveness or (2) the Commission's finding that 100% fuel cost recovery will not "assure that [the utility] will take appropriate steps to keep its fuel and purchased power costs down."[38] Without such assurances, the Commission should summarily reject Empire's proposal to implement a 100% pass-through fuel adjustment clause.

The issue, then, is the degree to which the Commission implements a sharing mechanism within the fuel adjustment clause. As mentioned, Empire originally proposed

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[35] *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).
[36] Case No. ER-2007-0004, Report and Order, issued May 17, 2007, at page 43.
[37] *Id.* at page 53.
[38] *Id.* at page 54.

a 95% fuel adjustment sharing mechanism. This mechanism is not based upon any analysis of the incentives or its ability to assure fuel cost minimization. Rather, this proposal was blindly designed to mimic the fuel adjustment clause awarded to Aquila.

In its Initial Brief, Empire spends a great deal of time attacking Staff and Public Counsel's sharing proposal. Specifically, Empire claims that Staff and Public Counsel's proposal would divert a large amount of its earnings. Noticeably, however, Empire makes no similar claim regarding the sharing mechanism advanced by the Industrial Intervenors. As designed, the proposal advanced by Mr. Brubaker would: (1) provide incentives to assure fuel cost minimization; (2) cap the utility's financial exposure to large fluctuations in fuel cost[39]; (3) diminish the reliance on after-the-fact prudence reviews; and (4) under one proposal, provide stability in rates by ignoring small changes from base rates. As Mr. Brubaker explained his initial proposal:

> 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.

[39] The financial exposure for Empire's shareholders is capped at 50 basis points. Importantly, given the low end of Mr. Gorman's return on equity range is 50 points below his recommended return, this 50 point exposure in earnings will still allow the Empire shareholders a sufficient opportunity to earn a fair return on equity. (Ex. 501, page 2).

> 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 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.[40]

The benefits of this sharing mechanism should be obvious. ***<u>First</u>***, it provides the utility "an incentive to controls costs and to perform in a superior manner."[41] ***<u>Second</u>***, 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."[42] ***<u>Third</u>***, since the utility will be invested in its decision-making, it serves to diminish the reliance on an after-the-fact prudence review. Ultimately, the fuel adjustment clause proposed by Mr. Brubaker minimizes the inherent deficiencies 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 eliminates the dead band and extends 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

[40] Ex. 502, pages 8-9 and Schedule 2.
[41] *Id.* at page 9.
[42] *Id.* at page 8.

> them out over a broader range of cost changes, an incentive to control costs can be maintained over a much broader range.[43]

The ultimate effect of his alternative proposal is to: (1) make the incentive mechanism effective over a broader range of fuel and purchased power cost variations; (2) mirror the Empire's proposed 95% / 5% sharing in the earliest blocks of the sharing mechanism; and (3) maintain the financial cap on the shareholders' exposure to financial fluctuations.[44]

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

In its testimony and Initial Brief, the Industrial Intervenors warned that Empire is seeking "to cram as many expenses into a tracker mechanism as possible while still allowing for uncapped revenues."[45] Despite its recognition that fuel adjustment mechanisms are designed to allow for recovery of "volatile" fuel and energy costs,[46] Empire nonetheless seeks to "cram as many expenses into this tracker mechanism" even though such costs may not be volatile.

For instance, Empire seeks to utilize the fuel adjustment clause to recover "unit train and fuel handling costs." Empire does not suggest that such costs are volatile, but rather suggests that it would be "complicated, from an administrative standpoint" to exclude them from the fuel adjustment clause.[47] Further, Empire implies that such costs are mandated by the statute's extension to transportation costs.

The Industrial Intervenors do not dispute that the Commission can, under the statute, include these costs in a fuel adjustment clause. Rather, the Industrial Intervenors

[43] Ex. 505, page 14.
[44] Ex. 505, Schedule 1, page 1.
[45] Industrial Intervenors' Initial Brief at page 43. See also, page 5.
[46] Empire Initial Brief at page 32.
[47] *Id.* at page 43.

point out that, since these costs are not "volatile," they should not be subjected to the special treatment offered through the fuel adjustment clause.

As the Commission has recognized,

> 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.[48]

Given then, the unquestioned benefits of regulatory lag, the Commission should be extremely careful in deciding which costs will no longer be subjected to the strong incentives of regulatory lag and, instead, be allowed to pass through the fuel adjustment clause. 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.

The exclusion of certain fuel-related costs from the adjustment mechanism is not unusual. As pointed out in the Initial Brief, in the recent Aquila rate decision, the Commission agreed with the parties and denied fuel adjustment clause <u>treatment of unit train lease, depreciation, and maintenance costs</u>. Furthermore, the Commission excluded <u>fuel handling costs</u> as well as natural gas reservation and demand costs from inclusion in the fuel adjustment clause.[49] 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.[50]

The exclusion of these types of costs is also necessary to prevent undue discrimination on high load factor customers. As Mr. Brubaker points out:

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[48] *Id.* at page 18.
[49] *Id.* at page 9.
[50] *Id.* at page 11.

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.[51]

[51] Ex. 505, page 10.

IV. OFF-SYSTEM SALES MARGINS

In its Initial Brief, Empire offers little support for its position on off-system sales margins. Empire properly recognizes that the Commission should establish a level of margins that the Company "is likely to receive from the off-system sale of electric power during the period rates set in this case are in effect,"[52] Nevertheless, rather than analyze off-system sales margins with a view to their likelihood in the period in which rates will be in effect, Empire instead merely claims that the Commission should utilize its proposed five-year methodology because it "is the same method the Commission used to estimate off-system sales margins in Empire's last general rate case."[53]

As the Industrial Intervenors point out, Empire's insistence on using the test-year level of an increasing expense (i.e., tree-trimming), while simultaneously proposing a five-year average to reflect an increasing revenue item (i.e., off-system sales), constitutes "ratemaking hypocrisy."[54] Such hypocrisy is not surprising in that it continues to give the utility an opportunity to overearn. For instance, utilizing the five years preceding the last case (years 2001-2005), results in a five year average off-system sales margin of $2,831,108.

Calendar Year	Net Sales Margins[55]
2001	$832.651
2002	$5,116,368
2003	$3,016,910
2004	$1,687,445
2005	$3,502,169
Average	$2,831,108

[52] Empire Initial Brief at page 17.
[53] *Id.*
[54] Industrial Intervenors' Initial Brief at pages 5-6.
[55] Ex. 209, page 3.

Therefore, during 2007, when Empire realized off-system sales margins of $5,955,336, it recognized an immediate windfall of over $3 million. By continuing to advocate the five-year average, Empire seeks to continue this windfall.

In contrast, Public Counsel and the Industrial Intervenors recommend that the Commission utilize the most recent 12-month period as reflect in the true-up.[56] Regulatory lag still gives Empire an opportunity to realize a windfall if it is able to further increase the level of off-system sales margins. That said, it no longer gives Empire an opportunity to benefit from that level of off-system sales that it has already proven it should reasonably generate.

Finally, Empire suggests that the true-up level of off-system sales margins is unlikely to be realized again because of the BPU contract which is "due to expire shortly before the operation of law date in this case."[57] As Public Counsel witness Kind notes, however, the expiration of this contract will increase Empire's opportunities in the Southwest Power Pool Energy Imbalance Services market.[58] Additionally, Empire will have increased opportunities to generate off-system sales margins because of the recent addition of the Riverton 12 combustion turbine.[59] Given these unquestioned opportunities for heightened off-system sales margins, the Commission should reject Empire's ratemaking hypocrisy in favor of a level of off-system sales that is reasonably likely to be realized in the period in which rates are in effect.

[56] Ex. 317, page 2. ("I recommend including $6,116,915 in Empire's revenue requirement.").
[57] Empire Initial Brief at page 18.
[58] Ex. 303, page 3.
[59] *Id.* at page 5.

V. CONCLUSION

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

Respectfully submitted,

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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: July 3, 2008