BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of the Tariff Filing of the Empire District Electric Company of Joplin, Missouri To Implement a General Rate Increase for Retail Electric Service Provided to Customers In the Missouri Service Area of the Company	)))))	**Case No. ER-2006-0315**

POST-HEARING BRIEF OF THE EMPIRE DISTRICT ELECTRIC COMPANY

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NON-PROPRIETARY

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The Empire District Electric Company ("Empire" or "Company"), by and through the undersigned counsel, hereby submits this post-hearing brief to the Missouri Public Service Commission ("Commission") for its consideration in Case No. ER-2006-0315.

STATEMENT OF THE CASE

Empire initiated the current case when, on February 1, 2006, it filed revised tariff sheets, bearing an effective date of March 3, 2006, that were designed to increase rates for retail electric service provided to customers in the Company's Missouri service area by approximately $29.5 million, exclusive of gross receipts, sales, franchise, and occupational taxes.[1] That represents an increase of 9.63 percent over current rates. As required by the Commission's rules, the Company also filed the written testimony and schedules of eight witnesses in support of its rate increase request.

Empire has explained that its proposed rate increase request was driven primarily by higher costs for fuel used in generating electricity and purchased power, although other costs associated with providing safe and reliable electric service to customers also have increased since the Company's last rate adjustment. Another factor that influenced Empire's decision to file this case was the Company's desire to eliminate its current Interim Energy Charge ("IEC"), which, when combined with base rates, has failed to allow Empire to recover the significant increases in energy costs it has experienced. Empire sought to replace the IEC with an energy cost recovery mechanism that in combination with base rates would have allowed timely recovery

[1] The rate schedules were designed to generate $38,179,048 in additional revenues from base rates and to eliminate the Interim Energy Charge, which provided $8,665,335 in annual revenue. This represents a net increase of $29.5 million.

from customers of actual, prudently incurred fuel and purchased power costs.[2] Senate Bill 179, which was signed into law by Governor Blunt in July 2005,[3] authorizes the Commission to approve such mechanisms, but only in a general rate case.

On February 7, 2006, the Commission issued an order suspending the revised tariff sheets ("Suspension Order") for a period of 120 days plus six months, to January 1, 2007. The Suspension Order directed Empire to file by February 21, 2006, its recommendations regarding the appropriate test year and true-up period to use for the case and directed the Commission's staff ("Staff"), the Office of the Public Counsel ("OPC"), and any intervenors to file by March 7, 2006, their concurrence with the Company's recommendations or alternate recommendations of their own. Empire timely filed its recommendation that the test year be the twelve-month period ending December 31, 2005, adjusted and updated for known and measurable changes through March 31, 2006. All other parties to the case concurred with the Company's recommendation. The Commission also ordered a true-up of certain specified items through June 30, 2006.

Empire, Staff, the OPC, and intervenors Praxair, Inc., and Explorer Pipeline, Inc. (jointly "Industrial Intervenors") each filed testimony and schedules in this case, all in accordance with the procedural schedule adopted by order dated April 11, 2006. Local public hearings were held in Joplin and Reed Springs, Missouri, in June 2006. Evidentiary hearings in the case commenced on September 5, 2006, and were concluded on September 24, 2006.

[2] The Commission has indicated that Empire may not make any request for an energy cost recovery rider while the existing IEC is effective.

[3] Senate Bill 179 was codified as Section 386.266, RSMo.

1. RATE OF RETURN ON COMMON EQUITY

When the Commission considered the rate of return on common equity issue in Empire's last general rate case, Case No. ER-2004-0570, the evidence showed that the Company's credit rating had been downgraded; its access to capital had been impaired; its earnings per share had declined; and it had not been able to earn the rate of return it had been authorized in the preceding case. Regrettably, the evidence in this case demonstrates that things have gotten worse. Empire's debt rating has, again, been downgraded, further impairing its access to capital and increasing its costs of borrowing. Its needs for capital have increased due to investments in the Plumb Point and Iatan 2 generating facilities. Its fuel and purchased power costs have increased significantly. Due primarily to the under recovery of fuel and purchased power costs, the Company's earnings have consistently fallen well below the 11.0 percent return on equity authorized in the last case. Further, interest rates generally, which for many years were declining to historically low levels, are increasing.[4]

In its Report and Order in Empire's last case the Commission properly observed that to determine the appropriate return on equity it was essential to look at the performance of companies whose risks are comparable to Empire's. Mindful of the constitutional standards set forth in *Bluefield Water Works & Improv. Co. v. Pub Serv. Comm'n.*, 262 U.S. 679 (1923) and *FPC v. Hope Nat Gas Co.*, 320 U.S. 591 (1943), the Commission concluded "[o]nly through this sort of comparative analysis can a return commensurate with the returns of other enterprises with corresponding risks be determined."[5] Of the four witnesses that presented testimony in that case, the

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[4] See Transcript, pp. 408-419.

[5] Report and Order in Case No. ER-2004-0570 (March 10, 2005), p. 45.

Commission noted that only Empire's witness, Dr. James Vander Weide, performed the type of "risk-based, comparative analysis *required* by Hope and Bluefield."[6] Accordingly, in that case the Commission adopted Dr. Vander Weide's 11.3 percent recommended return on equity as a starting point for determining Empire's cost of equity, and ultimately held that the Company should be authorized an 11 percent return on equity.

With respect to the current case, the record reveals that little has changed with regard to the evidence regarding the Company's cost of equity and certainly nothing indicates that Empire's cost of equity has declined. Empire's witness, Dr. Vander Weide, again based his recommendation on his analysis of the results of his Discounted Cash Flow ("DCF"), Capital Asset Pricing Model ("CAPM"), and Risk Premium Method ("RPM") methodologies as applied to a large number of proxy companies that were selected on the basis of comparable business and financial risk. The witness for the Staff, on the other hand, while nominally abandoning the "company-specific" DCF method he used in the last case, and which the Commission rejected, performed only limited comparative analyses. The witness for the OPC did much the same thing. Because of their small proxy groups, these analyses were weak and half-hearted and produced recommendations – 9.5-9.6 percent for the Staff and 9.65 percent for the OPC – that are afflicted with the same shortcomings that caused them to be rejected in Empire's last case.[7] Indeed, Staff and OPC's comparative analyses are more designed to produce low cost of equity results than to provide insight into the returns investors expect to receive on other investments of comparable risk.

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[6] *Id.* (emphasis original).

[7] Staff's recommendation is only 31 basis points above the high end of his recommended cost of equity range in Empire's last rate case. (Transcript, pp. 402-03) His recommendation is 140 basis points below the rate of return allowed in that case.

Once again, only Dr. Vander Weide's broad-based approach provides results that the Commission can rely on for its decision in this case. Accordingly, Dr. Vander Weide's recommended return on equity of 11.7 percent,[8] with an appropriate adjustment for the increased risk associated with Empire not being able to implement a fuel and purchased power cost recovery mechanism, should again, at a minimum, be the Commission's starting point for determining the cost of equity for the Company.

A. Overview

As stated previously, the Company's approach to estimating its required rate of return on equity in this case is virtually identical to the one it employed in its last general electric rate case, Case No. ER-2004-0570. As in the last case, Empire's witness on this issue, Dr. James H. Vander Weide, is Research Professor of Finance and Economics at the Fuqua School of Business at Duke University, and the President of Financial Strategy Associates, a strategic and financial consulting firm.

Dr. Vander Weide used a two-step process to estimate Empire's cost of equity in this case. First, he applied several standard cost of equity estimation methods – the DCF method and the CAPM – to available market data for a broad group of proxy companies whose risk profiles are similar to Empire's. Using these standard cost of equity estimation methodologies, Dr. Vander Weide calculated an average equity return for the proxy group of 11.3 percent. (Exhibit 2, pp. 5-6) Next, he refined the results derived from the first step by adjusting the average cost of equity for the proxy group to account for the differences between the financial risk of the comparable companies and the financial risk that is implied for Empire by its recommended capital structure. (*Id.*, p.

[8] In Empire's last rate case, Dr. Vander Weide recommended a rate of return on equity of 11.3%. That recommendation in this case, 11.7%, is only 40 basis points – or approximately 3.5% -- greater than his recommendation in the previous case.

4) Because of Empire's relatively greater financial risk, this adjustment yielded a cost of equity recommendation of 11.7 percent, which is only 40 basis points greater than the proxy group average.

Contrary to Dr. Vander Weide's recommendation to apply several cost of equity methodologies to large samples of comparable risk companies, Staff's witness, David Murray, and the OPC's witness, Charles W. King, base their cost of equity recommendations primarily on the results of applying a single methodology, the DCF, to a limited sample of proxy companies.[9] Because their proxy company groups are much smaller than Dr. Vander Weide's proxy group, Staff's and OPC's studies suffer from the kinds of statistical distortions that are inherent to small survey samples. In addition, Staff's and OPC's studies fail to reflect the significant increase in capital costs that occurred in mid-2006. As Dr. Vander Weide demonstrated in his rebuttal testimony, the cost of equity was significantly higher in June 2006 than in December 2005, when he prepared his direct testimony.

B. Economic and Legal Principles Governing the Determination of a Fair Rate of Return

Economists define the cost of equity as the return that investors expect to receive on alternative equity investments of comparable risk. Unlike debt, the rate of return on equity is not contractual, so the cost of equity for a given company is more difficult to measure than the cost of debt. There is consensus among economists, however, that, because equity is more risky than debt, the cost of a company's equity will always be greater than its cost of debt. There is also consensus that any reliable estimate of a

[9] Both Staff and OPC witnesses also present results of the CAPM. However, they state that their recommended costs of equity for Empire are based on the results of their application of the DCF. (Exhibit 51, p. 4; Exhibit 72, p. 2)

company's cost of equity must be both market based and forward looking and must take into account the company's unique business and financial risk characteristics. Business risk reflects the variability in investment returns caused by uncertainty in a company's basic operating environment. Financial reflects the variability in investment returns caused by a company's use of fixed-cost debt to finance its operations. For companies like Empire, the regulatory environment in which it operates also has a significant impact on the market's evaluation of business risk.

These financial and economic principles relating to the cost of capital have been recognized in two key decisions of the United States Supreme Court that established the legal standards that govern the Commission's determination of a fair rate of return. In *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n.*, *supra*, the Court stated:

> A public utility is entitled to such rates as will permit it to earn a return upon the value of the property which it employs for the convenience of the public equal to that generally being made at the same time in the same general part of the country on investments in other business undertakings which are attended by corresponding risk and uncertainties. . . The return should be reasonable sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit, and enable it to raise the money necessary for the proper discharge or its public duties.

262 U.S. at 692.

Twenty-one years later, in *FPC v. Hope Natural Gas Company*, *supra*, the Court reiterated that maintaining a utility's financial soundness and its ability to attract capital remained the standard for determining whether the rate of return authorized by a regulatory commission meets the requirements of law:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital

costs of the business. These include service on the debt and dividends on the stock . . . By that standard the return to the equity owner should be commensurate with 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.

320 U.S. at 603.

Thus, the allowed rate of return on Empire's common equity that is authorized in this case must accomplish several objectives: it must allow the Company to maintain its financial integrity and attract capital at reasonable rates; it must accurately reflect Empire's unique business and financial risks; it must be forward looking; and it must provide investors with a rate of return on their invested capital that is comparable to that investors expect to earn on investments in other companies whose risk profiles are similar to Empire's.

These standards imply that the cost of equity must be estimated in several steps. First, the analyst must select a proxy group of companies whose average risk profile is similar to the target company's. Second, the analyst must use standard cost of equity methodologies to estimate the return investors expect to earn on an investment in the proxy companies. Third, the analyst must adjust the cost of equity results for the proxy companies to reflect the differences between the risks of the target company and the proxy group.

C. Determining an Appropriate Proxy Group

Proxy group selection is a critical first step in estimating a company's cost of equity because economic and financial principles require that the cost of equity is the return that investors expect to receive on other investments of comparable risk. Furthermore, cost of equity results can be sensitive to the companies included in the

proxy group. However, as Dr. Vander Weide explains, the potential for bias from the proxy selection process can be greatly reduced by using the largest available sample of comparable risk companies with sufficient data to apply cost of equity methods. Dr. Vander Weide's proxy groups meet these fundamental criteria for proxy group selection, while Staff's and OPC's proxy groups do not.

Dr. Vander Weide's proxy group is composed of the companies in Value Line's groups of electric and natural gas companies that: 1) paid dividends each quarter of the last two years; 2) did not increase dividends during any quarter of the last two years; 3) had at least three analysts included in the I/B/E/S mean growth forecast; 4) have an investment grade bond rating and a Value Line Safety Rank of 1, 2, or 3; and 5) have not, as of the time of their selection, announced a merger. (Exhibit 2, p. 28; Exhibit 3, p. 15) Forty-seven companies satisfied these criteria. As Dr. Vander Weide demonstrates, his proxy companies meet the *Hope* and *Bluefield* standards because their average Value Line Safety Rank and Standard & Poor's bond rating indicate that they are similar in risk, but slightly less risky, than Empire. (See Exhibit 2, Schedules JVW-1 and JVW-2)

Dr. Vander Weide did not limit his proxy group to electric energy companies alone for three reasons. First, financial theory does not require that companies be in exactly the same industry to be comparable in risk. (*Id.,* pp. 31-32) Second, widely used measures of comparability – such as Value Line's Safety Rank and bond ratings by Standard & Poor's and other rating agencies – demonstrate that gas and combination energy companies are perceived as having risks comparable to electric companies. (*Id.*, pp. 32-33; Exhibit 3, pp. 14-15) And third, a proxy group composed of a relatively large

group of comparable risk companies is desirable because it reduces the uncertainties inherent in the standard methodologies used to estimate the cost of equity compared to a smaller proxy group. (Exhibit 3, pp. 12-13; Transcript, pp. 269-270) Although available data show that, on average, the risk characteristics of the companies in Dr. Vander Weide's group are lower than Empire's, these data confirm that the group of electric, gas, and combination energy companies is a legitimate proxy for the risk of investing in Empire, albeit a conservative one. (Exhibit 2, pp. 29, 31; Exhibit 3, p. 15)

The proxy groups used by Staff consists of only five electric companies, which were selected from an original list of eleven companies listed in an August 2005 issue of Standard & Poor's *CreditStats*. As Dr. Vander Weide explains in his rebuttal testimony, the Standard & Poor's listing was not a comprehensive list of all integrated electric and natural gas companies that Standard & Poor's considers to be of equal or lower risk than Empire. Because its cost of equity analysis is based on such a small sample, Staff's results are inherently unreliable. Furthermore, as evidenced by the results obtained from Dr. Vander Weide's studies based on a much larger sample of comparable risk companies, Staff's results based on the small sample are downwardly biased.

OPC began its proxy group selection with the same companies Dr. Vander Weide used to estimate Empire's cost of equity. However, OPC inappropriately removed eighteen companies from Dr. Vander Weide's group based on arbitrary criteria that are unrelated to the relative risk of the companies. Thus, OPC obtained a final group that is significantly smaller than Dr. Vander Weide's proxy group. As Dr. Vander Weide explained, smaller samples are less reliable than larger samples and are more

prone to reflect statistical anomalies. Indeed, when Dr. Vander Weide updated his cost of equity results to include data through June 2006, he obtained cost of equity results that were significantly higher than OPC's.

In Empire's last rate case, the Commission accepted the results of Dr. Vander Weide's application of several cost of equity methodologies to a large sample of comparable risk companies. In this proceeding, Staff and OPC provide no evidence that the Commission should reject the approach it used as the basis for its decision in Empire's last rate case. Instead, Staff and OPC recommend that the Commission accept the results of applying the DCF method to a small proxy group. As a result, Staff and OPC still fail to provide the kind of reliable, comparable company information that the Commission has stated is critical to determine a fair and reasonable return on equity. As in the last case, the Commission should reject the recommendations of the witnesses for the Staff and accept the Company's recommended return on equity.

D. The DCF Analysis

As in the last case, Dr. Vander Weide used the DCF model as part of his analysis. Two fundamental assumptions underlie the DCF Model: 1) that investors value an asset based on the future cash flows they expect to receive from owning the asset, and 2) that investors value a dollar received in the future less than one received today. Applying these principles to an investment in a company's common stock results in the following cost of equity equation: $k = D_1/P_s + g$ where: k is the cost of equity; D_1 is the expected next period dividend; P_s is the current price of the stock; and g is the constant annual growth rate in earnings, dividends, and book value per share.

Because each of the companies in his proxy group pays dividends quarterly

instead of annually, Dr. Vander Weide used a modified version of the DCF equation that expresses a company's current stock price as the present value of a quarterly stream of dividend payments. This better reflects the time value of money aspect of the DCF Model.[10] (Exhibit 2, pp. 21-22; Appendix 1) Consequently, instead of a single dividend value (D_1), his DCF equation uses the estimated values of four future quarterly dividends (d_1,d_2, d_3, and d_4) that are calculated by multiplying the previous four quarterly dividends by the factor $1 + g$.[11]

The stock price for each of the companies in Dr. Vander Weide's proxy group was calculated based on a simple average of each firm's monthly high and low stock prices for the three-month period ending November 2005. In his rebuttal testimony, Dr. Vander Weide updated his DCF results based on a simple average of each firm's monthly high and low stock prices for the three-month period ending June 2006. He used a three-month average stock price because stock prices fluctuate and a three-month average price is more consistent with his use of analysts' growth forecasts, which are adjusted on a quarterly basis. (*Id.*, p. 27)

Dr. Vander Weide used as his growth component financial analysts' estimates of future earnings per share growth as reported by I/B/E/S Thomson Financial. (*Id.,* p. 24) He considers these estimates to be appropriate because they are widely circulated in the financial community, include projections of reputable financial analysts, are timely reported to investors, and are widely used by both institutional and private investors. (*Id.,* p. 25) In addition, he personally conducted a study, which was published in the

[10] Dr. Vander Weide recommends a quarterly DCF model because all of the companies in his proxy group pay dividends quarterly. (Exhibit 2 pp. 21-22)

[11] Even though their comparable companies pay dividends quarterly, both Staff and the OPC continue to use a DCF Model that assumes dividends are paid annually.

Journal of Portfolio Management, that confirmed that analysts' forecasts of future growth are the best tool available for predicting a firm's stock price. (*Id.,* p. 26)

Exhibit 3, Schedule JVW-1 shows that the updated DCF analysis yielded an estimate of the cost of equity of 10.9 percent for the energy companies in his proxy group.[12] Because investors' perceptions regarding the relative risks of investing in electric utilities has increased in recent years and also because of considerable volatility that has been observed over the past several years in DCF results for electric utilities, Dr. Vander Weide believes that the 10.9 percent estimate understates Empire's true cost of equity. (Exhibit 2, p. 30) These data, along with the updates of Dr. Vander Weide's other cost of equity methodologies, indicate that his recommended cost of equity of 11.7 percent is conservative.

E. The RPM Analysis

As part of his approach, Dr. Vander Weide also used an RPM analysis. The RPM is based on the principle that investors expect to earn a return on an equity investment in Empire that reflects a premium over and above the return they would expect to earn on an investment in a portfolio of bonds. The premium compensates investors for the additional risk they bear in making an investment in equity instead of debt. Although this method of estimating the cost of equity does not require the use of any particular debt instrument, it does require that the debt instrument that is used to estimate the risk premium be the same as the debt instrument used to calculate the interest rate component of the RPM. For example, if the risk premium is calculated by comparing the returns on stocks and A-rated utility bonds, then the interest rate component used for

[12] The data shown in Schedule JVW-1 to Dr. Vander Weide's rebuttal testimony are for the period ending June 30, 2006. A typographical error in the notes to the schedule erroneously identifies the date as being June 2005.

the RPM must be the interest rate on A-rated utility bonds. This does not mean, however, that the same *companies* be used to estimate both the stock and bond returns. (*Id.,* p. 34)

Dr. Vander Weide used two methods to estimate the required risk premium on an equity investment in Empire: the *ex ante* RPM and the *ex post* RPM. The *ex ante* RPM uses DCF-based estimates of expected returns on a proxy group of electric and gas companies and compares those estimates to the interest rate on Moody's A-rated utility bonds. Dr. Vander Weide performed a regression analysis to see if there was a correlation between the calculated risk premium and interest rates. The results of that analysis were used to estimate investors' required risk premium. To estimate the cost of equity, Dr. Vander Weide next added the required risk premium to a forecasted interest rate on A-rated utility bonds. (*Id.* pp. 35-36; Appendix 2; Schedule JVW-3) This methodology produced a cost of equity estimate of 10.9 percent for Dr. Vander Weide's proxy group of electric companies and 11.3 for his proxy group of gas companies for an average of 11.1 percent for both groups. (*Id.,* pp. 36-37)

The *ex post* RPM is based on a 67-year study that Dr. Vander Weide performed on the comparable returns received by bond and stock investors. He estimated the returns on the stock and bond investments using stock price and dividend yield data on the Standard & Poor's 500 and the bond yield on Moody's A-rated utility bonds. The study consisted of making investments of one dollar each in hypothetical portfolios of stocks and bonds beginning in 1937 and reinvesting the principal plus returns each year thereafter to 2004. As shown on Exhibit 2, Schedule JVW-5, the average annual return on the stock investment was 11.67 percent and 6.4 percent on the bond investment,

which results in a risk premium on the stock portfolio of 5.27 percent. (*Id.,* p. 38) Dr. Vander Weide also conducted a second study based on the same methodology but using stock data on Standard & Poor's utilities instead of the Standard & Poor's 500. In that study the average annual return on the stock investment was 10.57 percent, yielding a risk premium of 4.16 percent. Applying the results of both of his *ex post* studies to the forecasted interest rate of Moody's A-rated utility bonds for 2007 of 6.9 percent yields an expected return on equity within a range of 11.0 - 12.2 percent. (*Id.,* p. 44)

F. The CAPM Analysis

Dr. Vander Weide also used a CAPM analysis. The CAPM is based on the assumption that investors' expected or required return on a given company's security is equal to the risk-free rate of interest plus the product of the company's equity "*beta*" multiplied by the market risk premium. For purposes of this equation: the risk-free rate is the expected rate of return on a risk-free federal government security; the equity beta is a measure of the company's risk relative to the market as a whole; and the market risk premium is the return premium that investors require to invest in the market basket of all equity securities compared to the risk-free rate. To estimate the risk-free rate, Dr. Vander Weide used the forecasted yield to maturity of 5.50 percent on long-term Treasury bonds that was published in *Global Insight* for 2007. His betas came from Value Line. The average of the betas for the proxy group of companies was 0.84. The updated beta for the proxy companies is 0.94. (Exhibit 3, Schedule JVW-1)

Dr. Vander Weide used two different methods to calculate the risk premium. First, he calculated the difference between the arithmetic mean return on the Standard

& Poor's 500 and the income return on 20-year Treasury bonds, as reported in Ibbotson Associates' *2005 Yearbook*, which yielded a risk premium of 7.2 percent. The updated Ibbotson market risk premium is 7.1 percent. Second, Dr. Vander Weide calculated the difference between the DCF-based cost of equity for the Standard & Poor's 500 and the yield to maturity of 20-year Treasury bonds, which yielded a risk premium of 8.0 percent. (*Id.,* pp. 44-45)

The risk premium of 7.2 percent derived from the first calculation produces a CAPM estimate of the cost of equity of 11.5 percent for the proxy group, which Dr. Vander Weide terms the "historical CAPM." (*Id.,* pp. 45-46; Schedule JVW-8) In his rebuttal testimony, Dr. Vander Weide demonstrates that an updated CAPM estimate of the cost of equity, based on a market risk premium of 7.1 percent, a beta of 0.94, and a risk-free rate of 5.5 percent, is 12.2 percent. The risk premium of 8.0 percent derived from the second calculation yields an estimated cost of equity of 12.2 percent for the proxy group, which Dr. Vander Weide terms the "DCF CAPM." (*Id.,* p. 47; Schedule JVW-9) Dr. Vander Weide cautions that both of these estimates may understate Empire's true cost of equity, however, because the CAPM tends to underestimate the cost of equity for companies whose beta is less than 1.0. (*Id.,* pp.47-49) In addition, the CAPM fails to account for the fact that investors generally require a higher rate of return for smaller companies. (*Id.,* p. 48) Of the 63 publicly-traded electric utilities followed by Value Line, Empire is one of the three smallest.

In contrast to Dr. Vander Weide, Staff used a "mix and match" approach to the CAPM that renders its analysis of little value. For example, although Staff used data from Ibbotson Associates (which is based on 20-year Treasury bonds) to calculate its

risk premium, Staff applied that premium to a risk-free rate based on 30-year Treasury bonds. This violates the fundamental principle that if a risk premium is to be calculated based on 20-year bonds that premium must then be added to a risk-free rate that is based on 20-year bonds. Staff's witness Murray further corrupts his CAPM result by: 1) using an average beta for a small proxy group, that is significantly lower than the average beta for the Value Line electric utilities; 2) using Ibbotson Associate's geometric mean risk premium rather than their recommended higher arithmetic mean risk premium in two of its three CAPM analyses; and 3) using an extremely brief, recent time period (1996-2005) to calculate the risk premium in one of his CAPM applications. Had Staff used appropriate data for its CAPM analysis, Staff would have estimated a cost of equity for its proxy group of 12.2 percent. (See Exhibit 3, pp. 19-24)

OPC witness King's application of the CAPM is similarly flawed. For example, its estimate of the risk-free rate component of the CAPM understates analysts' predictions for the risk-free rate for the period in which Empire's rates will be in effect; and its estimate of the beta component of the CAPM is significantly lower than the average Value Line beta for electric utilities. (*Id.,* p. 33) In addition, OPC's lower estimates of beta result from its use of betas that fail to adjust for the well-known tendency of betas to move toward the overall mean beta of 1.0 over time. Had it used appropriate data from reliable sources, OPC would have estimated a cost of equity of 12.2 percent for its proxy group. (*Id.,* p. 41)

G. Staff's "Tests of Reasonableness"

Staff attempts to bolster the reasonableness of its low recommended return by citing: 1) the weighted average cost of capital used by UBS Investment Bank in a

presentation to Empire's Board regarding the purchase of Missouri Gas; and 2) the assumed return on pension assets used by Empire's actuaries at Towers Perrin to determine Empire's pension costs. (Exhibit 52NP, pp. 23 – 26) As Dr. Vander Weide explains, neither the UBS discount rate nor the Towers Perrin assumed return on pension assets support Staff's low cost of equity recommendation. (Exhibit 4, pp. 11-20)

With regard to the UBS weighted average cost of capital, Dr. Vander Weide notes first that the UBS weighted average cost of capital is not directly comparable to the weighted average cost of capital in this proceeding because the UBS cost of capital calculates debt costs on an after-tax basis, whereas the cost of capital in this proceeding calculates debt costs on a before-tax basis. Second, in its calculation of the Missouri Gas cost of capital, UBS used an average cost of equity equal to 11.13 percent, which is much closer to Dr. Vander Weide's estimated cost of equity of 11.7 percent than to Staff's estimated cost of equity of 9.5 percent to 9.6 percent. Third, taking into account the 100-basis point increase in long-term interest rates and the 11-basis-point increase in electric utility betas since the time of the UBS analysis, an updated analysis using the UBS method would produce an average cost of equity equal to 12.84 percent.

With regard to the Towers Perrin 8.5 percent expected return on pension assets, Dr. Vander Weide explains first that the Towers Perrin expected return is similar to a weighted average cost of capital, not a cost of equity, because Empire's pension plan assets include both stocks and bonds. Second, it is common for actuaries to use highly conservative estimates of the expected return on pension plan assets to estimate the

proper funding for a company's pension plan in order to protect the company's employees. Third, Towers Perrin estimated a return on the Russell 2000 stock index in the range 11.6 percent to 12.0 percent. This return is informative with respect to Empire's cost of equity because it includes returns on small capitalization stocks such as Empire, whereas the return on the S&P 500 only includes returns on large capitalization stocks.

In summary, the UBS and Towers Perrin analyses cited by Staff support Dr. Vander Weide's cost of equity recommendation in this proceeding, not Staff's or OPC's.

H. Financial Risk Adjustment

Staff witness Mark L. Oligschlaeger filed testimony regarding Staff's objection to Dr. Vander Weide's financial risk adjustment. As noted above, Dr. Vander Weide's financial risk adjustment is designed to the estimated cost of equity to reflect the difference between the financial risk of the proxy companies and the financial risk implied by Empire's recommended capital structure. In its rebuttal testimony, Staff argued that a financial risk adjustment should be rejected because: 1) it would force ratepayers to pay higher rates whenever the market value of equity in the proxy companies increases; 2) is inconsistent with the Commission policy of protecting ratepayers from the risks of fluctuations in market values; and 3) would force ratepayers to bear the risk of fluctuations in market values but not experience gains when market values increased. (Exhibit 56, pp. 6-13)

Dr. Vander Weide demonstrated that Staff's arguments regarding the financial risk adjustment are simply incorrect. (Vander Weide surrebuttal pp. 20 – 24) Specifically, Staff's first argument fails to recognize that the estimated cost of equity for

the proxy companies *declines* whenever the percentage of equity in the market value capital structure increases. Taken by itself, this lowering of the cost of equity for the proxy companies arising from increases in the market value of equity reduces the revenue streams provided by the target utility's customers, rather than increasing them, as Staff asserts. Dr. Vander Weide's financial risk adjustment is required to bring the cost of equity back to the level it would have been prior to the increase in the average market value of the proxy companies' stock. Thus, contrary to Staff's conclusion, Dr. Vander Weide's financial risk adjustment holds ratepayers harmless for the risk of increases and decreases in the market values of my proxy companies' stock.

Staff's second argument fails to recognize that an increase in the market value of equity for the proxy companies lowers the estimated cost of equity for these companies because of their reduced financial risk, while reductions in the market value of equity for the proxy companies increases the estimated cost of equity because of increases in their financial risk. Thus, without a financial risk adjustment, contrary to Staff's assertion, ratepayers bear the full risk of fluctuations in market values.

With regard to Staff's third argument, Dr. Vander Weide notes that his financial risk adjustment would actually protect ratepayers from bearing the risk of fluctuations in the market values of the proxy companies' equity. The purpose of the financial risk adjustment is to make the estimated cost of equity reflect the financial risk in Empire's recommended capital structure. Since Empire's recommended capital structure is based on book values of equity that do not change when market values of equity change, and his adjusted cost of equity now reflects the risks of Empire's recommended capital structure, Dr. Vander Weide's financial risk adjustment protects ratepayers from the

risks of fluctuations in the market values of the proxy companies' equity.

I. The Fair Rate of Return on Equity for Empire

Based on the results of his DCF, RPM, and CAPM analyses, Dr. Vander Weide estimated the average cost of equity for his comparable companies to be 11.3 percent. (*Id.,* p. 49)[13] He believes, however, that the cost of equity for the comparable company group understates investors' expected or required returns for an investment in Empire because the financial risk of Empire's recommended capital structure is greater than the financial risk of the comparable companies and Empire has a lower bond rating than the average bond rating for the comparable group. To adjust for the increased financial risk that is implied by Empire's more highly leveraged capital structure, Dr. Vander Weide estimates that Empire's true cost of equity is 11.7 percent. (*Id.,* p. 53) The Commission should note, however, that this estimate assumed that Empire would be authorized in this case to implement a fuel and purchased power cost recovery mechanism, which the majority of the companies in the proxy group already have in place. If that does not occur, Dr. Vander Weide testified that his recommendation will need to be increased by 25-30 basis points to accurately reflect Empire's increased risk profile relative to the proxy group. (Transcript, p 370)

Staff estimates Empire's cost of equity to be within a range of 9.5-9.6 percent. The Commission should reject Staff's low cost of equity recommendation because it is inappropriately based on: 1) too small a sample of proxy companies, 2) incorrect estimates of the proxy companies' dividends, 3) incorrect estimates of the risk-free rate,

[13] At the request of the Commission, Dr. Vander Weide updated the DCF results for his proxy group of comparable companies; updated his cost of equity estimates using the DCF, both versions of his CAPM, and both versions of his RPM; and calculated two DCF averages that were requested by the Commission, one excluding the three highest results from his proxy group and another excluding both the three highest and three lowest results. The results of these calculations are shown on Exhibit 97.

and 4) incorrect estimates of the risk premium on the market portfolio. In addition, Staff's 20-basis point adjustment to its cost of equity result to reflect Empire's greater risk is based entirely on Staff's judgment rather than on a methodical analysis. As Dr. Vander Weide demonstrated, a methodical analysis of the proper adjustment for Empire's greater financial risk alone would produce at least a 40-basis point upward adjustment to cost of equity results.

OPC witness King estimates Empire's cost of equity at 9.65 percent. Like Staff, OPC makes numerous errors in its applications of the DCF and CAPM methodologies that result in estimates of the cost of equity for both its proxy group and Empire that are well below what the models would have produced had they been properly utilized. OPC also used a group of comparable companies that was both too small to produce reliable results and that was composed of companies that appear to have been selected to achieve a predetermined result.[14]

Of the three witnesses who presented testimony in this case, only Dr. Vander Weide's recommendations provide meaningful and reliable insights into the rate of return investors require to make equity investments in companies whose risk profiles are comparable to Empire's. Dr. Vander Weide, alone, has performed the sort of risk-based, comparative analysis that was endorsed by the Commission in the Company's last rate case – the kind of analysis that can produce a rate of return that meets the standards of *Bluefield* and *Hope*: that the rate of return be fair and reasonable, compared to other companies of similar risk, and that it be sufficient to assure continued access to capital at reasonable rates. Dr. Vander Weide's recommended return on

[14] Under cross examination, it became clear that Mr. King did not properly or consistently apply his own criteria in selecting companies for his proxy group. See Transcript, pp. 1140-1144.

equity should, therefore, be adopted for ratemaking purposes.

2. Capital Structure

In the true-up direct testimony of Mark L. Oligschlaeger, Staff proposed using Empire's actual capital structure as of June 30, 2006, consisting of 50.80 percent common equity, 5.39 percent trust preferred stock, and 43.81 percent long-term debt. Empire agrees with Staff's proposal.

3. Off-System Sales

Due to variables such as weather, plant outages, and other factors beyond Empire's control, revenues derived from off-system sales fluctuate substantially from year to year. In addition to the off-system sales revenues themselves, the makeup of the supply resources used to generate electricity sold off-system also fluctuates from year to year, often dramatically. For example, a majority of Empire's off-system sales during 2001 involved the purchase and resale of hydroelectric power. By contrast, hydroelectric power accounted for less than twenty percent of the Company's off-system sales in 2006. (Exhibit 22NP, p. 3) To smooth out the effects of these fluctuations, Empire recommends that the amount of off-system sales revenues that is used to determine the Company's revenue requirement be based on an average of off-system sales activity for the past five years. This is the same methodology that the Commission used in the Company's last rate case. The average, however, should be based on normalized sales activity, which will require the Commission to exclude the effects of off-system sales sourced to a non-recurring purchased power transaction between Empire and AEP that occurred during a thirteen month period beginning June 1, 2002 and ending June 30, 2003. (*Id.*) If the Commission fails to exclude the effects of

this transaction, the resulting average will not reasonably reflect the amount of off-system sales that will likely occur during the period rates set in this case are in effect.

The wide fluctuations in Empire's total off-system sales for the years 2001–2006 are graphically depicted on Schedule WSK-4 of Exhibit 22HC. During that period, sales ranged from a low of approximately **_______** Mwh in 2001 to more than **_______** in 2002. Similar fluctuations for off-system sales by resource, off-system revenues by resource, off-system sales gross profit, and average gross profit per unit of off-system sales by power source are also graphically depicted on Schedules WSK-1, WSK-2, WSK-3, and WSK-5 of Exhibit 22HC, respectively. These schedules clearly show that the various characteristics of the Company's off-system sales for any one year could not accurately have been predicted based on the preceding years results. Had such a prediction been attempted, *it would have been wrong every time.*

Data submitted by both the OPC and the Staff support Empire's position that because of wide, year-to-year fluctuations it would be unreasonable to attempt to estimate future sales based on actual sales during the test period. Schedule RCS-R1, which accompanied the rebuttal testimony of the OPC's witness Ralph C. Smith (Exhibit 82), shows data for off-system sales margins for Empire on a calendar year basis for each year 2001 through 2005. During cross-examination, Mr. Smith calculated fluctuations for that period that ranged from an increase of more than 500 percent from 2001-2002 to a decrease of more than 44 percent from 2003-2004. (Transcript, pp. 669-670). When he was asked to make the same calculations for data shown on Schedule RCS-R2, which depicts annual off-system sales from April 1 through March 31 for each year 2002 through 2006, the fluctuations ranged from an increase of nearly 500 percent

from 2002-2003 to a decrease of almost 60 percent from 2003-2004. (Transcript, at pp. 670-671). Staff's witness, Janis E. Fischer, also sponsored a schedule showing annual off-system sales margins for various periods from 2001 through 2006. (Exhibit 40HC, Schedule 1-HC). When asked to make the same types of calculations as Mr. Smith, Ms. Fischer also calculated wild fluctuations that included one-year increases of more than 500 percent and decreases of almost 60 percent. (Transcript, pp. 1082-1086).

But just as it would be unreasonable to try to predict future off-season sales margins based on the sales margin achieved during the preceding year, it would be equally unreasonable to do so based on a five-year average that is not normalized to exclude the effects of any abnormal, non-recurring transactions. That is why Empire also proposes to eliminate the effects of a non-recurring, short-term energy purchase that the Company made from AEP during the thirteen month period from June 1, 2002, through June 30, 2003. Of the more than 1.2 million Mwh of power that Empire purchased from AEP during that period, almost 700,000 Mwh, or approximately 57 percent, was sold off-system. (Exhibit 21HC, p. 12) The AEP transaction also had a very significant effect on Empire's off-system sales profit margin. For 2002, the transaction accounted for **__________** percent of the Company's gross profit and in 2003 **____________** percent. (*Id.,* p. 14) Predictably, after the AEP contract expired, Empire's gross profit contribution from the resale of power purchased on the open market declined sharply.[15] (*Id.*)

Following the expiration of the AEP contract, no similar arrangement has replaced it or is contemplated to replace it in the future. (*Id.,* p. 15) If the Commission

[15] The Commission should note that the net margin amounts recorded during the period the AEP agreement was in effect were overstated because the capacity costs associated with the purchases from AEP were not included in the net margin calculation.

does not exclude from the data used to calculate a five-year average of off-system sales margins the sales related to the AEP contract, the resulting average will likely overstate the margins that Empire will receive from those types of sales in the future. This will artificially reduce the Company's revenue requirement and will cause the rates set in this case to be less than fully compensatory.

OPC's witness Smith, who supports the use of a five-year average but opposes the normalization adjustment, justifies his position by the fact that his five-year average closely approximates the amount actually booked during the test year. (Transcript, p.673) But that coincidence is of no probative value in light of the wide fluctuations in off-system sales margins that have occurred from one year to the next. Just as it would be folly for the Commission to attempt to estimate off-system sales margins based on the actual results for the previous year, it would be equally unreasonable to take comfort in an average that happened to be close to the actual data for any particular year. As shown above, if Mr. Smith had compared the results of his average to any year during the past five years other than the test year, he would have been assured neither of the legitimacy of his method nor the accuracy of his result.[16]

Empire's proposal to estimate future sales margins from off-system sales based on a normalized average of sales margins recorded during the past five years is the most reasonable method that has been proposed in this case. There is no basis in fact

[16] In evaluating Staff's proposed methodology, the Commission should also take care not be swayed by the graphs that Ms. Fisher attached to her rebuttal testimony that purport to validate using one year's off-system sales margins to predict the next year's. (Exhibit 40HC, Schedule 2). By using a short vertical axis for her graphs, Ms. Fisher distorts the year-to-year differences for each of the data sets she presents. For example, while the line on the graph depicting off-system sales revenue appears to be nearly straight for the period January 2003 through January 2005 – indicating minimal fluctuations – the annual changes in off-system sales during that period sometimes exceed 100%. Similar distortions can be seen in the graphs that depict off-system sales costs and off-system sales margins. If, therefore, the Commission seeks to utilize these graphs in its analysis of this issue, it should focus on the data points themselves and not on the lines that connect them.

or reason to adopt Staff's proposal, and although the OPC is correct about the need for a five-year average it is incorrect that the Commission need not normalize the data before that average is calculated. Empire's method is the best option available to estimate the amounts of off-system sales margins the Company is likely to achieve during the period rates set in this case are in effect, and the Commission should adopt the proposal for that reason.

4. REGULATORY PLAN AMORTIZATION

The Stipulation and Agreement in Case No. EO-2005-0263 provides for certain amortization amounts designed to "provide Empire the opportunity to maintain its debt at investment grade rating during the period of the [subject] construction expenditures." *In the Matter of the Empire District Electric Company*, Stipulation and Agreement, Case No. 2005-0263, p. 11. The amortization is designed to satisfy two of the three financial ratio targets utilized by rating agencies. (*Id.*, p. 12) The amortization provided for by the Commission's Order and the underlying Stipulation and Agreement in Case No. EO-2005-0263 should not be considered a substitute for timely recovery of prudent fuel and purchased power costs nor for recovery of an appropriate level of return on Empire's investment. (Exhibit 7, p. 2) These issues should be determined on their own merits.

The Industrial Intervenors, Staff, and OPC all appear to agree that this is the approach the Commission should take to this issue. Industrial Intervenors' witness, Mr. Brubaker, agreed that the regulatory plan should not be viewed as a replacement for timely recovery of prudently incurred fuel and purchased power expense, and stated that it was instead a "'safety net' designed to provide Empire with sufficient cash flow and credit metrics in the event that strict application of traditional ratemaking principles

is insufficient to achieve these results." (Exhibit 86, p. 6) Counsel for OPC and the Staff both agreed at hearing that in considering this case the Commission should first determine revenue requirement in the traditional manner and then calculate any necessary amortization thereafter. (Transcript, p. 568)

Empire believes that if the Commission should use Empire's return on equity and its proposed treatment of other costs, such as fuel and purchased power, additional amortization will not be necessary. (Transcript, p. 599) However, if, after the Commission makes its decision as to those issues, and the others presented in this case, the calculations found in Case No. EO-2005-0263 call for an amortization, Empire believes the amortization should be granted. (Transcript, p. 594)

As for the calculation itself, Empire agrees generally with the calculations performed by Staff witness Mark Oligschlaeger in regard to the amortization as presented in the True-Up Testimony of Mark L. Oligschlaeger. (Exhibit ___, Oligschlaeger True-Up, Schedules 3 and 4) The amortization, of course, continues to be a bit of a moving target as the Commission's decisions in this case as to other issues will first determine whether or not an amortization is called for by the Case No. EO-2005-0263 stipulation and, if it is, have an impact on the amortization itself. (*See* Transcript pp. 622-623)

OPC witness Ted Robertson also performed an amortization calculation in this case. Empire specifically disputes two adjustments made by Mr. Robertson (Plum Point and Off-Balance Sheet Obligations – Risk Factor) and will address a third issue raised at the hearing (Elk River Wind Farm).

A. Plum Point

First, as a result of inaccurate information provided by the Company that has since been corrected, Mr. Robertson did not include Empire's Plum Point agreement in his initial calculations because he believed that it was executed outside the update period. (Transcript, p. 633) Empire believes that this agreement was executed within the update period and should have been included. Mr. Robertson agreed during cross examination that Plum Point should have been included (Transcript, p. 633) Furthermore, Mr. Robertson included the impact of the Plum Point agreement in the OPC amortization calculation found in its true-up testimony. (Exhibit __, Robertson True-Up p. 2)

B. Off-Balance Sheet Obligations - Risk Factor

Second, OPC witness, Mr. Robertson, applies a risk factor of 10% to Empire's off-balance sheet obligations. (Exhibit 80, p. 8) Empire believes that it is important to utilize a methodology that mimics the rating agency methodology, to the greatest extent possible, in order to work toward the purpose of the regulatory amortization.

Mr. Robertson alleges that his use of the 10 percent risk factor is "based on Standard & Poor's methodology for calculating debt-equivalent values." (Exhibit 80, p. 8) The impact of utilizing a lower risk factor, all other things being equal, is to lower the ultimate amortization that would be called for by Case No. EO-2005-0263. (Transcript, p. 635)

Mr. Robertson's use of the 10 percent figure does not track the S&P methodology as his approach misconstrues the risk that is being measured. Mr.

Robertson focuses on the risk that Empire will ultimately default on the subject obligations or, as he states, what he believes "are the actual risks of default or non-payment associated with the contracts." (Exhibit 80, p. 8) This is not the risk that is being measured by Standard & Poor's. Standard & Poor's is measuring the risk that Empire will not receive recovery of these expenditures in rates. (Transcript, pp. 608-609; Exhibit 109)

Standard & Poor's states that "as a generic guideline for utilities with [power purchase agreements] included as an operating expense in base tariffs, Standard & Poor's believes that a 50% risk factor is appropriate for long-term commitments (e.g. tenors greater than three years). This risk factor assumes adequate regulatory treatment, including recognition of the PPA in tariffs; otherwise a higher risk factor could be adopted to indicate greater risk of recovery. . . . Furthermore, Standard & Poor's will take counterparty risk into account when considering the risk factor. If a utility relies on any individual seller for a material portion of its energy needs, the risk of non-delivery will be assessed." (emphasis added)(Exhibit 109, p. 2)

> Standard & Poor's further has described the proper risk factor as follows: Standard & Poor's continues to view the recovery of purchased-power costs via a fuel adjustment clause, as opposed to base tariffs, as a material risk mitigant. A monthly or quarterly adjustment mechanism would ensure dollar-for-dollar recovery of fixed payments without having to receive approval from regulators for changes in fuel costs. This is superior to base tariff treatment, where variations in volume sales could result in under-recovery of demand is sluggish or contracting. For utilities in supportive regulatory jurisdictions with a precedent for timely and full cost recovery of fuel and purchased-power costs, a risk factor of as low as 30% could be used. In certain cases, Standard & Poor's may consider a lower risk factor of 10% to 20% for distribution utilities where recovery of certain costs, including stranded assets has been legislated.

Id. (emphasis added).

Thus, if a risk factor must be applied, the use of a 30 percent risk factor already reflects a lower than normal risk. Until such time as Empire is able to make use of a fuel adjustment clause, there is certainly no basis to utilize the 10 percent risk factor suggested by the OPC.

It should be remembered, however, that it is not necessary to utilize any specific risk factor in this calculation. Staff avoided this question by utilizing the total quantification of the off-balance sheet obligations used by Standard & Poor's. (Transcript, p. 625) The risk factor discussed above is an element of the data used by Mr. Oligschlaeger. (*Id.*, pp. 625-626) However, by using the off-balance sheet composite, Staff was not required to make a separate assessment of the proper risk factor. The figure used by Mr. Oligschlaeger is found at Schedule 3 of his Supplemental Direct testimony (Exhibit 55) as well as in his true-up testimony.

C. Elk River Wind Farm

Lastly, OPC witness Mr. Robertson suggested that Empire's Elk River Wind Farm agreement should be treated as a purchased power agreement for purposes of the amortization calculation, rather than as an operating lease as OPC believes that it was initially treated by Standard and Poor's. Based on the Company's understanding, Empire agrees with OPC that the Elk River Wind Farm agreement should be treated as a purchased power agreement. Empire further believes that it is so treated (i.e. as a purchased power agreement) by the Staff calculation of the amortization.

D. Income Tax Gross-Up

If an amortization is believed to be necessary, in addition to the amortization amount, the Commission should also include in Empire's revenue requirement a gross-

up to take into account the impact income taxes will have on Empire's cash flow. This possibility was contemplated by the parties in the Stipulation and Agreement in Case No. EO-2005-0263, as it was stated that "additional taxes will be added to the amortization to the extent that the Commission finds such taxes to be appropriate." *In the Matter of the Empire District Electric Company*, Case No. 2005-0263, Stipulation and Agreement, p. 13.

There is a difference between book depreciation, as determined by the Commission, and the tax depreciation allowed by the IRS as a deduction for income tax purposes. This difference often arises in rate cases in the form of "deferred income taxes," as well as other matters. This Commission has described deferred taxes as "an artifact of the differing treatment accorded depreciation for federal income tax purposes as opposed to regulatory purposes. [Utility] rates are calculated using straight-line depreciation, while taxes are paid using accelerated depreciation." *In the Matter of Missouri-American Water Company*, Case No. WR-2000-281, Report and Order, (August 31, 2000).

The bottom line is that increasing book depreciation will not increase tax depreciation. (*See* Exhibit 14, p. 4) "Any change in book depreciation unrelated to a change in plant in service, such as the regulatory amortization, has no influence on tax depreciation because tax basis of the assets being depreciated for income tax purposes does not change." (*Id.*)

Because the regulatory amortization (or book depreciation) is not tax deductible, it needs to be increased to reflect the additional income taxes that are due and payable if the desired level of funds from operation (FFO or, more generally, cash flow) is to be

attained. (*Id.*) "If the amount of revenue requirement is determined in this case by erroneously assuming the regulatory amortization is tax deductible, the FFO will be provided at only the net of tax amount, slightly over 60% of the indicated FFO requirement" and the regulatory plan will fail to provide the targeted cash flow. (*Id.*, p. 6)

In its true-up testimony, the Staff has included additional book depreciation in order "to address the full cash flow requirements of the credit rating agency metrics." (Exhibit __, Oligschlaeger True-Up, p. 13) "The net result of the Staff's proposed increase in book depreciation recovery through the Regulatory Plan amortization mechanism addresses the agreement to provide Empire the opportunity to obtain the necessary after-tax cash flow required to meet the two Regulatory Plan credit metrics." (*Id.*, p. 14)

The OPC's true-up testimony also reflects the addition of additional book depreciation in order to address the tax/cash flow impacts of the necessary amortization. OPC witness, Mr. Trippensee, states that "OPC expects the [Staff's] calculation to reflect an increase in the amortization to recognize the decreased cash flow available due to reduction of deferred income tax expense resulting from the treatment of the amortization as additional book depreciation expense." (Exhibit __, Trippensee True-Up, p. 2) Mr. Trippensee goes on to state that "[t]his reduction in cash flow creates a need for additional amortization (to be treated as additional book depreciation expense) in order to provide sufficient cash flow to meet the financial metrics set out in the Regulatory Plan." (*Id.*)

It appears that Staff and the OPC both now agree that tax impacts must be taken into account in determining the appropriate level of regulatory amortization.

E. True-Up

One issue related to amortization is presented by the true-up testimony in this case. On June 1, 2006, The Empire District Gas Company (EDG) acquired the Missouri natural gas distribution assets of Aquila, Inc. Because the case is being trued-up through June 30, 2006, Staff and the OPC have proposed methods to "ensure that Empire's debt associated with its new gas and existing non-regulated operations is not included in the calculation of an amortization intended to cover only Empire's Missouri jurisdictional electric operations." (Exhibit __, Oligschlaeger True-Up, p. 12)

Empire agrees that the calculated amount of any Regulatory Plan amortization during the remainder of Empire's Regulatory Plan should reflect an allocation of Empire's total company capital structure to its Missouri jurisdictional retail electric operations. Empire takes no position at this point in time as to whether the Staff's or the OPC's method should be used in this case for that purpose.

5. FUEL AND PURCHASED POWER EXPENSE

A. Background

For Empire, fuel and purchased power is the largest expense category in the Company's overall cost of service, accounting for almost fifty percent of total expenses during the test year. (Exhibit 15, p. 2)

What is at issue here can be stated very simply. It is the natural gas price to be used in calculating the fuel and purchased power expense. Unfortunately, natural gas price is something Empire believes cannot be predicted with any degree of certainty. (Exhibit 18, p. 2) Staff is likewise pessimistic in regard to prospects of accurately predicting natural gas prices. Staff witness Choe stated that "we cannot predict, with

any certainty, what the future of the natural gas market will bring, and therefore, it is difficult to plan ahead for this market." (Exhibit 69, p. 4) Staff witness Busch similarly stated that ". . . the only certainty about forecasting either natural gas prices or purchased power prices is that the forecast will be wrong since a number of the significant factors (e.g. weather and natural disasters) cannot be forecasted with a reasonable level of certainty." (Exhibit 61, p. 3)

This being said, determining a natural gas price is currently a necessary part of setting a just and reasonable rate for Empire. A portion of that process does involve pricing information that is known and measurable. The price of natural gas that Empire has purchased through its hedging program can be determined as of any given date. Evidence exists in this case identifying the price of natural gas Empire has hedged, and the percentage of projected needs, as of March 31, 2006; June 30, 2006; July 10, 2006; and, September of 2006.

The spot gas price (i.e. the price that will be paid to purchase gas beyond the hedge gas) is much less certain in terms of the price to be paid. Similarly, the quantity of natural gas that will ultimately be needed to address Empire's needs is also less than certain. The parties have utilized several approaches to address these questions.

B. Production Cost Models – Empire and Staff

In arriving at its recommendation for the appropriate level of on-system fuel and purchased power expense, Empire used a sophisticated computer modeling system, known as PROSYM. (Exhibit 15, p. 17) This model is used by more than 100 energy companies worldwide to estimate their production costs. (*Id.*) It recommends the optimal dispatch of resources on an hourly basis based on a wide variety of data,

including fuel costs, unit start-up costs, and variable operating and maintenance costs. (*Id.*) It is a chronological production costing model that Empire has used for many years to estimate fuel and purchased power costs.

Staff used a similar computing modeling system - the RealTime production cost model -- to derive its recommendation as to on-system fuel and purchased power expense.(Exhibit 37, p. 2) This model performed an "hour-by-hour, chronological simulation" of Empire's generation and power purchases. (*Id.*, p. 3)

The results of the Staff and Empire model runs are extremely close except for the natural gas price.

The reconciliation in this case identified the difference between the Empire and Staff recommendations on a Missouri jurisdictional basis to be a total of $4,465,088 (setting aside the unwinding issue – Issue 7 *infra*) on an expense item that Empire believed at the time to be worth $166,012,277 on a total company basis. (Exhibit 17, p. 2) The identified difference is primarily due to variations in the weighted cost of natural gas used by Empire and Staff.

The true-up testimony of Staff witness Mark Oligschlaeger reflected that as of the true-up, Staff's recommended level of fuel and purchased power variable costs had risen an additional $2,560,951, thereby further narrowing the gap between Staff and Empire. (Exhibit __, Oligschlaeger True-Up, p. 3) Empire believes that the Missouri jurisdictional difference between the Company and Staff after true-up is approximately $3 million, excluding the unwinding issue that is addressed elsewhere. (Exhibit __, Keith True-Up, pp. 9-10)

The Staff's true-up testimony reflects a weighted natural gas cost of **____** per

MMBtu, as opposed to the **_____** weighted cost reflected in Staff's Surrebuttal testimony. (*Id.*, p. 4; Exhibit 41, Schedule 12) The Staff true-up calculation includes Empire's actual hedge gas cost of **______** per MMBtu, as of June 30, 2006, while assuming a higher percentage of hedged gas than was actually in place as of that date. (Exhibit __, Oligschlaeger True-Up, p. 4)

The weighted cost of gas utilized by Empire was **_____** per MMBtu. (Exhibit 17, p. 3; Transcript, p. 720) This figure included Empire's actual hedge price as of July 10, 2006, for 2007 natural gas of **______** per MMBtu, and utilizes the percentage of the hedged gas actually under contract as of that date. (Exhibit 16, p. 5)

C. OPC and the Industrial Intervenors

Neither the OPC nor the Industrial Intervenors used a model to estimate on-system fuel and purchased power expenses. However, a fuel model run was performed for the OPC prior to true-up utilizing the OPC's approach to natural gas prices. (Transcript, p. 691; Exhibit 111) The result of this run (using gas prices available as of March 31, 2006) was similar to the Staff and Empire recommendation. In fact, the costs in the OPC run essentially split the difference between Staff and Empire, producing a total Company fuel and purchased power cost of $164,804,530. (Transcript, p. 699) The weighted gas cost using OPC's pricing method was **_____** per MMBtu. (Transcript, p. 727; Exhibit 111)

The Industrial Intervenors attempted to predict future costs of spot natural gas using a mixture of historical prices and future prices. This resulted in a spot gas price that was approximately $1.70 less than the price used by Empire and the Staff and approximately $1.20 less than the spot gas price used by OPC as of the evidentiary

hearing. After true-up, the Industrial Intervenors' spot price is approximately $1.90 less than Empire's price, $2.04 less than Staff's price and $1.30 less than OPC's price.

The Missouri jurisdictional difference between Empire and the Industrial Intervenors (setting aside the unwinding issue) was $5.844 million at the time Industrial witness Brubaker filed his Surrebuttal Testimony. (Exhibit 88, Schedule 4) This difference between Empire and the Industrials had grown to $6.297 million by the time of true-up. (Exhibit __, Brubaker True-Up, Schedule 2)

As stated previously, the Industrial Intervenors' witness did not use a production cost model. (Exhibit 17, p. 9) The Industrial Intervenors, instead, only adjusted Empire's normalized computer model simulation from February to reflect changes in the natural gas prices. (*Id.*) By taking this approach, Mr. Brubaker does not consider other key parameters, such as increasing sales levels, included in the models or the impacts of the change of natural gas prices on the dispatch of Empire's supply resources. (*Id.*)

D. Differences between Empire and Staff

The difference between Staff and Empire can be better defined by looking at the elements of the weighted cost of gas used by each. The weighted cost of gas in this situation is a combination of the hedged cost of gas and the spot price.

i. Spot Price

While there are differences between the parties as to how to arrive at the appropriate spot gas price, the evidence shows that there is virtually no difference between Empire and Staff as to the resulting price. (Transcript, p. 751) At the time of the evidentiary hearing, Staff's spot gas price was **______** per MMBtu, while Empire's suggested spot gas price was **______** per MMBtu. (Exhibit 41, Schedule

12; Transcript, p. 747) Empire's spot gas price was derived using actual price quotes from July 10, 2006, for gas to be delivered in 2007. (Exhibit 18, p. 4) These actual quotes were used because Empire believed that they were the best proxy available for the non-hedged portion of Empire's natural gas requirements. (*Id.*, pp. 4-5)

The Staff's price was a "backward looking" price that utilized the weighted average of the actual natural gas spot purchases for a twelve month historical period. (Exhibit 17, p. 5) Using this approach incorporates the bias of actual weather in that period. (*Id.*) For example, January 2006, which was included in the historical period Staff considered, was one of the warmest Januarys of the past 75 years based on NOAA temperature data. (*Id.*) Typically, January is one of the coldest months of the year and represents one of Empire's higher natural gas requirement months and has some of the highest spot natural gas prices of the year. (*Id.*, pp. 5-6) In January 2006, Empire did not purchase any spot natural gas. (*Id.*, p. 6) Thus, the Staff method necessarily omits a set of prices that are normally some of Empire's highest. (*Id.*)

In the rebuttal testimony of its witness, Ralph Smith, OPC recommended using a combination of actual spot prices for the period of January – March 2006 and NYMEX futures prices (with an appropriate basis adjustment) for the period of April 2006 through December 2006. (Exhibit 18, p. 6) By using actual spot prices for January 2006, OPC's method has the same flaw as Staff. That is, it inappropriately weights an out of the ordinary January where Empire had no spot gas purchases. (*Id.*, p. 8)

As mentioned previously, the OPC later had a model run performed that resulted in a total fuel cost of $164,804,430, and a weighted gas price of **_____**. This run was based on future gas prices for the 12-months ending March 2007. The OPC's spot gas

price was **______** per MMBtu. (Exhibit 111)

ii. Hedge Price

The difference between the Staff's and Empire's weighted gas cost is actually based upon two items related to the hedge price. Staff derives its hedge price by using the actual hedge prices for periods in both 2006 and 2007. At the time of the evidentiary hearing, Staff was using the period April 2006 through December 2007. (Transcript, p. 751) A portion of these hedges – those from April 2006 through December 2006 -- would not be applicable to the period when rates will be in effect. (Transcript, p. 752) Further, the use of a 21-month period (rather than 12 or 24) weights certain parts of the year more heavily than others. (*Id.*)

Empire's hedge price was a known number related to the period of time when these rates will likely be in effect. Empire used the actual hedge price for hedges covering the period January 2007 through December of 2007, as they existed as of July 10, 2006. (Transcript, p. 752)

For purposes of its true-up testimony, Staff subsequently updated its hedge price to reflect an actual number as of June 30, 2006. However, Staff's approach continues to have the flaw described above. That is its price continues to include hedge costs for gas to be delivered in 2006, a period of time when the rates resulting from this case will not be in effect.

Once a hedge price and spot price are determined, a decision still must be made as to what extent each will apply to the gas to be burned. If the hedge price is lower than the spot price, applying a higher percentage of the gas to be burned to the hedge price will necessarily lower the weighted cost of gas.

The Staff hedge price at the time of the evidentiary hearing (in addition to including gas to be burned in 2006) was determined at a point in time when Empire had approximately **__** percent of its needs hedged for the period considered by the Staff (April 2006 – December 2007) and only **__** percent of its expected natural gas needs for calendar year 2007 were hedged at that time. (Exhibit 17, pp. 6, 11) However, Staff assumed that 80 percent of Empire's needs could be covered at an identical hedge price in deriving its weighted cost of gas. (Transcript, p. 755)

Thus, Staff necessarily assumed, for purposes of its estimate, that Empire could hedge 80 percent of its 2007 natural gas needs at the same price that Empire had hedged gas for the period April 2006 through December 2007, as of March 31, 2006. This assumption served to more heavily weight Staff's hedge price with historical hedge prices that are no longer available to the Company and further lowered Staff's weighted average natural gas price.

A certain amount of this inconsistency continues to exist in Staff's true-up position even with the benefit of the passage of time. Staff has trued up its hedge gas costs through June 30, 2006. This served to increase the hedge price used by the Staff. However, at that point in time, Empire still only had less than **__** percent of its 2007 needs hedged. (Exhibit 17, p. 11) In spite of this, Staff's true-up fuel costs still include an invalid assumption: that Empire would be able to increase its hedge position to 80% of its 2007 gas needs at the actual average hedge cost that existed as of June 30, 2006.

This is an assumption that we already know to be false. As of September 2006, Empire had increased its hedge position to a point where approximately **__** percent

of its needs for 2007 had been purchased. (Transcript, pp. 723-25) However, doing so had increased the actual cost of its hedge gas to **______** per MMBtu, a higher price than the **______** hedge price that was included in Staff's true-up. (Transcript, p. 728)

It is important that at whatever time an actual hedge price is selected, the Commission also utilize the actual percentage of gas hedged at that point in time. Otherwise, a mismatch is created in the calculation of the weighted cost of gas.

iii. Quantification of Empire and Staff Differences

Staff witness Fischer attempted to quantify the weighted gas cost difference between Staff and Empire in her Surrebuttal Testimony. At that time, there was a $.54 difference between Staff's weighted gas cost of **_____** and Empire's weighted gas cost of **_____**. The $.54 per MMBtu differential multiplied by roughly 10 million MMBtu of natural gas to be consumed accounted for the roughly $5.4 million difference between the parties on a total company basis.[17] (Exhibit 17, p. 13)

Ms. Fischer's calculations indicated that approximately $.36 of that difference was due to Staff's assumption that 80 percent of Empire's gas requirements could be hedged at the hedge price that existed for April 2006- December 2007 hedge gas. (Exhibit 41, Schedule 12; Transcript, pp. 749-750) Ms. Fischer further determined that approximately $.18 of the difference was due to the difference between the hedge gas prices used by Staff and Empire. (*Id.*)

iv. Summary of Positions

The parties' current positions as to the appropriate natural gas price to be used in calculating Empire's fuel and purchased power expense may be summarized as follows:

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[17] Applying the Missouri electric allocation factor to this total company difference results in the $4,465,088 difference identified on the reconciliation.

PARTY	SPOT PRICE	HEDGE PRICE	HEDGE PERCENTAGE	WEIGHTED COST OF GAS
EMPIRE PROPOSAL	** ______ **	** ______ ** – Actual as of July 10, 2006	** ___ ** Actual as of July 10, 2006	** ______ **
STAFF – TRUE-UP TESTIMONY	** ______ **	** ______ ** – Actual as of June 30, 2006, for period July 2006 – December 2007	80% Assumed (less than ** ___ ** actual)	** ______ **
OPC	** ______ **	** ______ **	** ___ **	
INDUSTRIAL INTERVENORS	** ______ **	** ______ **	** ______ **	** ______ **

6. Fuel and Purchased Power Expense Recovery Method

Empire currently recovers fuel and purchased power costs through a combination of base rates and an Interim Energy Charge ("IEC"). This method, however, has proven to be unsuccessful as it has failed to allow the Company to recover the full amounts of these ever-increasing costs. Since the inception of the current method, Empire's under recovery of its energy costs has exceeded $18 million. (Transcript, p. 934) There are several options available to rectify this problem. The Company's preferred method is to terminate the IEC and recover its fuel costs through base rates coupled with a fuel adjustment mechanism. A second option is to terminate the IEC and collect all energy costs through base rates. A third option, which was raised as a result of questions posed by the Commission during the hearing, is to modify the IEC so that it more accurately reflects and recovers the energy costs Empire is likely to incur during the period rates set in this case are in effect.

This brief will focus on only the second and third options. Empire's arguments in support of an energy cost recovery mechanism, however, can be found at pages 27-29 of the Company's pre-hearing brief, which are incorporated herein by reference.

In considering the arguments on this matter, the Commission should keep in mind that all parties have stipulated that Empire should be allowed to recover its prudently incurred fuel and purchased power costs.[18] This being the case, the only issue left for the Commission to decide would appear to be the method of recovery and the amount. Notwithstanding the concession of the parties, however, some continue to argue just the opposite -- that is Empire is "stuck" with its current level and method of fuel cost recovery. The Company will leave it to these parties to explain this obvious inconsistency.

A. Section 386.266, RSMo, Does Not Prohibit the Commission from Terminating or Modifying the Existing IEC

The Industrial Intervenors have argued that Section 386.266(8)[19] prohibits the Commission both from terminating the existing IEC[20] and from making changes to it.[21] Neither of these arguments has merit.

The statute on which the Industrial Intervenors rely did not take effect until January 1, 2006, while Empire's IEC was approved more than nine months before that date – in March 2005.[22] "Statutes are generally presumed to operate prospectively, 'unless the legislative intent that they be given retroactive operation clearly appears from the express language of the act or by necessary or unavoidable implication.'"

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[18] See Transcript, p. 567.

[19] All statutory citations are to the Missouri Revised Statues, RSMo.

[20] *Pre-Hearing Brief of Praxair, Inc. and Explorer Pipeline Company*, p. 7.

[21] *Response of Praxair/Explorer to Commission Notice Requiring Filing*, p. 1.

[22] See *Order Approving Tariff in Compliance with Commission Order*, Case No. ER-2004-0570 (March 21, 2005).

Dep't. of Soc. Servs. v. Villa Capri Homes, Inc, 684 S.W.2d 327, 332 (Mo. banc 1985) (quoting *Lincoln Credit Co. v. Peach*, 636 S.W.2d 31, 34 (Mo. banc 1982)). There is no language in Section 386.266 that suggests it is to be given retrospective application. In fact, just the opposite is true: subsection 12 of the statute specifically states that it is to take effect on January 1, 2006.

In addition, it is far from clear that Empire's current IEC is "an incentive-or performance-based plan" to which Section 386.266(8) applies. But even if it is, subsection 10 of the statute specifically states that "[n]othing contained in this section shall be construed as affecting any existing adjustment mechanism, rate schedule, tariff, incentive plan, or other ratemaking mechanism currently approved and in effect."

The provisions of Section 386.266 similarly do not prohibit the Commission from making changes to Empire's IEC. As noted previously, the statute does not apply to Empire's existing IEC.[23]

B. The Stipulation and Agreement in Case No. ER-2004-0570 Does Not Prohibit the Commission from Terminating or Modifying Empire's IEC

Whatever else can be said about the Stipulation and Agreement that was entered into by several of the parties in Empire's last rate case, Case No. ER-2004-0570, it is clear and unambiguous on one point: the Commission is free, in accordance with applicable law, to terminate the IEC at any time. Section 1(c) of that document includes the following statement: "The IEC tariff or rate schedule will expire *no later than* 12:01 a.m. on the date that is three years after the original effective date of the revised tariff

[23] Irrespective of the exemption provided by Section 386.266(10), the rulemaking requirement included in subsection 9 of the statute does not appear to apply to interim energy charges. Subsection 1 of the statute distinguishes between "an interim energy charge" and "periodic rate adjustments outside of general rate proceedings to reflect increases and decreases in prudently incurred fuel and purchased-power costs . . .." The rulemaking requirement, however, applies only to "such rate adjustments."

sheets authorized by the Commission in this case, Case No. ER-2004-0570, unless earlier terminated by order of the *Commission*." (emphasis added) Regardless of what else the Stipulation and Agreement may say regarding the IEC, the language quoted above clearly shows that the parties understood and agreed to two things: 1) that the IEC would have a term not of three years, but of up to three years, and 2) that the IEC could be terminated by the Commission at any time during that term.

For more than a century, the primary rule governing the construction or interpretation of contracts in Missouri has been to give effect to the intent of the parties based on the language of their contract. Among the many rules that have been developed to accomplish this objective is the rule that requires the interpreter to consider everything within the four corners of the document. *Hanna v. South St. Joseph Land Co.*, 28 S.W. 652, 654 (Mo. 1894) Corollary rules that have developed around this primary standard include the requirement that contracts be construed as a whole, giving effect to every part of the contract if it is fairly and reasonably possible to do so;[24] the requirement that each term of the contract be construed in a manner that would avoid rendering other terms of the agreement meaningless;[25] and the requirement that the intent of a contract is to be determined by looking at the entire document instead of at isolated provisions within the document.[26]

The arguments by some parties to this case – primarily the Industrial Intervenors – regarding the intent that is reflected in the Stipulation and Agreement violate or ignore the aforementioned rules of construction. Although these parties have repeatedly been heard to argue that their preferred interpretation of the agreement is consistent with the

[24] *Thomas v. Utilities Bldg. Corp*, 74 S.W.2d 578, 581 (Mo. 1934).
[25] *JEP Enterprises, Inc. v. Wehrenberg, Inc.*, 42 S.W.3d 773, 776 (Mo.App. 2001).
[26] *Spirtas Co. v. Div. of Design & Constr.*, 131 S.W.3d 411, 416 (Mo.App. 2004).

"four corners rule" as announced in *Hanna*,[27] in reality their arguments violate this rule because they ignore or fail to appropriately deal with the language from Section 1(c) of the Stipulation and Agreement. In fact, these parties do not even attempt to reconcile the references to a three-year term for the IEC –on which they heavily rely for their interpretation of the agreement – with the language of Section 1(c) that states that the IEC tariff will expire "no later than" three years after it becomes effective "unless earlier terminated by the Commission."

The parties included language that allows the Commission to terminate the IEC because they knew that to do otherwise would render the Stipulation and Agreement unenforceable. The fixing of reasonable rates is an exercise of the sovereign police power of the state and it cannot be contracted away.[28] In *State ex rel. City of Sedalia v. Pub. Serv. Comm'n.*, the Missouri Supreme Court stated:

> Under [the Missouri constitution] the sovereign police power of the state is preserved intact irrespective of contracts with reference to rates for public service. Under it no contract as to rates will stand against the order of the Public Service Commission for reasonable rates, whether such reasonable rates be lower or higher than the contract rate.

204 S.W. at 498 (1918). In addition, because the Commission must maintain flexibility so that it can exercise its ratemaking authority in a manner that allows it to deal with changing circumstances, public utilities cannot enter into contracts that limit the

[27] See, e.g., *Response of Praxair, Inc. and Explorer Pipeline Company to Motion for Clarification or, in the Alternative, Request for Extension to Conduct Further Discovery and Motion for Hearing*, pp. 6-13 (filed April 24, 2006).

[28] *State ex rel. City of Sedalia v. Pub. Serv. Comm'n.*, 204 S.W. 497, 499 (Mo. 1918); *see also*, *State ex rel. Kansas City Pub. Serv. Co. v. Latshaw*, 30 S.W. 2d 105, 108 (Mo. banc 1930); *State ex rel. Missouri Gas & Elec. Serv. Co. v. Trimble*, 271 S.W. 43, 45 (Mo. banc 1925); *City Water Co. of Sedalia v. City of Sedalia*, 231 S.W. 942, 944-945 (Mo. 1921); and *Gains v. Van Gibbs*, 709 S.W. 2d 541, 544 (Mo.App. 1986).

Commission's ratemaking authority.[29]

Interpreting the Stipulation and Agreement as a whole and giving effect to all of its terms leads inexorably to the conclusion that while some or all of the parties to that agreement hoped or assumed it would remain in effect for a full, three-year term, they agreed to a term of *up to three years* and acknowledged and agreed that the Commission could terminate the IEC at any time within that term. To interpret the Stipulation and Agreement otherwise renders the language in Section 1(c) meaningless – a result that is contrary to law.

But beyond the language the parties included in the Stipulation and Agreement, terms that the parties *did not* see fit to include in the agreement equally as important. Nowhere in the agreement is there any language imposing a rate freeze or moratorium or otherwise limiting Empire's ability to seek to terminate or modify the IEC and/or increase its rates as authorized by Chapter 393 of the Missouri Revised Statutes.[30] "Moratorium" language in stipulations is not uncommon and its absence here is telling.

Language in Section 4, which the Commission has indicated prohibits Empire

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[29] *State ex rel. Capital City Water Co. v. Pub. Serv. Comm'n.*, 850 S.W.2d 903, 911 (Mo.App. 1993).

[30] Had the parties to the Stipulation and Agreement intended to impose a moratorium on future rate cases or on the right of a party to seek to terminate or modify the IEC, their counsel clearly knew how to accomplish that objective. The Commission has taken administrative notice of a stipulation and agreement in Case No. GO-2006-0205. (Transcript pp. 433-434) The following language appears in that stipulation:

> EDG [Empire District Gas Company] agrees that it will not file a rate increase request for non-gas costs for a period of 36 months following the date of closing, unless there is the occurrence of a significant, unusual event that has a major impact on any of its service territories such as (i) terrorist activity or an act of God; (ii) a significant change in federal or state tax laws; or (iii) a significant change in federal or state utility or environmental laws or regulations. The other Signatories agree that they will not file an earnings complaint against the EDG during the same period.

Unanimous Stipulation and Agreement (Case No. GO-2006-0205) at pp. 16-17. The names of the signatory counsel to that agreement should be familiar to the Commission.

from requesting an energy cost recovery mechanism while the IEC is in effect, does not bar the Company from seeking a general rate increase including termination or modification of the IEC tariff. There can be no question, therefore, that the Company was free both to file the current case, including a request to terminate the IEC, and to have all elements of its cost of service fully and fairly considered. Further, there is nothing in the agreement that restricts the Commission's authority to entertain such a request. And, having been presented with Empire's request for a rate increase, the Commission must consider and appropriately deal with all aspects of the Company's cost of service – including energy costs – if the rates set in this case are to be fair and reasonable, as required by law.

As a matter of constitutional law, a utility's rates must be adequate to both cover its reasonable operating expenses and provide a reasonable rate of return. *FPC v. Hope Nat. Gas Co.*, 320 US 591, 603 (1944). And, when setting rates, the Commission must consider all relevant factors, including all operating expenses.[31] Rates that fail to provide for recovery of Empire's current and projected fuel and purchased power costs fall well short of these standards. But that will be the result if the Commission forces Empire to continue with its current level and method of fuel cost recovery.

C. Empire's Actions Since It Entered Into the Stipulation and Agreement Neither Negate the Terms of that Agreement Nor Indicate the Company's Belief that It Was Prohibited from Seeking to Terminate the IEC

As stated previously, the Stipulation and Agreement is not ambiguous with respect to Empire's ability to seek, or the Commission's ability to order, termination of the IEC within three years of its effective date. A contract is not ambiguous merely

[31] *State ex rel. Office of Pub. Counsel v. Pub. Serv. Comm'n.*, 858 S.W.2d 806, 812 (Mo.App. 1993).

because the parties disagree over its meaning. *Armstrong Bus. Svcs., Inc. v. H & R Block*, 96 S.W.3d 867, 874 (Mo.App. 2002). And because the Stipulation and Agreement is not ambiguous, there is no need for the Commission to consider parol evidence to determine the intent of the parties. In this case – at least insofar as issues still in contention in this case are concerned – the intent of the parties can be determined from the words of the agreement itself.

The Industrial Intervenors apparently argue both sides of this proposition. First, they claim the Stipulation and Agreement is not ambiguous and that Empire is stuck with both the IEC and the amount of fuel cost recovery it provides for three, full years.[32] They then turn around and make the opposite argument: that the Stipulation and Agreement is ambiguous regarding how and when the IEC can be terminated.

To make their second argument, the Industrial Intervenors expended considerable effort presenting parol evidence intended to show that Empire's words and deeds, after it entered into the Stipulation and Agreement, evidenced the Company's understanding and belief that the term of the IEC was three full years and could not be modified or terminated within that period. But their evidence shows no such thing. In fact, it proves just the opposite. The Industrial Intervenors have, thus, failed to bear the burden of proof that the provisions of the Stipulation and Agreement that govern termination of the IEC are ambiguous in the first place or that Empire's actions evidence an understanding of that agreement that differs from the interpretation the Company has

[32] See *Response of Praxair, Inc. and Explorer Pipeline Company to Motion for Clarification or, in the Alternative, Request for Extension to Conduct Further Discovery and Motion for Hearing*, Case No. ER-2006-0315, pp. 1, 3; *Prehearing Brief of Praxair, Inc. and Explorer Pipeline Company*, Case No. ER-2006-0315, p. 8.

argued for in this case.[33]

Empire submits that the Stipulation and Agreement is not ambiguous and, therefore, parol evidence is irrelevant to any issue regarding that agreement and should not be considered by the Commission in its decision in this case. Nevertheless, Empire wishes to briefly address several exhibits that were offered by the Industrial Intervenors for the sole purpose of pointing out what they do and do not prove.

Exhibits 121–124 are, respectively, Empire's Form 10-K report for 2004 and its Form 10-Q reports for the first, second, and third quarters of 2005. The Industrial Intervenors contend that the disclosures regarding the IEC that are contained in some or all of these reports either evidence Empire's belief that the IEC was to last for three years or unlawfully fail to disclose information required by the rules of the Securities and Exchange Commission ("SEC"). Neither contention is correct. The SEC's rule governing disclosures in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") portion of a company's financial reports are found at 17 CFR §229.303. Subsection (a)(3)(ii) of that rule describes a registrant's disclosure obligation as follows:

> Describe any <u>known</u> trends or uncertainties that have had or that the registrant reasonably expects will have a <u>material</u> favorable or unfavorable impact on net sales or revenues or income from continuing operations. If the registrant <u>knows</u> of events that will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments), the change in relationship shall be disclosed. (emphasis added)

Under this rule, registrants must disclose trends, uncertainties, and events that it knows or reasonably expects will have a material favorable or unfavorable impact on sales, revenues, or income from continuing operations.

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[33] See *McCormick's Handbook on the Law of Evidence* §336 (2d ed. 1972).

The SEC periodically provides guidance to assist reporting companies comply with its rules. In December 2003, the SEC issued Release No. 33-8350, which interpreted the requirements for the MD&A.[34] In the portion of its discussion dealing with the materiality standard applicable to disclosures in the MD&A, the SEC stated as follows:

> Companies must provide specified material information in their MD&A, and the also must provide other material information that is necessary to make the required statements, in light of the circumstances in which they are made, not misleading. MD&A must specifically focus on known material events and uncertainties that would cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition. Companies must determine, based on their own particular facts and circumstances, whether disclosure of a particular matter is required in MD&A. However, <u>the effectiveness of MD&A decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information</u>.

(emphasis added) As the SEC's statement makes clear, there is no "bright line" test to distinguish between information that needs to be disclosed and information that does not. Instead, each reporting company must use its judgment. In doing so, each company must be careful not to disclose either too little or too much information, as an error either direction can be detrimental to the current and prospective investors to whom the disclosures are directed.[35]

In the MD&A section of Empire's 2004 Form 10-K report, filed on or about March 14, 2005 – which was after the Commission issued its report and order in Case No. ER-2004-0570, but before the Commission issued its order approving tariff sheets – the Company briefly explained the evolution of IEC, including the nonunanimous stipulation

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[34] 2003 SEC LEXIS 3034.

[35] *See also, In the Matter of Caterpillar, Inc.*, 50 S.E.C. 903 (1992)(Disclosure of an event is not required unless the event will or is likely to have a material effect and is known or reasonably likely to occur.)

that was submitted to the Commission, and described the final result as "establishing a three year refundable IEC". (Exhibit 121, p. 53)

Empire's next financial report – the Form 10-Q Report for the first quarter of 2005 – included a greatly enhanced description of both the overall outcome of the Company's rate case and the IEC. The five sentences devoted to the IEC, which is described as "effective March 27, 2005 and expiring three years later," includes a discussion of the reason for the IEC, what fuel costs it is designed to mitigate, and Empire's refund obligations. (Exhibit 122, pp. 18-19) Much of the detail regarding both the rate increase authorized in Case No. ER-2004-0570 and the IEC are repeated in the Form 10-Q reports for the second and third quarters of 2005, but the discussion in those reports was expanded to include disclosure of the fact that amounts collected through the IEC did not cover all of the Company's fuel and purchased power costs for the reported quarter. In addition, in its description of Empire's potential refund obligations, the following statement appears in each of the last two quarterly reports: "The entire excess amount of the IEC not previously refunded, will be refunded at the end of three years, unless the IEC is terminated earlier." (emphasis added) (Exhibit 123, pp. 23-24; Exhibit 124, p. 24) All four financial reports also include in the MD&A section a sentence that states that Empire "will continue to assess the need for rate relief in all of the jurisdictions that we serve and file for such relief when necessary."[36]

Applying the SEC's disclosure rules and standards to the aforementioned financial reports, there can be little doubt that the descriptions that Empire included in the MD&A regarding the rate increase that was authorized in Case No. ER-2004-0570 and the IEC fully comply with applicable law. Just as it was supposed to do, Empire's

[36] See, e.g., Exhibit 121, p. 22.

description of the IEC changed over time as more information became available about the impact the IEC would or likely would have on the Company. That Empire did not include information in its 2004 Form 10-K report or Form 10-Q report for the first quarter of 2005 regarding the fact that the Commission could terminate the IEC prior to the expiration of three years merely shows how scrupulously the Company complied with the SEC's disclosure rule and guidance. That fact was not material until Empire determined – sometime during the second quarter of 2005 – that the IEC was not fulfilling its intended purpose. To have disclosed from the outset the Commission's ability to terminate the IEC at any time would have been contrary to the SEC's caution that too much information can obscure rather than enlighten.[37]

The Industrial Intervenors also introduced into evidence copies of the minutes of Empire's April 27-28, 2005[38], and July 27-28, 2005[39], board of directors meetings, and have suggested that the fact that those minutes do not contain any reference to either the IEC, in general, or to the Company's ability to terminate the IEC indicate: 1) that Empire's management failed to provide material information to the board, 2) that Empire did not believe it could terminate the IEC, or 3) both. This suggestion is both unfounded and illogical for several reasons.

First, this suggestion is premised on a view that the minutes of a board meeting are supposed to be akin to a verbatim transcript of that meeting. They are not, so just because a matter is not described in the minutes of a meeting does not mean it was not

[37] The ability of the Commission and other similar utility regulatory authorities to initiate *sua sponte* changes in the rates of regulated companies is well known. It is part of the legal context in which all regulated utilities operate. As such, it is part of the body of basic information that investors who are contemplating an investment in that industry are presumed to have or be able to readily obtain. It need not, therefore, be repeatedly disclosed in each utility's routine financial reports.

[38] Exhibit 127.

[39] Exhibit 128.

discussed there. Second, the Industrial Intervenors' position assumes that board meetings are the only vehicle Empire has for communicating with its board members and for providing them important information about the Company. That is also incorrect. It is interesting to note that Exhibit 127 – the minutes from the first board meeting following the Commission's final order in Case No. ER-2004-0570 – contain no mention whatsoever of the rate increase that was authorized. Is it, therefore, fair to conclude from that fact that Empire's management provided its board members no information regarding that matter, or is it more reasonable to assume that the Company provided its board information regarding the rate case, including the IEC, outside the context of a regular board meeting? The answer to that question is obvious.

All of the other parol evidence that the Industrial Intervenors presented is equally unconvincing. In fact, Exhibit 137HC, a portion of the response to DR 269 which the Industrial Intervenors chose not to offer, is further evidence that in August of 2005 Empire believed it could seek to terminate the IEC before the March 2008 end of the three year term. (Transcript, pp. 974, 975)

More importantly, however, no amount of parol evidence can change what the Stipulation and Agreement says. That agreement clearly states that the IEC tariff that was approved in Case No. ER-2004-0570 would expire "no later than" a date that is three years from its original effective date "unless earlier terminated by order of the Commission." Empire understood that these terms to mean that the IEC would be in effect not for three years, but for up to three years and that the term of the IEC would ultimately be determined by the Commission. Nothing the Company did or said following the approval of the Stipulation and Agreement either contradicts that understanding or

changed the terms of that agreement. And when the terms of an agreement are clear, it is those terms that govern the agreement's meaning and not the conduct of the parties.

D. Empire's Tariff Filing Pursuant to Section 393.140 Is the Appropriate Vehicle to Seek to Terminate the IEC

Section 393.140(11) describes the process that Empire and other public utilities operating in Missouri must follow in order to obtain changes to its filed tariff. As stated there:

> Unless the commission otherwise orders, to change shall be made in any rate or charge, or in any form of contract or agreement, or any rule or regulation relating to any rate, charge or service, or in any general privilege or facility, which shall have been filed and published by a gas corporation, electrical corporation, water corporation, or sewer corporation in compliance with an order or decision of the commission, except after thirty days' notice to the commission, which shall plainly state the changes proposed to be made in the schedule then in force and the time when the change will go into effect.

Pursuant to and in accordance with the statute, on February 1, 2006, Empire filed tariff sheets designed to increase rates for service provided in the Company's service area. Among the tariff sheets that Empire filed was 5th Revised Sheet No. 14 from Section 4 of the Company's tariff which cancelled 4th Revised Sheet No. 17, issued on March 17, 2005. The 4th Revised Sheet No. 17 was the "Interim Energy Charge Rider, Rider IEC."

Empire's filing fully complies with the requirements of the statute and all applicable Commission rules. The Company is not required to seek termination of the IEC through an application filed pursuant to 4 CSR 240-2.060. The IEC has always been a part of Empire's tariff and the "file and suspend" method prescribed in Section 393.140(11) is the lawful and appropriate way to seek to modify or cancel the IEC.

The argument made by the Industrial Intervenors that Empire's decision to cancel its IEC tariff sheet as part of its overall rate filing is unfair to interested parties because

of the chance that the Commission might allow the Company's filing to go into effect without suspension is nonsense. This is obvious from the fact that the argument was first advanced in a pre-hearing brief filed months after the Commission had already suspended Empire's tariff filing for the full period allowed by law.[40] In addition, all parties to the Stipulation and Agreement that created the IEC have intervened in the present case and have participated in it as fully as they desired. Therefore, even assuming that Empire could have sought termination of its IEC through an application filed pursuant to 4 CSR 240-2.060 – a proposition that the Industrial Intervenors advance without any supporting legal authority – the opportunities for interested parties to participate would have been no greater than has been the case already. The Industrial Intervenors' argument based on the remote potential for prejudice to interested parties is not enough, especially when the historical record of this case establishes that no prejudice actually has occurred.

E. The Appropriate Standard for Judging Empire's Request to Terminate the IEC is the "Just and Reasonable" Standard That Applies to All Issues in a General Rate Case

As noted in the preceding section of this brief, Empire's request to terminate the IEC was filed pursuant to Section 393.150(11) as part of the Company's request for a general increase in rates. Although the Commission, in appropriate circumstances, is empowered to grant temporary, interim, or emergency rate relief pursuant to Section 393.150,[41] the Company did not request such relief and further did not object to the Commission's suspension of the tariff filing for the maximum period allowed by law.

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[40] *Prehearing Brief of Praxair, Inc. and Explorer Pipeline Company* , p. 9.

[41] See *State ex rel. Util. Consumers' Council of Missouri, Inc. v. Pub. Serv. Comm'n.*, 585 S.W. 2d 41, 48 (Mo. 1979); *State ex rel. Laclede Gas Co. v. Pub. Serv. Comm'n.*, 535 S.W.2d 561, 568 (Mo.App. 1976).

Empire's request to terminate the tariff sheet for the IEC should, therefore, be judged on the same standard as the rest of its requested tariff changes: that all charges for electric service that are authorized by the Commission must be just and reasonable.[42]

The Industrial Intervenors have advanced a spurious argument that seeks to impose an alternate, more stringent standard – such as imminent harm to the Company – for the Commission's deliberations regarding termination of the IEC.[43] But, as with many of their other arguments, the Industrial Intervenors have provided no legal authority to support of their position. The reason for this is simple: there is none. Empire's request for termination of the IEC must be judged on the basis on which that request was made – as part of a general rate case filing made pursuant to Section 393.140(11). The Company has not asked for special or expedited treatment of its request to terminate the IEC, so the standards that would apply to such a request are not applicable in this case.

F. If the IEC is Continued in Its Current Form, the Financial Losses That Empire Has Suffered Due to Under-Recovery of Fuel and Purchased Power Costs Will Continue

Interestingly, no party to this case has argued that the IEC, as it currently exists when combined with its base rates, allows Empire to recover the costs of fuel and purchased power that the Company prudently incurs to provide service to its customers. Instead, those opposed to terminating the IEC argue that Empire should be forced to continue to hemorrhage red ink due to the under-recovery of energy costs because "a deal is a deal."[44] This argument is wrong on two counts.

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[42] Section 393.130(1); *State ex rel. Hotel Continental v. Burton*, 334 S.W.2d 75, 79 (Mo. 1960).
[43] *Prehearing Brief of Praxair, Inc. and Explorer Pipeline Co.*, pp. 9-10.
[44] Again, the Commission should remember that these same parties have stipulated that Empire should be able to recover its prudently incurred fuel and purchased power costs. (Transcript, p. 567)

First as indicated, the "deal" gives the Commission authority to terminate the IEC and does not prevent Empire from seeking to have it terminated. Moreover, such an argument is the antithesis of fairness, reasonableness, and responsible regulation – the standards the Commission is bound by law to apply to its ratemaking decisions – and ought not to be given the Commission's imprimatur in the form of an order continuing the current IEC.

The evidence regarding the magnitude of the losses that Empire has suffered as a result of the current method of fuel cost recovery is uncontested and uncontroverted. From the inception of the IEC through June 30, 2006, Empire's costs for fuel and purchased power have exceeded the amounts collected through base rates and the IEC by approximately $18.9 million. This deficit, alone, has wiped-out nearly sixty percent of the return on common equity that the Commission authorized in Empire's last rate case.[45] And, because for more than a year the Company's average fuel and purchased power costs have exceeded the IEC ceiling, those losses continue today and into the future.[46] In addition, Empire also is failing to recover a significant portion of related costs, such as demand and gas reservation charges, that were not included among the costs to be collected through the IEC.[47]

Currently, those losses are being funded by Empire's shareholders, but this cannot be allowed to continue. A utility has a constitutional right to rates that are sufficient both to cover its reasonable operating expenses and provide a fair rate of

[45] Exhibit 20, p. 8.
[46] Exhibit 15HC, p. 5.
[47] *Id.*, p. 4.

return to shareholders.[48] Under its current rates, including the IEC, Empire and its shareholders are denied both benefits to which they are entitled. But beyond their effect on current shareholders, rates that deny the Company the opportunity to recover its costs and earn a fair return will make it difficult, if not impossible, to obtain at reasonable interest rates the capital that will be needed in the near term to complete necessary infrastructure projects, including Iatan 2. So, if the IEC is continued, not only will Empire under-recover current and future energy costs it likely also will experience an increase in its cost of capital. At some point those under-recovered and increased costs must be passed on to customers if the Company is to continue to provide safe and adequate service while maintaining its financial stability.

As for Empire's customers, since the inception of the IEC they have not paid the full cost of the energy they have consumed. Instead, their costs were subsidized by Empire's shareholders in the form of a diminished rate of return. The Industrial Intervenors (who usually argue that rates should be based on cost of service) and others who oppose termination of the IEC argue that this subsidy should continue. Indeed, they argue that the subsidy should grow in the future as ever increasing costs of fuel and purchased power take an even bigger bite out of the Company's rate of return. But customers are not entitled to expect or receive subsidized rates for electrical service. Although the subsidy that the IEC provided in the past was unintentional, continuing the IEC in its current form, in the face of unchallenged evidence that the IEC denies Empire the right to fully recover its fuel and purchased power costs, would result in an intentional, but unconscionable and unlawful, subsidy.

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[48] See *FPC v. Hope Nat. Gas Co., supra* at 603; *Bluefield Waterworks v. Pub. Serv. Comm'n., supra* at 692.

By proposing to continue the IEC in effect without change, and thus restricting Empire to its current method and amount of fuel cost recovery, the Industrial Intervenors and others are urging the Commission to act in a manner that is both irresponsible and unlawful. These parties do not seek rates that are just and reasonable; they seek rates that are unjust and punitive. There is no legal basis for such a result. The Commission's duty to set just and reasonable rates includes the duty to provide Empire a reasonable opportunity to recover all of its prudently incurred fuel and purchased power costs. Whether that is accomplished through base rates or a combination of base rates and a revised and revamped IEC is a matter left to the Commission's discretion. But one thing is clear: the Commission cannot achieve the result that is required by law if the current level and method of fuel cost recovery continue.

Although continuing the current level and method of fuel cost recovery may produce some short-term benefits for customers in the form of subsidized rates for electric service, the longer term results are all negative. Empire will be unjustly punished and its financial position will be damaged, its shareholders will be denied a fair rate of return, and needed capital will be much more difficult and costly to obtain. The Commission must allow Empire to terminate the current IEC and, in so doing, to act in what truly is the best interests of the Company, its shareholders, and its customers.

Based on the foregoing, the Commission should deal with the issue of the recovery of fuel and purchased power costs necessary to provide electric service to customers in one of two ways: include all energy costs in Empire's base rates or include a portion of those costs in base rates and collect the balance through a significantly revised version of the IEC. Whichever alternative is selected, the fuel costs used by the

Commission should reflect, as accurately as possible, the energy costs that the Company likely will incur during the period rates set in this case are in effect.

7. GAIN FROM UNWINDING FORWARD NATURAL GAS CONTRACT

During the third quarter of 2005, Empire elected to "unwind" a portion of a long-term, forward natural gas contract with British Petroleum ("BP"). (Exhibit 39, p. 19) Empire sold back its positions on certain deliveries and recorded a gain of slightly more than $5 million during 2005. (Exhibit 21, p. 2-3) It did so: 1) in an effort to offset dramatic price increases in the cost of natural gas that the Company needed for the summer, fall, and winter of 2005; 2) to reduce its credit exposure with BP; and, 3) to use this decrease in its credit exposure to increase its near-term natural gas hedge positions. (*Id.*)

Staff proposes to amortize the $5 million gain over five years by reducing the Company's Missouri fuel and purchased power expense on a going-forward basis by approximately $850,000 per year and continuing that reduction until the Missouri jurisdictional piece of the gain is fully amortized. (Exhibit 39, p. 19) The Industrial Intervenors propose to reduce annual fuel and purchase power expense by the full amount of the gain, which has the effect of continuing to pass through to customers the entire gain each and every year rates set in this case remain in effect. (Exhibit 85, p. 11) Both of these proposals should be rejected.

Staff witness Fischer's testimony seems to indicate her belief that Empire's "customers are required to pay for costs associated with Empire's generation of electricity." (Exhibit 41, p. 18) However, Ms. Fischer admits that Empire has suffered huge losses in regard to fuel and purchased power expenses during calendar year 2005

and beyond. (Transcript pp. 1046-1048)

By the end of 2005, Empire had been unable to recover $13.5 million of Missouri retail fuel and energy costs after taking into account the $5 million gain associated with the unwinding transaction.[49] (Exhibit 21, p. 5) If Empire is not allowed to use this gain to offset those losses, Empire's under-recovery for 2005 is in excess of $18 million. (*Id.*) By June 30, 2006, Empire's fuel and energy costs had exceeded recoveries by $18.9 million, after giving Empire the benefit of the unwinding transaction. (*Id.*, p. 6) If Empire is not allowed to receive the benefit of the gain from the unwinding transaction, Empire's under-recovery is approximately $24 million as of that date. (*Id.*)

There is no proposal in this case to seek to recover those losses on a going-forward basis nor does Staff witness Fischer believe that Staff would allow a company to go back and recover past fuel and energy cost losses. (Transcript pp. 1050-1051) Those losses are gone. In fact, when a utility last sought to obtain an accounting authority order that would allow the utility to defer fuel and purchase cost under-recoveries for consideration in a future rate case while an IEC was in effect, the Commission summarily denied the request. *In the Matter of the Application of Aquila, Inc.*, Determination on the Pleadings and Order Denying Application, Case No. EU-2005-0041 (October 7, 2004).

The past under-recovery has been borne by Empire and its shareholders. (Exhibit 21, p. 5) Empire's rate case is based on the recovery of future fuel and energy costs, not on past under-recovery of energy costs. (*Id.*) Thus, it is somewhat misleading when Mr. Brubaker and Ms. Fischer indicate that Empire's customers should

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[49] Empire believes it is appropriate to take into account the gain from the unwinding in computing the under-recovery as the gain is recorded in an account that is included in the IEC. *See* Transcript, p. 1055.

receive a benefit from this unwinding transaction. (Exhibit 85, p. 11; Exhibit 39, p.20) Empire's customers have received a benefit. As of June 30, 2006, they have paid $18.9 million less for fuel and energy since the current rates have been in effect than Empire's costs. Staff and the Industrial Intervenors apparently believes the customers have received no benefit in this past period unless the gain can be reflected in such a way that those customers pay approximately $24 million less than Empire's costs.

The Industrial Intervenors' proposal to reduce annual fuel and purchased power expenses by the entire $5 million gain not only pushes this past event into the future, it does so in a way that will multiply the effect of this inappropriate treatment. Reducing fuel and purchase expense by this amount has the effect of flow this $5 million gain to ratepayers each and every year the resulting rates are in effect. (Exhibit 21, p. 3) In other words, if the Industrial Intervenors' proposal is accepted and the rates are in effect for two years, ratepayers will receive $10 million as a result of the unwinding transaction. Thus, if the Commission does believe that this gain should be reflected on a going forward basis, the Industrial Intervenors' proposal would be particularly inappropriate as it would over recover the amount in question.

Ultimately, the identified gain should be treated in the same fashion as the under-recovery. There is no reason to pull the past fuel and purchase power gain forward to account for it on a going-forward basis when losses are not being treated in this fashion.

8. INCENTIVE COMPENSATION

Although "[t]here is no scheme of rate control that will simulate the forces of a purely competitive market,"[50] one of the Commission's most important roles in regulating Missouri utilities is to serve as a surrogate to competition with the objective of

[50] James C. Bonbright et al., *Principles of Public Utility Rates*, 148 (1988).

making sure that prices charged for public utility services conform to the level of costs under competition. In fulfilling this responsibility, it is often instructive to look to competitive industries to see what types of expenses routinely are incurred there and in what amounts. The fact that an expense is widely incurred by companies in the competitive marketplace provides at least prima facie evidence that the expense is also appropriate for a regulated monopoly, like Empire.

When determining the operating expenses that are allowable in a utility's cost of service for ratemaking purposes, the actual expenses incurred "are presumed to be reasonable and necessary for efficient operation until proved otherwise."[51] In addition, in evaluating a utility's operating costs, the Commission must be mindful of the limits of its authority.

> It must never be forgotten that, while the state may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies, and is not clothed with the general power of management incident to ownership. The applicable rule is well expressed in States Public Utilities Commission ex rel. Springfield v. Springfield Gas & Electric Co., 291 Ill. 209, 234, 125 N.E. 891, 901: 'The commission is not the financial manager of the corporation, and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses, unless there is an abuse of discretion in that regard by the corporate officers.'"

State ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n., 262 U.S. 276 (1923).

Like most large companies today, Empire has an incentive compensation plan in place for its executives that puts a significant portion of their total compensation "at risk." An employee can earn the at-risk portion of his or her compensation by meeting specified performance objectives that are designed to help the Company achieve important business, financial, and operational objectives. Senior executives are eligible

[51] Paul J. Garfield & Wallace F. Lovejoy, *Public Utility Economics*, 47 (1964).

to receive three types of incentive compensation: a cash bonus, which is based on the achievement of goals and objectives that are set annually; grants of stock options; and long-term compensation in the form of grants of restricted shares of the Company's common stock. Non-executive managers also are eligible to earn a cash bonus based on their achievement of annual objectives, but are not eligible for grants of stock options or restricted shares. In addition, certain of Empire's management employees are eligible to receive "Lightning Bolt" awards, which are one time, lump sum payments for exceptional performance on special projects or in performing the employee's normal job responsibilities.

Demands for corporate accountability in the wake of business scandals such as those involving Enron, WorldCom, and Alelphia led to the passage of the Sarbanes-Oxley Act of 2002 and to the adoption of tough, new rules by the SEC, the New York Stock Exchange, and NASDAQ. One focus of these legislative and rulemaking actions has been to more closely align compensation, especially of senior executives, with the achievement of key corporate objectives. In late 2004, the New York Stock Exchange adopted rules establishing corporate governance standards, which included the requirement that the board of directors of each listed company adopt a written charter for its compensation committee that made the committee directly responsible for certain, specified tasks. The Exchange's rules stated one of those responsibilities as follows:

> (b) The compensation committee must have a written charter that addresses:
>
> (i) the committee's purpose and responsibilities – which, at minimum, must be to have direct responsibility to:
>
> (A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other

> independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation; and
>
> (B) <u>make recommendations to the board with respect to non-CEO executive officer compensation, and incentive-compensation and equity-based plans</u> that are subject to board approval . . ..

(emphasis added)[52]

These rules reflect the fact that incentive compensation plans that are performance-based and are tied to the achievement of important corporate goals and objectives are both prevalent in American corporations and desirable from a corporate governance standpoint. That is why Empire's plan was described as reflecting a "best practice" of corporate governance and compensation.

In accordance with both the New York Stock Exchange's rules and pursuant to its own written charter[53], the compensation committee of Empire's board of directors is responsible for designing and administering the incentive compensation plan. With the assistance of compensation professionals from The Hay Group, the committee has created a plan that enables the Company to attract, retain, and motivate high quality management talent that is necessary to efficiently and effectively run the business. In addition, through its variable compensation structure, the plan has created a performance-based culture at Empire where managers are able to earn incentive compensation only by meeting key financial and operational targets that benefit both the Company and its customers.

But the Company has taken great care to assure that the overall costs of its compensation plan, including the at-risk portions of that plan, are reasonable.

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[52] Exhibit 92.
[53] Exhibit 93.

In developing the compensation plan for Empire's senior officers, the Company's compensation committee asked the Hay Group to collect data regarding each executive position for two peer groups of companies. One peer group was a broad national group of more than 700 diverse companies and thousands of executive positions. The other was a peer group composed entirely of electric utility companies. The results of the Hay Group's analysis were presented to the committee in 2004, and a copy of that report was entered into evidence in this case as Schedule ACM to Exhibit 50HC. As can be seen from that report, data from both peer groups that was presented side-by-side which, enabled the committee to easily compare compensation paid to executives in the diverse company peer group to the utility peer group. In addition, data presented for the electric utility peer group included each company's revenues and market capitalization, which enabled the committee to easily make judgments based on the relative size of the companies in that peer group as to what would be appropriate for Empire.

Based on its analysis, and after further consultation with the Hay Group, the committee determined that compensation targets for Empire's senior executives should be set as follows relative to the salary data from the broad-based peer group:

- base salary is targeted at the 25th percentile;
- total cash compensation (base salary plus annual cash incentive) is targeted at the 25th percentile; and
- total direct compensation (total cash compensation plus long-term incentives)

is targeted at approximately the 37th percentile.[54]

Because Empire targets total compensation for each of its executives at a level that is below the mean for the executive's position based on peer group data, there can be little doubt that the total compensation, including all incentive compensation, which the Company paid during the test year was reasonable.[55]

There also can be no doubt as to what is required for Empire's executives and senior managers to earn their incentive compensation. Exhibit 94HC shows the goals and objectives of each of Empire's top six executives for 2005 and the target cash bonuses each would receive in 2006 if they achieved their objectives. Exhibit 95HC shows the incentive compensation goals for Empire's non-executive managers for 2005, whose cash bonuses also would be payable in 2006. Although Staff characterized these goals and objectives as "related to attainment of earnings goals,"[56] a review of these exhibits shows Staff's characterization to be inaccurate. The majority of the goals for Empire's executives relate to expense control, capital markets, regulatory performance, corporate governance, completion of capital projects, and customer service. The few goals that fall within categories entitled "Financial Performance" pertain to things like securing bank lines of credit, cash management, and analyzing financing alternatives. The same is true for the objectives of the Company's non-executive managers. All these objectives are focused on controlling costs, completing needed capital projects, and running the business as efficiently as possible; none of the objectives directly focus on increasing earnings; and all of the objectives provide benefits both to the Company and

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[54] Exhibit 1, pp. 6-7.

[55] Staff's witness does not dispute this conclusion – probably because, inexplicably, she did no analysis of Empire's total management compensation to determine whether the amount of compensation paid during the test year was reasonable or unreasonable. (Transcript, pp. 149-150)

[56] Exhibit 48NP, p. 11.

its customers.

Staff also proposed to disallow a portion of the bonuses paid to Empire's non-executive managers on grounds that the objectives related to an employee's normal job responsibilities. But when asked how she determined what activities were within an employee's normal job responsibilities and what was not, Staff's witness stated it was based on her opinion, even though it was clear from her answers during cross-examination that her opinion was not based on any substantive facts.[57] She also stated that it was unreasonable for Empire to reward its non-executive managers for performing their normal job responsibilities exceptionally well. That judgment was based solely on her unfounded opinion, as well.

As for the "Lightning Bolt" awards that Empire made during the test year and that Staff has proposed to disallow in total, Staff's witness again mischaracterized the types of activities for which these awards were paid. In her pre-filed direct testimony, she stated that these payments were made for "working on the United Way Campaign, working on the Aquila United, Inc. gas property acquisition, and performing normal job responsibilities."[58] But when she was confronted with a complete list of the "Lightning Bolt" awards made during 2005[59], she was forced to admit that only three of the 49 awards were for the activities she had identified in her testimony. Twenty-nine of the awards were made for special projects and nine were made for setting a record for continuous operation at Empire's Asbury generation station.[60] And, as before, either contrary to the evidence or based on no evidence at all, Staff's witness expressed her

[57] See Transcript, pp. 161-171.
[58] Exhibit 48NP, p. 16.
[59] Exhibit 96HC.
[60] Transcript, p. 173.

opinion that these awards were made for performing normal job responsibilities for which no extra payments were justified, even if the performance was exceptional.[61]

As noted earlier in this section, Staff proposes to eliminate from Empire's test year cost of service most of the incentive compensation paid by the Company. More specifically, Staff proposes to eliminate the costs of all "Lightning Bolt" awards and all stock options and restricted share awarded to Empire's senior management. The only portions of Empire's incentive compensation that Staff proposes to allow are those that, in the subjective opinion of its witness on the issue: 1) were earned by the recipient, and 2) provided direct benefit to Empire's customers.

Staff's proposed adjustment is based in large part on its interpretation of past Commission orders that have disallowed incentive compensation payments from the cost of service used for ratemaking purposes. For example, in its Report and Order in Case No. GR-96-285,[62] the Commission excluded incentive compensation payments "because the incentive compensation program is driven at least primarily, if not solely, by the goal of shareholder wealth maximization, and it is not significantly driven by the interests of ratepayers."[63] In Case Nos. EC-87-114 and EC-87-115, the Commission stated: "At a minimum, an acceptable management performance plan should contain goals that improve existing performance, and the benefits of the plan should be ascertainable and reasonably related to the plan . . .."[64] And, in Case No. GR-2004-0209, the Commission excluded incentive payments on grounds that the incentive payments were made for activities designed to improve the company's bottom line and

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[61] *Id.*
[62] *Missouri Gas Energy*, 5 Mo.P.S.C.3d 437 (1997).
[63] *Id.*, p. 458.
[64] *Union Electric Company*, 29 Mo.P.S.C.(N.S.) 313, 325 (1987).

that "the shareholders that benefit from that plan should pay the costs of that plan."[65]

The rationale of Case Nos. GR-96-285 and the two Union Electric cases do not apply to Empire's plan. As can be seen from the goals and objectives of the Company's senior executives and non-executive managers, shareholder wealth maximization is *not* the primary driver of Empire's plan. Exhibits 94HC and 95HC also clearly show that Empire's plan does contain goals that are designed to improve existing performance. And Exhibit 96HC shows that the activities for which "Lightning Bolt" were made also were not driven by wealth maximization but, instead, represent employee actions that actually have improved Empire's performance in numerous key areas.

As to Case No. GR-2004-0209, the Commission should reconsider the reasons for denying incentive compensation payments that are stated in its report and order. First, it is not correct that improving a company's bottom line benefits only its shareholders. Second, in the world that exists following the passage of Sarbanes-Oxley, tying compensation to financial performance is considered a virtue not a vice. In addition, unlike the situation that the Commission faced in *Missouri Gas Energy*, the goals and objectives on which Empire based its incentive compensation payments were not designed to improve the Company's bottom line but, instead, were for improvements to areas such as customer service, expense reduction, and completion of infrastructure projects. Any effect these objectives had on Empire's bottom line was incidental.

Staff's proposal to disallow incentive compensation is based on numerous faulty or groundless assumptions, analytical errors, and the misapplication of past Commission decisions. But the most serious defect in Staff's case concerns the qualifications – or lack thereof – of its witness in support of the proposed adjustment.

[65] *Missouri Gas Energy* (2004).

Section 490.065, which governs testimony by expert witnesses in civil and administrative proceedings in Missouri,[66] states that a witness who wishes to provide opinion testimony on matters requiring scientific, technical, or other specialized knowledge must be qualified to do so by virtue of "knowledge, skill, experience, training, or education . . .." Insofar as issues regarding compensation, in general, and incentive compensation, in particular, Staff's witness is unqualified under any of these standards.

In terms of her training and education, Staff's witness has a bachelor of science degree in accounting, but has received no degrees or other formal training in the areas of compensation or incentive compensation. (Transcript, pp. 121-122) When she learned she would be testifying in this case on the issue of incentive compensation, she did not read any books or articles on the subject to better prepare her for her tasks. (Transcript, p. 124) As for experience, Staff's witness has never worked for an employer who had an incentive compensation plan (Transcript, pp. 122-123); she has never before filed testimony on the issue of incentive compensation (Transcript, pp. 123-124); and her duties at the Commission, which consist of performing audits and examinations of public utilities, do not involve any tasks related to compensation. (Transcript, p. 123) When asked what she believed qualified her to provide expert testimony on the issue of incentive compensation, she stated that she has "specialized knowledge and practical experience in compensation matters" was based entirely on her "review of past case work papers, testimony, and past report and orders for the Commission" and "guidance from senior level auditors . ..." (Transcript, pp. 124-125) Surely the Commission must insist on more than this if it is to give credence to the testimony of Staff's witness critical of Empire's incentive compensation plan – especially testimony expressing opinions as

[66] See *State Bd. of Reg. for the Healing Arts v. McDonagh*, 146 S.W.3d 146, 149 (Mo. 2003).

to what is and is not appropriate about the plan.

Empire's incentive compensation plan was devised with the assistance of compensation expert to reflect the best compensation practices in large corporations and thereby enable the Company to attract, retain, and incentivize its employees. Because there is ample evidence that Empire's total compensation expense during the test year is reasonable – and no evidence that it is not – the Commission should defer to the judgment of the Company's board of directors that a compensation plan that includes a portion of at-risk compensation is the best way to assure that employee's interests are closely aligned with those of the Company, its shareholders, and its customers.

9. LOW INCOME ASSISTANCE

In 2003, the Commission approved tariff sheets containing an Experimental Low Income Program (or ELIP) for Empire. That program was conceived by a Stipulation and Agreement filed in October 2002, and approved by the Commission on November 14, 2002, in Case No. ER-2002-424. While the parameters of the program were provided in the Stipulation, the details of the program were left to be developed in a later tariff filing. Those details were ultimately contained in tariff sheets that were filed on March 31, 2003, and approved by a Commission Order issued April 24, 2003.

The Program provides bill discounts of $40 to qualifying low-income program recipients with a household income of up to 50 percent of the federal poverty level. (Exhibit 75, p. 14) Bill discounts of $20 are given to program participants with a household income of between 51 percent and 100 percent of the federal poverty level. (*Id.*) The discounts are available for a maximum of twenty-four (24) months. (*Id.*) The

ELIP tariff (but not the original Stipulation (Transcript, p. 521)) provides that any excess funds remaining at the end of the ELIP program "shall be contributed to Project Help." (Exhibit 106, Empire Tariff Sheet No. 11)

Funding for the ELIP has been provided by $150,000 collected annually from customers through rates, matched by an additional $150,000 provided by shareholders. (*Id.*, p. 15) Participation in the program has been less than the design level and in fact has fallen off since 2004. As of April 30, 2006, ELIP funding has exceeded ELIP expenses by $655,425. (*Id.*) Based on current participation rates, that number will continue to grow. (Transcript, p. 534-535)

Recently, as a result of the Commission's order approving the stipulation and agreement in Empire's regulatory plan case – Case No. EO-2005-0263 – a Customer Programs Collaborative (or CPC) was created to assist with the development, implementation, monitoring and evaluation of Empire's affordability, energy efficiency and demand response programs. Part of the CPC's task, as stated in the Stipulation, was to "coordinate its activities with Empire's existing customer programs and Empire's IRP process in order to reduce any redundancy and to increase the effectiveness of all these related activities." The costs of the programs created and authorized by Case No. 2005-0263 and the CPC will be recorded as a regulatory asset and amortized to expense over ten years. (Exhibit 9, p. 6)

Some modification of the ELIP is in order. No party suggests that the public is well-served by a continuation of the program under the existing terms and at the existing rate of funding.

The program is currently provided twice as much funding on an annual basis

than it spent in its most expensive year. (Exhibit 75, p. 15) More striking is the fact that the excess funding as of April 30, 2006, was twice as much as the total amount spent on the program in the over three years it had been in existence. (*Id.*)

Staff witness Mantle recommends that the ELIP be terminated. She further indicated that at the time the ELIP was designed, it was envisioned that there would be no excess dollars at program end or, in the alternative, excess funds would be in the $10,000 to $50,000 range. (Transcript, pp. 518-519) Although Staff believes that Project Help is a worthy program, Staff believes the level of unspent funds that currently exist exceed those expectations. (Exhibit 67, p. 4) Therefore, Staff recommends that the unspent funds be accounted for with the CPC's regulatory asset, so that the funds could be redirected toward a program aimed at helping low income customers reduce their usage or other demand side programs. (*Id.*, p. 3-4)

OPC witness Meisenheimer recommends continuation of the ELIP, with modifications. Significantly, she recommends a reduction in the funding level. Ms. Meisenheimer recommended that both the ratepayer and shareholder funding level be reduced to an annual amount of $50,000. (Exhibit 75, p. 18) Even with this reduced funding level, Ms. Meisenheimer believes that there will be excess funds in the amount of approximately $300,000 in three years. (*Id.*)

Ms. Meisenheimer also recommends that changes be made to increase participation (to include a longer participation period), an increase in available bill credits, an increase in the percentage of the federal poverty level necessary for participation and an experimental arrearage repayment element. Exh. 75, Meisenheimer Dir., p. 17-18. Each of these modifications would require changes to the

tariff sheets governing the ELIP. (Exhibit 106)

If the program is not modified, the OPC recommends that the program be terminated and, "given the apparent level of excess funding," the unused funds returned to the ratepayers. (Exhibit 75, p. 18)

Empire suggests that the Commission order that the ELIP be terminated and that the unused funds associated with the program be made available for the CPC to utilize in a program to assist low income customers with their electric bills. This would be accomplished by the filing of tariff sheets to reflect the ELIP termination and the recording of the unused funds as a negative asset in the regulatory asset account associated with the CPC.

If the Commission agrees with Empire's proposal to account for the ELIP funds, Empire's revenue requirement in this case should be reduced by $150,000, to remove the expense associated with the ratepayer funding of the ELIP. (Exhibit 9, p. 7)

If the ELIP is not terminated, Empire recommends, like OPC witness Meisenheimer, that the CPC be asked to review and provide recommendations for the modification of this program and that accounting for future ELIP expenditures be recorded as a part of the regulatory asset associated with the CPC. The state of the program does not justify a continuation of the funding at the current level.

10. Unspent Funding of Current Energy Efficiency and Affordability Programs

Empire has had funding commitments for several programs provided for through rates as a result of the Commission's approval of a Stipulation and Agreement in Case No. ER-2004-0570. These programs include the residential Energy Star program (residential appliance and HVAC rebate program); a Commercial Energy Efficiency

Audit program; a lighting program (Change a Light, Change the World); and, a low income weatherization program.

Unspent funds exist in regard to all four of these programs. (Exhibit 10, p. 4) Empire proposes that the unspent funds be used to reduce the regulatory asset established for the Case No. EO-2005-0263 and CPC programs. (Exhibit 9, p. 6) If the Commission agrees with Empire's proposal, Empire's revenue requirement in this case should be reduced by $50,001, to remove the test year expenses associated with the 2004 programs. (*Id.*, p. 7)

CONCLUSION

For the reasons stated previously, the Commission should adopt Empire's position on all remaining contested issues and grant the Company the full amount of its requested increase in rates.

Respectfully submitted,

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Certificate of Service

I hereby certify that a true and correct copy of the above and foregoing document was sent by U.S. Mail, postage prepaid, or hand-delivered, on this 16th day of October, 2006, to:

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