BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Empire District Electric Company of Joplin, Missouri, for authority to file tariffs increasing rates for electric service provided to customers in the Missouri service area of the company.	)))))	Case No. ER-2008-0093

EMPIRE'S POST-HEARING REPLY AND TRUE-UP BRIEF

James C. Swearengen	#21510
L. Russell Mitten	#27881
Paul A. Boudreau	#33155
Dean L. Cooper	#36592
Diana C. Carter	#50527

Brydon, Swearengen & England P.C.
312 East Capitol Avenue
P.O. Box 456
Jefferson City, MO 65102
Telephone: (573) 635-7166
Facsimile: (573) 634-7431
E-Mail: DCarter@BrydonLaw.com

Attorneys for The Empire District Electric Company

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COMES NOW The Empire District Electric Company ("Empire" or the "Company"), by and through counsel, and for its post-hearing reply and true-up brief in this matter, respectfully states as follows to the Missouri Public Service Commission (the "Commission"):

Introduction and Summary

Empire initiated this rate case in October of 2007 by filing proposed tariffs to implement an overall increase in the Company's Missouri retail rates in the approximate amount of $34.7 million, which would represent about a 10 percent increase. Capital additions made by the Company to its electric system in 2007 and the financial impact of the catastrophic ice storms that hit Empire's service area in 2007 are the major factors driving Empire's rate increase request. Additionally, Empire has been exposed to increased fuel cost risk because of the continued volatility of both fuel and purchased energy costs and the absence of an effective fuel adjustment mechanism. (Ex. 1, Gipson Direct, pp. 4-5)

Public hearings were held in this matter in Joplin and Reeds Spring, Missouri, in March of 2008. On April 4, 2008, a non-unanimous stipulation and agreement was presented to the Commission as to certain matters which were originally at issue in this proceeding. No other party objected to the proposal, and on April 23, 2008, the Commission issued its Order Approving Stipulation and Agreement as to Certain Issues, effective May 3, 2008. Evidentiary hearings were held in Jefferson City, Missouri, May 12 through May 19, 2008. Two additional non-unanimous stipulations were presented to the Commission at a hearing on May 20, 2008. No party objected to the proposals, and on May 20, 2008, the Commission issued its Order Approving Second and Third Stipulation and Agreements as to Certain Issues, effective May 30, 2008.

Due to an issue involving the rate treatment to be afforded the SCR installed and put into service at Empire's Asbury plant, the Commission, on May 13, 2008, issued its Order Scheduling True-Up Hearing and Directing Filing in which the Commission ordered a true-up of Empire's case through February 29, 2008. Accordingly, true-up testimony was filed by the parties and admitted into evidence. There was no true-up hearing. No new issues to be decided by the Commission came about as a result of the true-up. With this true-up through February 29, 2008, and the inclusion of the Asbury SCR in rate base (and the related expenses included in Empire's cost of service), five issues remain contested.

With regard to these five issues, the competent and substantial evidence in the record supports:

- the award of an 11.6 percent return on common equity ("ROE") for Empire;
- a holding that the Missouri jurisdictional portion of a simple five-year average of Empire's off-system sales margins should be used as an offset to the Missouri jurisdictional cost of service;
- a holding that Empire's projected costs of compliance with the Commission's rules concerning vegetation management and infrastructure inspections should be included in Empire's cost of service and that Empire should be allowed deferral treatment through a tracker mechanism of any incremental expenses it incurs above the amount reflected in its rates to comply with these rules;
- a holding that Empire's proposed depreciation rate changes should be adopted; and

- the authorization of a fuel adjustment clause ("FAC") for Empire pursuant to RSMo. §386.266, as detailed by Empire witnesses Bill Gipson, Scott Keith, and Ed Overcast.

<u>Revenue Requirement Issues</u>

<u>Return on Common Equity</u>: What return on common equity should be used for determining Empire's rate of return? In the event the Commission grants Empire a fuel adjustment clause, what, if any, is the appropriate adjustment to the authorized return on equity?

A return on common equity, or ROE, of 11.6 percent should be used for determining Empire's authorized rate of return ("ROR") in this proceeding. In the event the Commission authorizes an FAC for Empire, the ROE should not be adjusted downward. Empire witnesses Dr. James H. Vander Weide and Dr. H. Edwin Overcast presented competent and substantial evidence supporting Empire's request for an 11.6 ROE. These issues were dealt with fully through Empire's testimony and in Empire's pre-hearing brief and initial post-hearing brief.

With the portion of their initial post-hearing brief dealing with ROE, Explorer Pipeline Company, General Mills, and Praxair, Inc. (the "Industrials") sing the praises of the "zone of reasonableness," point to credibility findings from prior Commission cases involving other utilities, make a failed attempt to discredit the methodology employed by Dr. Vander Weide, attack Chairman Davis, take issue with the Staff's ROE methodology, and opine as to the impact of an FAC being authorized for Empire. The portion of the initial post-hearing brief of the Office of the Public Counsel ("Public Counsel") on this topic is basically a "Cliffs Notes" version of the Industrials' discussion regarding witness credibility, use of the zone of reasonableness, and the impact of an FAC. The Staff of the Commission ("Staff") also praises the use of the zone of reasonableness and mischaracterizes the testimony of Dr. Vander Weide. Despite there being many pages of discussion, the initial post-hearing briefs filed on behalf of the other parties present no new points on the ROE issue in need of rebuttal. Empire will, however, briefly address some of the attacks made by these other parties.

1. Credibility. The Industrials and Public Counsel spend little time explaining why they believe the analysis conducted by Industrial witness Gorman should be accepted by the Commission. Instead, the parties focus on credibility determinations from other rate cases involving other utilities. The Industrials go so far as actually asserting that the Commission "should utilize . . . its previous findings of the relative levels of credibility of the witnesses." (Industrial Brf., p. 8)[1] This is absurd. The Commission must decide the contested issues in this case based upon the record in this case, and the Commission must judge the credibility of the witnesses with regard to the testimony presented in this case.

Dr. Vander Weide and Dr. Overcast presented credible testimony in this case – opinions and recommendations grounded in sound financial and regulatory theory and practice. These opinions and recommendations should not be cast aside based upon a Commission finding on credibility in another case, involving a different set of facts and even a different regulated utility. Although the Commission may exercise its discretion with regard to witness testimony and credibility, the courts have made it quite clear that the Commission must lawfully exercise its discretion. *State ex rel. GS Technologies Operating Co., Inc. v. Public Service Commission*, 116 S.W.3d 680, 690-691 (Mo.App. W.D. 2003) (*citing Missouri National Education Association v. Missouri State Board of Education*, 34 S.W.3d 266, 280 (Mo.App. 2000)). Utilizing findings

[1] All brief references are to the initial post-hearing briefs which were filed herein by the parties.

from other cases involving other companies and other circumstances, as suggested by the Industrials, would not be a lawful exercise of the Commission's discretion.

Dr. Vander Weide's 11.6 percent recommendation in the current case is consistent with his past proposals for Empire (except that, due to an express directive from Empire, he is not proposing a financial risk adjustment). Staff has increased its recommendation relative to Empire's last two rate cases, and Staff witness Barnes testified in this case that he would be in agreement with an award of 10.8 percent. (Tr. 514) Mr. Gorman, the witness for the Industrials (with support from Public Counsel), said he would not take issue with an award of 10.3 percent. (Tr. 797-798) In the current case, the evidence clearly demonstrates that Empire's financial circumstances have not improved since 11 percent and 10.9 percent ROEs were awarded to Empire in its past two rate cases. For example, Empire's construction expenditures have increased and will continue to increase, fuel costs have continued to rise, and interest rates in the long-term bond market have risen since the last rate case decisions.

2. The Zone of Reasonableness. Conflicting testimony was presented regarding the boundaries of what has been labeled as the "zone of reasonableness," due to a dispute over whether only integrated electric utilities, such as Empire, should be included, as suggested by Empire witness Dr. Vander Weide. More significantly, however, the expert witnesses on this issue seemed to lend little credence to the strict application of this regulatory tool. As Dr. Vander Weide testified, "(t)here's a great deal of circularity in using average allowed rates of return in other states as an indicator of the cost of equity at present in this state." (Tr. 461) Mr. Gorman, speaking for the Industrials, also stated that he would suggest looking at the industry average only as a "double-check" of the reasonableness of the end result of a "more detailed assessment of the relative risk of the underlying enterprise. . ." (Tr. 801-802)

Contrary to the testimony of their expert witness, with their initial post-hearing brief, the Industrials urge the Commission to utilize the zone of reasonableness, pointing to the use of this range to view a recommendation with skepticism in a prior AmerenUE rate case and to reject another recommendation in a KCPL rate case. (Industrial Brf., pp. 8-9) Like the Industrials, Public Counsel points to this prior KCPL rate case (Commission Case No. ER-2006-0314) and urges the Commission to apply the zone of reasonableness in this case "exactly the same way" it was applied by the Commission in the KPCL rate case. (Public Counsel Brf., pp. 13-14) Interestingly, Public Counsel sought judicial review of the Commission's decision in that case and strenuously argued that use of the zone of reasonableness was unlawful as it had not been supported by the testimony of an expert witness in that case.

If the Commission decides to use the zone of reasonableness as a tool in deciding the issue of ROE in this case, Empire encourages the Commission to look to companies of comparable risk, excluding less risky "wires only" companies in determining the average ROE. If this is done for the six month period of October, 2007 to March, 2008, the zone of reasonableness is 9.7 to 11. 7 percent. If an entire year is used, the zone of reasonableness is 9.6 to 11.6 percent. (Ex. 30, Vander Weide Surrebuttal, p. 10) Considering Empire's relative risk, it makes sense that the ROE recommendation for Empire would be at the top of these ranges.

The Industrials argue that the evidence indicates that the classification of an electric utility as either integrated or wires-only, does not provide an accurate assessment of the utility's risk. (Industrial Brf., p. 10) The evidence, however, does indicate that integrated utilities *are more risky than wires-only electric utilities*. First, integrated utilities are currently making large investments in electric generation plants, whereas wires-only electric utilities are not. (Ex. 30, Vander Weide Surrebuttal, p. 10) Second, as illustrated by the following table, the record demonstrates that the average authorized ROE for integrated electric utilities is 60 to 90 basis points higher than the average ROE for wires-only electric utilities. (Ex. 30, Vander Weide Surrebuttal, Schedule 1)

Period	Average ROE Integrated Electric Utilities	Average ROE Wires-Only Electric Utilities	Risk Premium Integrated vs. Wires-Only
2007 – Q1 2008	10.5%	9.9%	60 basis points
Q4 2007 – Q1 2008	10.7%	9.8%	90 basis points
Most Recent 12 Months (Q2 2007 – Q1 2008)	10.6%	9.8%	80 basis points

The Industrials make the statement that, as Mr. Gorman indicated, there are several examples of wires-only electric utilities which have a higher risk than Empire operating as an integrated utility. (Industrials Brf., p. 10) The question is not whether there are one or two examples of wires-only electric utilities that are more risky than integrated utilities, but whether, on average, integrated utilities are more risky than wires-only electric utilities. The evidence from allowed rates of return indicates that commissions nation-wide believe that integrated utilities are more risky than wires-only utilities. Second, Mr. Gorman does not cite "several examples" – he only cites the example of Ameren's Illinois utilities, which, if anything, are more risky because of regulatory actions rather than because of their inherent business risk.

Staff contends that Dr. Vander Weide's exclusion of certain utilities "is, at best, inconsistent with his other study methods, and, at worst, a disingenuous attempt to make Empire's requested return on equity appear tenuously reasonable." (Staff Brf., p. 7) In discussing the Commission's zone of reasonableness, Dr. Vander Weide's exclusion of wires-only electric utilities' allowed returns is not inconsistent with his other study methods. Specifically, Dr. Vander Weide's group of proxy electric utilities includes only one wires-only electric utility, Consolidated Edison; and Consolidated Edison's DCF result was significantly below the average DCF result for the group. (Ex. 28, Vander Weide Direct, Schedule 1)

Thus, Dr. Vander Weide's DCF results are consistent with his statement that wires-only electric utilities are less risky than integrated electric utilities. Further, Dr. Vander Weide did not include natural gas distribution companies in his testimony in this proceeding because, as he explains, the risk of investing in electric companies has increased relative to the risk of investing in natural gas companies because electric companies are now investing heavily in new electric generation and transmission facilities to meet customer needs, whereas the capital expenditures of natural gas companies are relatively modest at this time. (Ex. 30, Vander Weide Surrebuttal, pp. 5-6)

The Industrials suggest in their Initial Brief that the Commission, if it is going to exclude wires-only companies, use quite circular logic, look only to Missouri regulated utilities, and employ a range of 9.4 to 11.4 percent. (Industrial Brf., p. 11) As noted, judging allowed ROEs in Missouri by looking at other allowed ROEs in Missouri is obviously circular. Furthermore, Empire was awarded ROEs of 11.0 percent and 10.9 percent in its most recent prior cases at times when interest rates on Baa-rated utility bonds were approximately 80 basis points lower than they are currently. (Tr. 469, lines 1-16) The Industrials argue that, after all, the Supreme Court directs the Commission to consider the returns "generally being made at the same time and in the same general part of the country." (Industrial Brf., p. 11) The Industrials, however, cite only the *Bluefield* case, which was decided in 1923. In the subsequent *Hope* case, decided in 1944, the Supreme Court deleted the phrase, "in the same general part of the country." (*See* Ex. 29, Vander Weide Direct, pp. 9-10) The Supreme Court recognized in the *Hope* case that capital markets are national and that public utilities must compete for funds on a nation-wide basis. Indeed, today's competition for capital is a global proposition.

3. Dr. Vander Weide's Methodology. In arriving at his ROE recommendation of 11.6 percent, Dr. Vander Weide applied several standard cost of equity estimation techniques, including the discounted cash flow ("DCF") model, the risk premium method, and the Capital Asset Pricing Model ("CAPM") to a large group of comparable companies. (Ex. 28, Vander Weide Direct, p. 3) The method applied by Empire witness Dr. Vander Weide in formulating his ROE recommendation was set out at length in his pre-filed testimony and was summarized in Empire's Statement of Positions and Prehearing Brief. With their initial post-hearing briefs, the Industrials and Staff attempt to attack Dr. Vander Weide's techniques.

For example, the Industrials assert that there are problems inherent in Empire's methodology. Specifically, the Industrials state that Dr. Vander Weide relies on an unreasonable growth rate. (Industrial Brf., p. 15) This criticism is fully rebutted in Dr. Vander Weide's rebuttal (Ex. 29, pp. 27-32) and surrebuttal (Ex. 30, pp. 11-15) testimony. The DCF model requires the use of investors' growth expectations, whether rational or irrational. (Ex. 29, Vander Weide Rebuttal, p. 28) Dr. Vander Weide uses analysts' growth forecasts in the DCF model because his studies indicate that analysts' growth forecasts are the best proxy for investors' long-term growth expectations. (Ex. 30, Vander Weide Surrebuttal, pp. 11-12) The DCF model requires the growth forecasts of investors, not those of Mr. Gorman. (*Id.*, p. 12) If Mr. Gorman believes that investors' growth forecasts are irrational, he should adjust the stock prices in his DCF analyses as well as the growth forecasts. (*Id.*)

The Industrials also assert that Mr. Gorman recognized the obvious limitation of the constant growth DCF model and eschewed it in favor of the two-stage DCF model which allowed him to utilize the short-term inflated growth rates while still preserving the rational nature of the DCF model. (Industrial Brf., p. 17) Dr. Vander Weide demonstrates conclusively that investors do not use the two-stage growth rates Mr. Gorman employs in his two-stage DCF model. (Ex. 29, Vander Weide Rebuttal, pp. 31-32; Ex. 30, Vander Weide Surrebuttal, pp. 13-15).

For example, Dr. Vander Weide provides a statistical test of whether investors use analysts' growth rates or Mr. Gorman's two-stage model growth rates to value stocks. (Ex. 29, Vander Weide Rebuttal, pp. 31-32). Dr. Vander Weide's test demonstrates that the analysts' growth rates are significantly more correlated with electric companies' price/earnings ratios than Mr. Gorman's two-stage model growth rates. These results provide strong evidence that the constant growth DCF model using the analysts' forecasted growth rates is a reasonable approximation of how investors value securities in the marketplace. Dr. Vander Weide provides further evidence that Mr. Gorman's two-stage DCF model does not capture investors' growth expectations. (Ex. 30, Vander Weide Surrebuttal, pp. 13-15) Specifically, Dr. Vander Weide demonstrates that Mr. Gorman's two-stage DCF model applied to electric utilities and to companies in the S&P 500 produces the unreasonable result that companies with greater risk have lower DCF costs of equity. These studies again demonstrate the superiority of the constant growth DCF model with analysts' growth rates to Mr. Gorman's two-stage DCF model.

Next, the Industrials assert that Mr. Gorman, demonstrating the inflated nature of the DCF analysis performed on the proxy group, compared Dr. Vander Weide's DCF for the proxy group to the average authorized return on equity for each time period. (Industrial Brf., p. 19) Dr. Vander Weide notes that Mr. Gorman's comparison of DCF results to authorized allowed rates of return is both inappropriate and inherently circular. He also points out that Mr. Gorman's statement that Dr. Vander Weide's DCF results are higher than industry-average allowed returns is simply incorrect. "Considering the years 2004 through 2007, the average DCF component in my ex ante risk premium studies is less than the average authorized return for these years." (Ex. 30, Vander Weide Surrebuttal, p. 18)

The Industrials also contend that Mr. Gorman noted that the current yield for A-rated utility bonds is 15 basis points lower than the yield utilized by Dr. Vander Weide. (Industrial Brf., p. 19) Mr. Gorman's claim that Dr. Vander Weide used projected A-rated utility bond yields is false, and his claim that current yields are lower than the yields used by Dr. Vander Weide in his studies is false. Recent Moody's A-rated utility bonds have been virtually the same as the 6.25 percent yield Dr. Vander Weide used in the studies reported in his direct testimony. (Ex. 30, Vander Weide Surrebuttal, p. 19)

Lastly, the Industrials argue that there are several flaws in Dr. Vander Weide's historical market risk premium. (Industrial Brf., p. 21) In his CAPM analysis, Dr. Vander Weide correctly uses the income return on government bonds "because the CAPM requires that the return on equity investments be compared to the rate of return on a risk-free investment. Since capital gains and losses are highly uncertain, the income return on Treasury bonds is the best estimate of the risk-free rate in the long horizon CAPM." (Ex. 30, Vander Weide Surrebuttal, p. 21)

Like the Industrials, the Staff makes an unsuccessful attempt to discredit Dr. Vander Weide. Specifically, the Staff points to alleged inconsistencies. (Staff Brf., pp. 8-12) The criticism with regard to the "zone of reasonableness" is discussed above. Staff's next criticism is that Dr. Vander Weide's recommendation regarding the small size of Empire's market capitalization and the attendant risk is not consistent with his acknowledgement of various risks being included in the bond ratings of the companies that make up his proxy groups. (Staff Brf., p. 8) Dr. Vander Weide, however, does not recommend a small-size premium for Empire. He merely notes that Staff witness Barnes would have obtained a CAPM cost of equity for Empire equal to 12 percent if he had recognized the small company size premium in his CAPM analysis. (Ex. 29, Vander Weide Rebuttal, p. 21) Further, the small size premium is related to the cost of equity, not to the cost of debt. Bond ratings refer only to the risk of a company's debt.

Staff next contends that Dr. Vander Weide "apparently places his imprimatur upon Empire witness Overcast's advocacy of the application of a regulatory risk premium . . . ignoring the fact that Wall Street already acknowledges and both includes this risk in its valuation of Empire, which is eventually captured in Empire's beta relative to the market as a whole, and also considers this risk in the bond rating process." (Staff Brf., p. 8) With regard to the "bond rating process," Empire's BBB- bond rating compared to the average BBB+ bond rating of Dr. Vander Weide's proxy companies supports his claim that Empire is more risky than his proxy companies. With regard to betas, a beta for an individual company is measured with a great deal of uncertainty and hence are unreliable as a measure of an individual company's risk. More importantly, as Dr. Overcast amply demonstrates, Dr. Vander Weide's cost of equity is based on the result of his application of methods to proxy companies that have fuel adjustment clauses, whereas Empire does not.

Staff also asserts that Dr. Vander Weide, in one instance, "vehemently argues that his study ROE should be inflated to compensate for what he describes as additional risk attendant to Empire's capitalization relative to the market" but then "bloats his study results by rejecting the arithmetic mean of his study companies' performance in favor of a market capitalization-weighted average, which emphasizes the ROEs of large market capitalization companies." (Staff Brf., p. 10) Dr. Vander Weide, however, does not "vehemently" argue "that his study ROE should be inflated" to include a small cap risk premium. Dr. Vander Weide's recommendation in this proceeding conservatively ignores the small market capitalization risk premium that the financial literature suggests should be included. Dr. Vander Weide only noted in response to Chairman Davis' questioning that investors expect a risk premium on investments in small market capitalization companies like Empire, and thus, that his recommended cost of equity is conservative.

As noted above, Empire directed Dr. Vander Weide to refrain from making a risk adjustment, as the same had been rejected in a recent rate case involving AmerenUE. (Ex. 28, Vander Weide Direct, p. 42) Further, Dr. Vander Weide uses market-weighted results because market weights indicate the relative share of each company in a typical investor's portfolio of companies; and the expected return on a portfolio of companies depends on the market values of the companies in the portfolio. (Ex. 30, Vander Weide Surrebuttal, p. 15) Thus, Dr. Vander Weide did not "bloat" his study results by using market weights. Rather, he made his study results more consistent with investors' expected returns on companies in the electric utility industry.

Staff next makes the false assertion that while Dr. Vander Weide "recognizes that virtually all gas utilities are distribution only . . . he apparently does not recognize any inherent flaw in the logic of claiming distribution-only gas companies are comparable while claiming distribution-only electric utilities are not comparable." (Staff Brf., p. 11) Dr. Vander Weide does not claim that distribution-only gas companies are comparable to integrated electric utilities. Indeed, Dr. Vander Weide did not apply his cost of equity methods to natural gas companies in this proceeding for Empire because the risk of investing in electric companies such as Empire has increased relative to the risk of investing in natural gas companies. (Ex. 30, Vander Weide Surrebuttal, pp. 5-6)

<u>Off-System Sales Margins:</u> What amount of off-system sales margins, if any, should be included as an offset to Empire's cost of service?

In determining the revenue requirement to use for setting rates in this case, the Commission must examine each item of Empire's cost of service to determine, based on available evidence, the amounts of revenue and expense that most accurately reflect the Company's operating experience during the period rates set in this case will be in effect. For most categories of revenue and expense, that task is fairly straightforward: the Commission starts with the amount actually booked by Empire during the test year and then makes necessary adjustments to that amount based on future changes that are both known and measurable. But when an item of revenue or expense fluctuates significantly from year to year, and especially when those fluctuations do not reflect any identifiable trend, the Commission's task becomes more difficult. Under such circumstances, the Commission cannot rely too heavily on amounts booked during the test year; instead, it must look at a range of data and then apply reasoned judgment to those data in order to accurately predict the level of income or expense that the utility likely will experience in the future.

This latter scenario is the one the Commission faces with regard to its determination of the appropriate level of off-system sales margins to include in Empire's test period cost of service. As the Company discussed in its initial post-hearing brief, uncontroverted evidence presented by both Empire and Staff clearly establishes that the off-system sales margins booked by the Company since 1999 have fluctuated wildly from year to year, with no discernable short-term trends. Faced with facts such as these, the Commission, in the past, has elected to normalize the level of test period off-system sales margins by averaging actual costs over a recent period.

In Empire's last general rate case, Case No. ER-2006-0315, the Commission used a five-year average, and that is the methodology that the Company has proposed to use in the present case.

Staff and Public Counsel disagree, however. Although Empire does not believe that the averaging methodology that Staff used is particularly reliable, Staff's estimate of off-system sales margins closely approximates the Company's own estimate, so Empire has stated it would be willing to use Staff's estimate for ratemaking purposes. But Public Counsel's proposal, which would base test period off-system sales margins on the amount actually booked by Empire during 2007, is not appropriate. The 2007 amount – $5,955,336 – is the largest amount of revenue related to off-system sales that Empire has booked in more than ten years. It exceeds the amounts booked in 2005 and 2006 by more than 70 percent each and the amount booked in 2004 by more than 250 percent. Moreover, almost a quarter of the off-system sales margins that Empire booked during 2007 came from a single power supply agreement that is due to expire shortly before the operation of law date for this case.

Public Counsel argues that recent developments that affected the amount of off-system sales margins that were booked during 2007 – such as the Southwest Power Pool's EIS market – likely will sustain the 2007 levels into the future. But there is simply no way that Public Counsel, or the Commission, can make that prediction with any reasonable degree of confidence. Historical data presented by Empire and Staff show that an exceptionally high level of off-system sales was *never* sustained over the succeeding few years, and there is no reason to believe that history will not repeat itself. Public Counsel's position, based solely on unfounded conjecture, is a poor basis for setting rates.

Empire stated in its initial post-hearing brief, and reiterates here, that the effect of an overly-generous estimate of future off-system sales margins will be mitigated if the Commission approves an FAC for the Company that includes off-system sales margins. But that does not relieve the Commission of its burden to carefully, reasonably, and thoughtfully set the level of off-system sales margins that will be included in base rates. If the estimate of off-system sales margins included in base rates is higher than Empire reasonably can be expected to achieve, then future FAC-related rate increases likely will be greater than otherwise would be the case. Conversely, if the estimate is lower than the Company is actually able to achieve, the result will be FAC-related increases that are lower.

For all the reasons presented above and in its initial brief, Empire believes it is both reasonable and prudent for the Commission to use the five-year average proposed by the Company to set the amount of off-system sales margins to be used in the test period cost of service.

Commission Rules/Tracker: Should Empire's projected costs of compliance with the Commission's rules concerning vegetation management and infrastructure inspections be included in Empire's cost of service? If yes, should such costs be recovered using a "tracker mechanism" similar to that currently in place for Ameren UE? Should Empire be allowed deferral treatment of any incremental expenses it incurs above the amount reflected in its rates to comply with these rules?

Yes. Empire's projected costs of compliance with the Commission's rules should be included in Empire's cost of service, and Empire should be allowed deferral treatment of any incremental expenses it incurs above the amount reflected in its rates to comply with these rules. The initial post-hearing briefs filed by both the Staff and the Public Counsel address the proposed Commission Rules Tracker. The tracker would address costs of compliance associated with the Commission's new vegetation management and infrastructure inspection rules

(Commission Rules 4 CSR 240-23.020 and 4 CSR 240-23.030). The final Orders of Rulemaking were published in the May 1, 2008, *Missouri Register*, and are now effective (as of June 30, 2008).

The Staff states that "it is good policy in this situation to allow Empire upfront recovery in rates of its estimated compliance costs for the new rules, rather than have Empire incur the costs first and seek recovery of rule compliance cost deferrals later." (Staff Brf., p. 18) In order "to ensure that all of the projected expenditures are made and that the amounts provided upfront to the Company in rates are used for the intended purposes," Staff recommends the use of a "tracker" mechanism. *Id*. The tracker proposed by Staff would require that if Empire does not spend the required amount in any given year, it must spend that shortfall the next year with interest. *Id*. Staff states that "a more reliable system for Empire is clearly in the public interest, and the Staff's proposal for rate funding of vegetation management and infrastructure inspections in this proceeding is the most appropriate approach for reaching this important goal." *Id*. at p. 19.

Empire has a slightly revised proposal that does not cap the expenditures necessary to comply with the Commission's rules. Under Empire's proposal, if Missouri expenditures do not reach $8.9 million, then in the following year Empire would be required to spend $8.9 million plus the shortfall from the prior year, including an interest component calculated using the Company's short term interest rate. (Ex. 4, Keith Surrebuttal, p. 13) If Missouri expenditures exceed $8.9 million, Empire proposes that it be authorized to record these costs as a regulatory asset so that they can be considered for recovery in Empire's next rate case. No interest component would apply to this regulatory asset under Empire's proposal. (Ex. 4, Keith Surrebuttal, p. 14)

The Public Counsel opposes both the Staff proposal and Empire's proposal. Public Counsel argues: 1) that the compliance costs should not be addressed because Public Counsel believes they are not known and measurable; and, 2) Staff's proposal could require Empire to spend more than what may be necessary and prudent.

These concerns are addressed by the tracker mechanism proposed by Empire and could be even more directly addressed if the Commission should decide to make a slight change to the proposals. A regulatory tracking mechanism reduces the need for precision in cost estimation. The tracker allows for an assessment of the company's performance and consequences if the actual expenses are less (or greater) than projected. For this reason, this approach has been used by the Commission regularly as to FAS 87 (pensions) and FAS 106 (retirement benefits other than pensions). (Tr. 403) In fact, it has been used in those situations precisely because the expenses vary greatly from period to period and are difficult to predict.

As to the second Public Counsel argument, any concern as the possibility that Empire would be required to spend more than necessary, can be easily addressed through a tracker that creates a regulatory liability in any year where the Company spends less than the target amount and a regulatory asset where the Company spends more than the target amount. This approach would allow assets and liabilities from year to year to be netted against one another. (Tr. 403) In the next rate case, the Company could then seek to recover any excess expenditures it has made, or be required to return to customers any under expenditures the company has made in relation to the level that has been set in rates. (Tr. 412-413)

The Public Counsel also offers other unsupportable arguments. The first of these is the argument that there will not be an opportunity to perform a prudence review in future cases because the Staff does not have appropriately trained employees. (Public Counsel Brf., p. 33)

The Public Counsel does not indicate whether appropriate employees could be assigned to the task, trained or hired for this purpose. However, this is not really an argument against the proposed tracker. Whether or not the Commission approves the proposed tracker, one would think that there will be a need for a review of the Empire's expenditures. The presence of personnel for this purpose may be something that should be examined by the Commission. However, it has no bearing on the determination of the issue at hand.

Public Counsel further argues that the proposal is undeveloped because Empire has not segregated compliance costs during the test year. Again, this is irrelevant to the issue of whether there should be a tracker implemented in future periods. There is no tracker in place at this time and the proposed tracker will only apply to future periods beginning with the effective date of compliance tariffs approved at the conclusion of this case. There is nothing to be tracked, unless the Commission approves the proposed mechanism.

Similarly, because rates are set on a prospective basis, Public Counsel is incorrect when it asserts that "when Empire's tree-trimming costs increase, as they did between 2005 and 2006, those increases are captured in rate cases." (Public Counsel Brf., pp. 33-34) When costs increase, the increased amount may ultimately be picked up in a rate case for the purpose of setting future rates. However, the increase experienced prior to the time new rates go into effect is borne by the Company in the absence of a deferral or other special regulatory treatment. The increase in tree-trimming costs between 2005 and 2006 was borne by the Company, as will compliance costs for the new rules, unless the Commission approves some type of regulatory device to address the situation.

Public Counsel also argues that the proposal will allow Empire to be compensated for amounts that will not be spent until a year after rates go into effect. While the amount Staff utilizes in its tracker is greater than the first year cost estimate, it is also less than the estimates for years two, three and so on. This is merely a function of having to pick a single number for developing rates that will likely be in effect for more than one year. Both of the tracker proposals address this issue by providing interest to customers for any dollars that are not spent in year one (as well as future years).

Empire's proposed tracker mechanism should be approved as it will provide Empire with the needed resources to address the requirements of the vegetation management and infrastructure inspection rules, while providing protection for both Empire's customers and Empire.

Depreciation Rates: Should Empire's depreciation rates be subject to change during the duration of its Regulatory Plan? If yes, should Empire's proposed changes to its depreciation rates be adopted in this proceeding? Are Empire's record keeping practices regarding its plant assets and depreciation accounting adequate?

Yes. Empire has proposed revised depreciation rates which are supported by a comprehensive study performed by Donald Roff, President of Depreciation Specialty Resources.[2] Mr. Roff also performed and sponsored the Company's depreciation study in its 2004 rate case, Case No. ER-2004-0570. The Commission may recall that it adopted a number of Mr. Roff's recommendations in its Report and Order in that case.[3] Staff and Public Counsel filed initial post-hearing briefs addressing the topic of depreciation rates. Where Staff's brief is concerned, Empire has already thoroughly addressed Staff's ill-conceived legal premise (i.e., that depreciation rates should remain unchanged because of the Company's pending regulatory plan

[2] Importantly, no other party has offered a comprehensive depreciation study for the Commission's consideration in this case.

[3] Depreciation rates were not an issue in Empire's 2006 rate case, Case No. ER-2006-0315.

amortization mechanism) in its pre-hearing brief and initial post-hearing brief. Staff's brief offers nothing additional that would warrant further response on this topic.

Public Counsel and, to a lesser extent Staff, challenge the validity of Mr. Roff's depreciation study alleging the use of inappropriate methodologies and/or unreliable data. None of these arguments justify disregarding Mr. Roff's depreciation study which is comprehensive in nature and gives appropriate recognition to historical experience, recent trends and Company expectations. The data provided by the Company was accurate and reliable and the procedures Mr. Roff used were consistent with prior depreciation studies considered by the Commission.

At page 17 of its initial post-hearing brief, Public Counsel alleges inconsistent treatment of reserve deficiencies and surpluses. This argument should be disregarded. Public Counsel's allegation that certain accounts have less money than the actual book reserve is grounded on an incorrect premise. There is no money in the actual book reserve; it is merely an accounting balance. Mr. Roff explained his use of a "theoretical reserve", a forward-looking calculation, instead of book reserve which is a historical analysis. The former was used by Mr. Roff as an estimate of what <u>should be</u> in the accumulated provision for depreciation today. (Roff Rebuttal, p. 2-3) Additionally, Public Counsel's allegation that Mr. Roff used a double standard is just plain wrong. For every account for which traditional depreciation accounting is proposed, Mr. Roff utilized the authorized whole life technique. Ultimately, Public Counsel is arguing that the Commission should abandon its long-standing policy of using whole life accounting technique and instead use remaining life technique. This is an argument that has sweeping implications for all regulated Missouri utilities. Empire believes the Commission should reject Public Counsel's misguided policy recommendation.

At page 20 of Public Counsel's brief, it is argued that the Company's plant investment is not being depreciated over the service life of the property. Public Counsel asserts that there is no recognition of the actual book depreciation reserve amount. This assertion is incorrect. The definition of service value (the amount of the property to be depreciated) is contained in the FERC-approved uniform system of accounts as follows: "Service value means the difference between original cost and net salvage value of utility plant." Mr. Roff's depreciation study produces depreciation rates related to the service value of the property.

On page 22 of its brief, Public Counsel adopts Staff's criticism of the manner in which Mr. Roff has treated reimbursements. As explained at pages 7 and 8 of Mr. Roff's surrebuttal testimony, his treatment of reimbursements produced the correct credit to depreciation. The fact that Staff (and by extension, Public Counsel) do not understand the process does not negate the correctness of Mr. Roff's approach. Public Counsel takes issue with the fact that Mr. Roff's omitted insurance proceeds from the depreciation study salvage and cost of removal analysis. As he explained in his surrebuttal testimony at pages 6 and 7, these proceeds were eliminated from salvage and cost of removal because they are not a proper component of depreciation. The regulatory definition reads as follows:

> Depreciation, as applied to depreciable utility plant, means the loss and service value not restored by current maintenance, incurred in connection with the consumption or perspective retirement of utility plant in the course of service from causes which are known to be in current operation <u>and against which the utility is not protected by insurance</u>. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolesce, changes in the art, changes in demand and requirements of public authorities. (emphasis added)

It is apparent, then, that insurance is not a part of depreciation and insurance proceeds were appropriately eliminated by Mr. Roff from the salvage and the cost of removal analysis. It also should be pointed out that the effect upon the service life indications of including the insurance related retirements in the life analysis, while reducing the indicated average service life, is immaterial due to the fact that there are relatively few, minor insurance retirements and only within a very few accounts.

With respect to Public Counsel's conclusion #2 on page 25, that the Commission should adopt the remaining life depreciation technique, this is a recommendation that would represent a material change in existing Commission well-established depreciation policy of using whole life technique. Consequently, it should be rejected. Likewise, the other conclusions and recommendations presented and offered by Public Counsel should be rejected based on flawed or misguided analysis as noted above.

Fuel Cost Recovery

In their initial post-hearing briefs, Public Counsel and the Industrials argue that the Commission should not authorize Empire to implement a fuel adjustment clause, or FAC, at all or, in the alternative, that any FAC that is approved should include a so-called "sharing" or "incentive" mechanism that will prohibit Empire from recovering from its customers some portion of the Company's prudently-incurred fuel and purchased power costs. Although supportive of the authorization of an FAC for Empire, Staff also proposes such a "sharing" or "incentive" mechanism. The arguments of the Industrials, Public Counsel, and the Staff in this regard are either unfounded or unpersuasive, or both.

1. The Stipulation and Agreement in Case No. ER-2004-0570 Does Not Prohibit Empire from Seeking an FAC in the Present Case.

Public Counsel and the Industrials persist in their claim that the Stipulation and Agreement that was approved by the Commission in Case No. ER-2004-0570 prohibits Empire from seeking an FAC in this case. The utter lack of any factual or legal foundation for the fundamental premise underlying this argument – that the interim energy charge ("IEC") that was approved by the Commission in Case No. ER-2004-0570 remains in effect – was discussed at pages 34-36 of Empire's initial brief, and the Company will not repeat those arguments here. Instead, Empire will focus its reply on the argument that appears at pages 36-37 of the Industrials' initial brief: that because of the October 30, 2007, decision of the Missouri Supreme Court in *State ex rel. Office of Pub. Counsel v. Pub. Serv. Comm'n.*,[4] the compliance tariff sheets that Empire filed in response to the Commission's December 21, 2006, *Report and Order* in Case No. ER-2006-0315, which, *inter alia*, terminated the IEC, were never lawfully approved by the Commission.

In considering this issue, the Commission must remember that the Industrials' argument is premised on the assumption that the Missouri Supreme Court will ultimately conclude that, notwithstanding reality and the "filed rate doctrine," the tariffs that took effect of January 1, 2007, never existed. That assumption is speculative, at best, and unless and until the Supreme Court issues a decision that reaches that conclusion there is no basis for the Industrials' argument.

But assuming *arguendo* that the compliance tariffs filed by Empire were not validly approved in December of 2006, the Industrials' argument still fails for two reasons. First, even without an order approving the compliance tariffs effective on January 1, 2007, those tariffs would have gone into effect by operation of law on January 27, 2007[5] – well in advance of the filing date of the current case. Second – and perhaps more importantly – regardless of how the

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[4] 236 S.W.3d 632.

[5] Under the "file and suspend" provisions of Missouri law, unless the Commission issues a suspension order a filed tariff takes effect on its effective date by operation of law. *See* §§393.140(11) and 393.150; *see also State ex. rel. Util. Consumers Council of Missouri, Inc. v. Pub. Serv. Comm'n.*, 585 S.W.2d 41, 49 (Mo. banc 1979) (a utility's rates may be increased without requirement of a hearing); and *State ex rel. Laclede Gas Co. v. Pub. Serv. Comm'n.*, 535 S.W.2d 561, 566 (Mo.App. 1976) (because of the statutory "file and suspend" provisions, the Commission has the discretionary power to allow new rates to go into effect by non-action).

Supreme Court ultimately rules, it is a fact that the tariff sheets approved by the Commission in its December 29, 2006, order were in effect at the time that Empire filed its current rate case and that the "filed rate doctrine" controls.[6] Because those tariff sheets did not include an IEC, the terms of the Stipulation and Agreement in Case No. ER-2004-0570 did not prohibit Empire from seeking an FAC in this case.

2. It Would Be Sound Regulatory Policy for the Commission to Authorize an FAC for Empire.

Staff, Public Counsel, and the Industrials recite concerns about the complexity that an FAC will introduce into the regulatory process and rate uncertainty for customers and claims that the FAC will constitute an unlawful delegation to Empire of the Commission's authority to regulate rates.[7] Indeed, the Industrials, quoting from the Missouri Supreme Court's decision in *UCCM*, characterize FACs as a "radical departure" from usual ratemaking practices.

But the other parties ignore several inconvenient facts that refute their arguments quite convincingly. First, FACs are the current regulatory norm for dealing with ever increasing fuel and purchased power costs. Second, without a mechanism for adjusting rates between rate cases for the effects of increased energy costs it is a virtual certainty that Empire, which was forced to absorb more than $85 million in fuel and purchased power costs over a recent five-year period – will continue to under recover its costs into the future and have no opportunity to earn the return allowed by the Commission.

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[6] *See, e.g., Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 577 (1981) (a regulated entity is prohibited from charging a rate for services other than that filed with appropriate regulatory authority).

[7] The Industrials' claim that an FAC constitutes unlawful delegation of the Commission's ratemaking authority is unpersuasive for at least two reasons: first, the cases cited in support of that claim are not court cases but, instead, are regulatory commission decisions from outside Missouri; and second, the two regulatory commission decisions that are cited were decided in 1917 and 1921, respectively.

Empire noted in its initial brief that 42 states and the FERC currently authorize electric utilities in those jurisdictions to recover their prudently-incurred fuel and purchased power costs through some sort of automatic cost recovery mechanism. Were it not for *UCCM*, Missouri would have long been part of this regulatory mainstream – as it was until the Missouri Supreme Court ruled the Commission lacked the authority to allow electric utilities, like Empire, to adjust rates between rate cases to reflect increasing energy costs. Certainly a ratemaking scheme that has been embraced by more than 80 percent of the federal and state utility regulatory commissions in this country can hardly be viewed as "radical," regardless of what the Missouri Supreme Court may have said in 1979. Similarly, given their widespread use, there is no basis for anyone reasonably to contend that FACs constitute bad regulatory policy or are an unlawful delegation of the Commission's ratemaking authority.

The Commission need look back only a few years to see the devastating financial impact that the lack of an FAC can have on a utility like Empire. The more than $85 million in fuel and purchased power costs that the Company was forced to absorb during the five-year period 2002-2007 resulted in earned rates of return that were but a fraction of what the Commission had determined to be a fair and reasonable return in any of the general rate cases that Empire prosecuted during that period. Adverse financial consequences like these for Empire and other Missouri electric utilities are what prompted the General Assembly to enact Section 386.266, RSMo. 2005, which removed the restrictions imposed on the Commission by *UCCM*. And it goes without saying that the General Assembly would not have acted as it did if it believed FACs to constitute bad regulatory policy or to be bad for Missouri's electric ratepayers, in general.

But the promise that §386.266 represents can only be realized if the Commission uses the authority it has been given and approves a reasonable FAC for Empire. The Commission approved an FAC for Aquila, Inc., in Case No. ER-2006-0004, and Staff's Cost of Service Report in this case (Ex. 204) concludes that, based on the three criteria for an FAC that the Commission announced in the Aquila case,[8] Empire's demonstrated need for an FAC is even greater than was Aquila's. Accordingly, the Commission should approve an FAC for Empire in this case and not be dissuaded by any of the arguments made by Staff, Public Counsel, or the Industrials in their initial post-hearing briefs or elsewhere.

3. There Is No Need to Include a So-Called "Incentive" or "Sharing" Mechanism in Any FAC that Is Approved in This Case.

Staff, Public Counsel, and the Industrials also continue to argue that any FAC that the Commission approves for Empire in this case should include a so-called "incentive" or "sharing" mechanism. Empire generally opposes the mechanisms that have been proposed by those parties for three primary reasons: 1) those mechanisms are not reasonably designed to "improve the efficiency and cost-effectiveness of [the Company's] fuel and purchased power procurement activities" and, therefore, fail to comply with limitations on such mechanisms that are imposed by Section 386.266, RSMo. 2005; 2) those mechanisms do not provide any real incentive but, instead, penalize Empire for cost increases that are beyond its control; and 3) requiring the Company to "share" prudently-incurred energy costs is unlawful. If, however, the Commission ultimately determines that some sort of "incentive" or "sharing" mechanism should be included in an FAC, then Empire believes its proposal to pass on 95 percent of future energy cost increases or savings is the only reasonable proposal that has been presented in this case.

As Empire discussed in its initial brief, although Section 386.266.1, RSMo. 2005, authorizes the Commission to include an incentive feature as part of an FAC, the language of the

[8] The criteria for authorizing an FAC that the Commission announced in Case No. ER-2006-0004 were: 1) fuel and purchased power must me a significant portion of the utility's costs; 2) fuel and purchased power must fluctuate significantly; and 3) fuel and purchased power costs must be outside the utility's control.

statute requires that any such feature be reasonably designed "to provide the electrical corporation with incentives to improve the efficiency and cost-effectiveness of its fuel and purchased-power procurement activities." As also noted in the Company's initial brief, the statutory language quoted above implies a second requirement: that improvements in efficiency and cost-effectiveness be achievable. None of the incentive mechanisms that have been proposed by other parties in this case satisfy either of those requirements.

Because both the statute and rules governing FACs require that all fuel and purchased power costs that are passed through an FAC be prudently-incurred, it is doubtful, at best, whether the mechanisms proposed by the other parties will achieve the objective required by law – improved efficiency and cost-effectiveness in a utility's energy procurement activities. It is axiomatic that if a utility's costs are already prudent, nothing more can, or should, be expected or can be achieved. Accordingly, the periodic prudence reviews that are required to be part of any FAC that is authorized by the Commission are the ultimate assurance that a utility's energy procurement activities are as efficient and cost-effective as possible. Moreover, these prudence reviews are supplemented by rules requiring utilities with an FAC to file monthly and quarterly reports, which allow Staff and other interested parties to closely monitor fuel and purchased power costs and other information related to Empire's overall financial performance.

The response of Staff, Public Counsel, and the Industrials to this argument is to claim that prudence reviews will not be effective in ferreting out imprudent procurement decisions. These parties' bald assertions, however, do not constitute substantial evidence to support this claim. Periodic prudence reviews are an integral part of the fuel cost recovery mechanisms that have been in place for many years at the FERC and in more than 40 states. If those reviews were as ineffectual as Empire's adversaries claim, is it likely that those jurisdictions would have continued to use automatic cost recovery mechanisms year after year? And based on the Commission's own experience with automatic fuel cost recovery mechanisms for Missouri's gas utilities, alleged incidents of imprudence routinely are identified and raised for review by the Commission. Indeed, the evidence in this case demonstrates that this occurs more than one-third of the time.

Even beyond the fact that the so-called "incentive" mechanisms proposed by Staff, Public Counsel, and the Industrials are unnecessary, such mechanisms would actually punish Empire for cost increases that are beyond its control. Dr. Overcast testified that because Empire purchases both fuel and purchased power in competitive commodity markets and receives delivery through regulated transportation options, the Company has no control over the market prices of those commodities. (Ex. 8, Overcast Direct, p. 6) Certainly Empire can mitigate the effect of fluctuating market prices by entering into fixed price contracts and hedging arrangements, but at some point the Company's ability to reasonably control energy costs ends completely. The more than $85 million in energy costs that Empire had to absorb in recent years – when an FAC was unavailable – is stark evidence both of the Company's lack of control over energy costs and the financial consequences that can result. But despite the fact that only prudently-incurred energy costs can be flowed through the FAC and that a substantial portion of fuel and purchased power costs are beyond Empire's control, Staff, Public Counsel, and the Industrials propose to prohibit the Company from recovering a significant portion of any future cost increases.

But there is a more fundamental reason why the Commission should reject the so-called "incentive" and "sharing" mechanisms proposed by Staff, Public Counsel, and the Industrials: by prohibiting Empire from recovering of a portion of its prudently-incurred operating costs, these mechanisms prevent the Company from earning a fair rate of return. The reason for this is quite simple: each dollar of prudently-incurred energy costs that Empire is prohibited from recovering from customers must be paid from funds that were included in the Company's revenue requirement to provide a fair return to shareholders. And as the funds available to pay a return to shareholders are diverted to pay a portion of operating costs, there is a coincident reduction in the rate of return – both in terms of what Empire will earn and also what it can earn. That is unlawful for two reasons: first, Section 386.266.4(1), RSMo. 2005, specifically requires that any FAC authorized by the Commission be "reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity"; and second, controlling case law clearly establishes that rates that fail to allow full recovery of a utility's reasonable and properly incurred operating costs do not satisfy the requirement that a utility be allowed a reasonable opportunity to earn a fair rate of return.

It would appear that the statutory standard is clear and unambiguous: an FAC must provide a sufficient opportunity for a utility to earn a fair rate of return. The controlling case law is equally clear. In *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), the United States Supreme Court stated: "[I]t is important that there be enough revenue *not only for operating expenses* but also for the capital costs of the business. *Id.* at 603 (emphasis added). In *Mississippi River Fuel Corporation v. FPC,* 163 F.2d 433 (1947), the United States Circuit Court of Appeals of the District of Columbia emphatically echoed the standard announced in *Hope* and clearly and unambiguously explained what that standard means in terms of how a utility's reasonable operating costs must be treated for ratemaking purposes:

> Expenses (using that term in its broad sense to include not only operating expenses but depreciation and taxes) are facts. They are to be ascertained, not created, by the regulatory authorities. *If properly incurred, they must be allowed as part of the composition of the rates.* Otherwise, the so-called allowance of a return upon the investment, being an amount over and above expenses, would be a farce.

Id. at 437 (emphasis added).[9]

In its initial brief, Staff argues that "Missouri Courts of Appeals have held that this Commission may disallow recovery of prudent costs that are not of benefit to ratepayers . . .." But the two cases that Staff relies on to support its argument – *State ex rel. Laclede Gas Co. v. Pub. Serv. Comm'n.*[10] and *State ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n.*[11] – do not stand for the proposition for which they are cited. Instead, these two decisions simply upheld Commission rate orders wherein certain categories of expense were excluded from the cost of service *because the Commission concluded that those costs were improper*.[12]

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[9] Similarly, the Supreme Court of California reached the following conclusion in *Southern California Edison Co. v. Pub. Util. Comm'n*, 576 P.2d 945 (1978): "'The basic principle [of ratemaking] is to establish a rate which will permit the utility to recovery its cost and expenses *plus* a reasonable return on the value of property devoted to public use.' . . . It is thus elementary regulatory law that the 'return' – i.e., the profit – of the utility is calculated solely on the rate base – i.e., the capital contributed by its investors; the utility is not entitled to earn an additional profit on its expenses, but only to 'recover' them on a dollar-for-dollar basis as part of the rates." *Id*. at 947 (emphasis original). In *Daily Advertiser v. TransLa*, 612 So.2d 7 (1993), the Supreme Court of Louisiana concluded that the legal principles recounted above, which were developed to address questions arising out of general ratemaking, also govern automatic cost recovery mechanisms like an FAC: "(a)utomatic fuel adjustment clauses are widely-accepted rate making tools utilized to allow a utility to recoup fluctuating fuel costs on an ongoing basis. . . As their name implies, fuel adjustment clauses are not designed to allow the utility to earn a profit; rather, they are recoupment devices designed to permit *dollar-for-dollar recovery* of fluctuations in fuel costs." *Id*. at 53 (emphasis added).

[10] 600 S.W.2d 222 (1980), *appeal dismissed*, 449 U.S. 1072 (1981).

[11] 645 S.W. 2d 44 (1982).

[12] In *Laclede Gas*, the Court of Appeals for the Western District affirmed a Commission order that had excluded from the cost of service used to set rates certain charitable contributions and advertising expense. The Commission explained its rationale for excluding charitable contributions as follows: "[T]he long established policy of this Commission has been to disallow the inclusion of charitable contributions above-the-line." *Report and Order* in Case No. GR-77-33, 21 Mo. P.S.C. (N.S) 430, 441 (1977). The Commission further stated that its decision to disallow a portion of Laclede's advertising expenses for ratemaking purposes was based on the determination that those expenditures provided no direct benefit to ratepayers. *Id*. at pp. 443-46. In *Southwestern Bell*, the same Court of Appeals affirmed the Commission's disallowance for ratemaking purposes of certain costs attributable to the defense of an antitrust action against AT&T. In its *Report and Order*, the Commission concluded that "the portion of the contract payment relating to antitrust litigation should be disallowed since no expense should be included when the Commission Staff has been denied access to the supporting records to determine the proper level of the reasonableness of the claimed expense." *Report and Order*, Case Nos. TR-77-214 and TR-79-213, 23 Mo. P.S.C. (N.S.) 374, 380 (1980).

The costs at issue in the Laclede and Southwestern Bell cases bear no resemblance to the fuel and purchased power costs that Empire would be prohibited from recovering under the FAC proposed by Staff in this case. The charitable contributions and advertising costs in *Laclede* and the litigation costs in *Southwestern Bell* were found by the Commission to be unreasonable or of no benefit to ratepayers, and that is why they were excluded from the cost of service used to set rates. The energy costs at issue in the instant Empire case, however, are of unquestioned benefit to ratepayers. Moreover, in order to be flowed through the FAC, costs must be determined to have been prudently-incurred. Therefore, the controlling case law on this issue is that cited by Empire; the cases cited by Staff are both inapplicable and irrelevant.

One final point regarding the so-called "sharing" mechanisms that have been proposed in this case: in their initial post-hearing brief, the Industrials claim that the notion of implementing a "sharing" mechanism as part of an FAC is not unusual, and point to utilities in a handful of western states that have adopted such a mechanism as support for that claim. But the Commission should be careful not to read too much into the Industrials' argument. From the limited information that was provided by the Industrials' witness, Maurice Brubaker, in late-filed Exhibit 32, it is clear that some of those "sharing" mechanisms were implemented as part of case settlement agreements. Empire believes that had the Industrials provided the information requested by the Company in late-filed Exhibit 32, it would have revealed that all of the "sharing" mechanisms came from case settlement agreements. Such agreements, by their nature, reflect compromises on a host of issues, and it is impossible to know from the information provided as a part of the record in this case what the utilities in those western states received as a *quid pro quo* for the "sharing" mechanisms they agreed to implement. Empire is unaware of any case from any other jurisdiction in which a "sharing" mechanism has been imposed on a utility over that utility's objection.

Conclusion

With a true-up of this case through February 29, 2008, and the inclusion of the Asbury SCR in rate base (and the related expenses included in Empire's cost of service), five issues remain contested. In this regard, the competent and substantial evidence in the record supports: (1) the award of an 11.6 percent return on common equity ("ROE") for Empire; (2) a holding that the Missouri jurisdictional portion of a simple five-year average of Empire's off-system sales margins should be used as an offset to the Missouri jurisdictional cost of service; (3) a holding that Empire's projected costs of compliance with the Commission's rules concerning vegetation management and infrastructure inspections should be included in Empire's cost of service and that Empire should be allowed deferral treatment through a tracker mechanism of any incremental expenses it incurs above the amount reflected in its rates to comply with these rules; (4) a holding that Empire's proposed depreciation rate changes should be adopted; and (5) the authorization of a fuel adjustment clause ("FAC") for Empire pursuant to RSMo. §386.266.

Respectfully submitted,

Brydon, Swearengen & England P.C.

By:
/s/ Diana C. Carter
James C. Swearengen #21510
L. Russell Mitten #27881
Paul A. Boudreau #33155
Dean L. Cooper #36592
Diana C. Carter #50527
312 East Capitol Avenue; P.O. Box 456
Jefferson City, MO 65102
Telephone: (573) 635-7166; Fax: (573) 634-7431
E-Mail: DCarter@BrydonLaw.com

Certificate of Service

I hereby certify that the foregoing has been sent by United States mail, hand-delivered, or transmitted by facsimile or electronic mail to all counsel of record on the 3rd day of July, 2008.

/s/ Diana C. Carter