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

STAFF'S POST-HEARING BRIEF

Comes now the Staff of the Commission by and through the Commission's General Counsel, and for its Post-Hearing Brief, states as follows:

INTRODUCTION

In the Staff's Prehearing Brief, Staff noted Empire's request for $34.7 million in additional revenue, representing a 10.1% increase in Missouri jurisdictional revenues. Empire's testimony described the major driving factors for the rate increase as: 1. Capital additions made in 2007 including the Riverton 12 generating plant and pollution control facilities at the Asbury power station; 2. The financial impact of the January 2007 ice storm; and 3. Capital expenditures made to participate in new coal-fired generation at Iatan II and Plum Point. Empire also requests a fuel adjustment clause. (Ex. 1, Gipson Direct, p. 4). In testimony and at hearing, the parties also addressed the issue of ice storm expenses that affected Empire in December 2007, two months after the rate case was filed.

The effective date of Empire's tariffs is August 28, 2008. A Commission order should be in effect sufficiently in advance of that date to allow the parties an opportunity to seek rehearing and address any compliance tariffs that will be filed.

AGREEMENT AS TO CERTAIN ISSUES

On April 23, 2008, the Commission approved a Stipulation and Agreement resolving the following issues:

Outside Services

Edison Electric Institute Dues

State Income Tax Flowback

Rate Case Expense

Ice Storm Costs – Rate Base Treatment

Ice Storm Costs – Deferred Taxes

Amortization of January and December 2007 Ice Storm Expenses

Production Maintenance Expense (all issues except Asbury SCR), and

Deferred Taxes – VEBA

The result of the first Stipulation and Agreement was to increase Empire's revenue requirement by $1,248,000, exclusive of December 2007 ice storm expenses.

A second Stipulation and Agreement, approved by the Commission on May 20, 2008, resolved the following issues by increasing Empire's revenue requirement by $110,000, exclusive of the expensed Project Costs:

Bad Debt Expense

Payroll/Incentive Compensation

Expensed Project Costs

Pensions/OPEBs

Amortization Structure/Net Balance Sheet Investment

Rate Design/Tariff Changes/Facilities Charge.

Also, "project costs" charged to expense within the test year of $443,744 were included as part of the plant investment in Iatan II and will be recovered over the life of that plant, per the second Stipulation.

A third Stipulation was presented to the Commission and approved on May 20, 2008, to resolve issues surrounding the ELIP, Empire's Experimental Low Income Program.

ISSUES REQUIRING DECISION

The following issues are those requiring Commission determination. These issues were tried at hearing from May 12, 2008, to May 19, 2008. The Commission ordered a true-up audit on May 13, 2008. No new issues arose with the true-up audit through February 29, 2008.

REVENUE REQUIREMENT

Rate of Return Issues

1. Return on Common Equity: What return on common equity should be used for determining Empire's rate of return?

    a. In the event the Commission grants Empire a fuel adjustment clause, what, if any, is the appropriate adjustment to the authorized return on equity?

In the present case, Empire seeks an ROE of 11.6% (Ex. 28, Vander Weide Direct, p. 4, l.. 3-11) which is 139 basis points above the industry average award of 10.21%.[1] The Industrials, as endorsed by Public Counsel (OPC), favor an ROE of 10%. (Ex. 501, Gorman Direct, p. 2, l. 12-14). The Staff, the only party without an axe to grind, recommends 10.26%. (Ex. 219, Barnes Surrebuttal, p. 2, l. 14-16). Thus, in

[1] *See* Ex. 229 & 230: First Quarter 2008, 10.15%, Fourth Quarter 2007, 10.39%; Third Quarter 2007, 10.02%, and Second Quarter 2007, 10.27% - as reported by Regulatory Research Associates' consideration of 36 cases.

making this decision, the Commission should be mindful that the industrials and OPC ask the Commission to deny Empire of $1.4 million that the Staff has determined Empire's shareholders require, and that Empire would have this Commission allow it to collect $7.9 from ratepayers in excess of what the Staff has calculated to be a fair and just return on Empire's shareholders' investments.[2]

The Commission's duty:

The Commission's duty with respect to ROE is to award a "fair and reasonable" return to investors on the value of the utility property committed to the public service.[3] Too little is an unconstitutional taking;[4] too much is an unconscionable windfall. The right amount – the "just and reasonable" amount -- is a return "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties[.]"[5] The right amount is one that is fair to both the utility's investors and the utility's customers.[6]

What is Return on Equity?

Utility rates are designed to produce a certain amount of revenue on an annual basis, the "revenue requirement."[7] This revenue requirement has three components: First, an amount equal to the utility's prudently-incurred operating and maintenance

[2] Per the Reconciliation filed May 2, the difference on the ROE issue between Staff's recommendation and Empire's recommendation is worth $7.9 million; the difference between Staff's recommendation and the industrial intervenors is worth $1.4 million.

[3] *St. ex rel. Missouri Public Service Co. v. Fraas,* 627 S.W.2d 882, 886 (Mo. App., W.D. 1981).

[4] *Bluefield Water Works & Improv. Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 690, 43 S.Ct. 675, 678, 67 L.Ed. 1176, 1181 (1923).

[5] *Id.,* 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-1183.

[6] *St. ex rel. Valley Sewage Co. v. Pub. Serv. Comm'n.,*515 S.W.2d 845 (Mo. App., K.C.D. 1974).

[7] *In the Matter of The Empire District Electric Company,* 13 MoPSC3d 350, 368-69 (*Report & Order,* March 10, 2005).

expenses on a going-forward basis. Second, an amount sufficient to pay the utility's annual tax obligations. Third, an amount sufficient to service the capital used by the utility. Part of that capital is debt and debt is serviced by making regular payments to creditors. The other part of that capital is equity. Equity is serviced by paying dividends to the equity investors. It is this very last part of the revenue requirement that is the ROE. Another word for ROE is "profit." After all, all of the rest of the utility's annual revenue will be spent on operating expenses, taxes and debt payments. Only the fraction that is left after these obligations are met will flow to the utility's owners as a return on their investment.

Calculating the Cost of Capital:

The vast majority of businesses use a mixture of debt capital and equity capital; the particular percentage of each type for any given business is referred to as its "capital structure."[8] The cost of debt capital can be readily determined from the instruments in question. These costs are thus historical or "embedded." The cost of equity capital or ROE, on the other hand, cannot be so easily determined. Instead, it is a matter of expert opinion.

ROE Recommendations[9]				
Analyst	**ROE**			
	Low	**Midpoint**	**High**	**Recommended**
Vander Weide (Empire)	11%	11.75%	12.5%	11.6%
Barnes (Staff)	9.72%	10.26%	10.8%	10.26%
Gorman (Industrials)	9.5%	9.9%	10.3%	10.00%

[8] For this discussion, *see Empire, supra,* 13 MoPSC3d at 369-70.

[9] *See* Ex. 28, Vander Weide Direct, p. 4, l. 3-11; Ex. 219, Barnes Surrebuttal, p. 2, l. 14-16; & Ex. 501, Gorman Direct, p. 2, l. 12-14.

The Commission has the onerous task of sifting through the conflicting opinions of the various expert witnesses who have testified in this case.[10] The chart above sets out the several ROE recommendations offered in this case by three different experts. The several resultant ranges extend from a low of 9.5% to a high of 12.5. Each of these experts, it should be noted, is eminently qualified in this field. Predictably, the Company's experts offer the highest ROE recommendation – 11.6%.

It is noteworthy that these experts have reached such widely differing conclusions, although their training, data and methods are much the same. The fact is that the analytical methods used by the experts only appear to be mathematical and objective. They are actually quite subjective and thus offer ample scope for manipulation in any desired direction. The Commission has pointed out, previously, that "it is not the method employed, but the result reached, that is important."[11]

The Zone of Reasonableness ("ZOR"):

The Commission has devised an objective, analytical tool to assist it in parsing the recommendations of the experts and reaching a fair and reasonable result. That tool is the "Zone of Reasonableness" (ZOR). The ZOR is defined as extending one hundred basis points – one percentage point – above and one hundred basis points below the recent national average of ROE awards in the appropriate regulated industry.[12] The national average ROE award for electric utilities for the most recent four quarter period was

[10] *In the Matter of The Empire District Electric Company,* 13 MoPSC3d 350, 370 and 372 (*Report & Order,* March 10, 2005).

[11] *See Empire, supra,* 13 MoPSC3d at 372 n. 52, and collected cases there cited.

[12] *See Empire, supra,* 13 MoPSC3d at 375; *In the Matter of Missouri Gas Energy,* 12 MoPSC3d 581, 593 (*Report & Order,* September 21, 2004); *In the Matter of The Empire District Electric Co.,* Case No. ER-2006-0315 (*Report & Order,* issued December 21, 2005); *In the Matter of Kansas City Power & Light Co.,* Case No. ER-2006-0314 (*Report & Order,* issued December 21, 2006).

10.21%,[13] so the ZOR extends from 9.21% to 11.21%.

The ROE recommendations offered by Empire's expert witness, Dr. Vander Weide, is significantly above the top of the ZOR.[14] Further, it is barely within the ZOR that Vander Weide himself endorses. (Ex. 30, Vander Weide Surrebuttal, p. 10, l. 12-16). Dr. Vander Weide advocates excluding distribution-only utilities from his calculation of the industry average to be used in determining the ZOR, which results in a ZOR of 9.7% - 11.7%, based on the **six months** October 2007 – March 2008. (Ex. 30, Vander Weide Surrebuttal, p. 10, l. 12-16; p 11, l. 1-10). Dr. Vander Weide did acknowledge that for the year April 2007 – March 2008 his non-distribution-only average was slightly lower at 10.6%. (Ex. 30, Vander Weide Surrebuttal, p. 10, l. 17-22). As discussed below, 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.

According to the Commission's own application of its analytical tool, excessive recommendations must simply be discarded. In its decision regarding Kansas City Power & Light Company, the Commission stated: "Because the return on equity recommended by DOE falls outside of the 'zone of reasonableness', the Commission will discard it and find that it merits no further discussion."[15]

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[13] *See* Ex. 229 & 230: First Quarter 2008, 10.15%, Fourth Quarter 2007, 10.39%; Third Quarter 2007, 10.02%, and Second Quarter 2007, 10.27% - as reported by Regulatory Research Associates' consideration of 36 cases.

[14] 11.6% - 10.21% = 1.39% = 139 basis points, or 139% of the 100 basis point range extended above the industry average in the development of the ZOR.

[15] *In the Matter of Kansas City Power & Light Co.,* Case No. ER-2006-0314 (*Report & Order,* issued December 21, 2006), pp. 21-22.

Dr. Vander Weide's Inconsistencies

Empire's witness Dr. Vander Weide argues that the ROE resulting from his various studies should be tweaked, if not outrightly adjusted, in formulating a recommended ROE for Empire for a number of reasons. Specifically, Dr. Vander Weide states that given the small size of Empire's market capitalization, and what he describes as the attendant risk of the relative size of that capitalization, that investors demand a higher return. (Tr. Vol. 8, p. 483, l. 16 – p. 484, l. 11). However, this recommendation is not consistent with his acknowledgement of various risks being included in the bond ratings of the companies that make up his proxy groups. (Tr. Vol. 8, p. 473 l. 9-12).[16] For example, Dr. Vander Weide acknowledges that the financial community's ratings capture the analysts' perception of factors such as a company's reliance on alternative generation. (Tr. Vol. 8, p. 472 l. 18-23; p. 485 l. 6 – p. 487, l. 22). Similarly, Dr. Vander Weide apparently places his imprimatur upon Empire witness Overcast's advocacy of the application of a regulatory risk premium, (Ex. 10, Overcast Rebuttal, p. 14, l. 20 – p. 15, l. 17) 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. (Ex. 30, Vander Weide Direct, p. 9, l. 10-14). It is this bond rating and investors' knowledge of Empire's situation acquired through publicly available information that already encompasses the financial community's valuation of Empire's risks that is used in Risk Premium studies presented by all three experts – thus no extraneous risk adjustment is required.

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[16] *See* Ex. 30, Vander Weide Direct, p. 9 l. 10-14. "Q: Do economists and investors consider future industry changes when they estimate the risks of a particular investment? A: Yes. Economists and investors consider all the risks that a firm may be exposed to over the future life of the company."

Dr. Vander Weide acknowledges that Empire's generation fleet is much more dependent on natural gas than that of other utilities. (Tr. Vol. 8, p. 471 l. 20-24) He also cites the volatility of natural gas as being of particular concern when he examines risks attendant to the utility industry as a whole. (Ex. 28, Vander Weide Direct, p. 15, l. 11-12) Further, he acknowledges that a FAC mitigates the risk of natural gas volatility. (Tr. Vol. 8, p. 467 l. 2-9). Finally, he demonstrates that the majority, if not all, of his proxy companies already have the benefit of a FAC, which is embedded in their ROEs and bond ratings. (Tr. Vol. 8, p. 466 l. 15-16). However, he fails to close the loop to acknowledge that to a company with a disproportionately high level of risk attendant to reliance on a disproportionately highly volatile commodity, that a disproportionate benefit should be expected from the award of an FAC. Thus, while he characterizes the FAC as allowing Empire to break even with the fuel risk of comparable utilities, (Tr. Vol. 8, p. 466 l. 12-16) the application of an FAC to Empire in fact, gives Empire a leg up on the proxies, in terms of mitigation of fuel-related risks. Thus, while the award of an FAC should not reduce Empire's allowed ROE (Barnes, Tr., Vol. 8, p. 527, l. 13-25) this one-sided portrayal of the situation certainly casts doubt on Dr. Vander Weide's credibility. Dr. Vander Weide also fails to acknowledge that this is publicly available information that is surely known to investors.

Also cited by Vander Weide as an industry-wide risk is the potential for addition environmental regulations and clean-air requirements, driving up investors' required allowed ROEs. (Ex. 28, Vander Weide Direct, p. 12, l. 11-17). Vander Weide acknowledges that natural gas is "environmentally a much better fuel source than coal." (Tr., Vol. 8, p. 476, l. 5-9). As noted above, Dr. Vander Weide is aware of the fact that

Empire's coal fleet is substantially smaller, as a percentage of total generation, than most utilities. (Tr. Vol. 8, p. 471 l. 20-24). What Dr. Vander Weide fails to acknowledge is that given that the risk associated with additional environmental regulation is embedded in his proxy group's ROEs and bond ratings, and that Empire faces reduced exposure to that risk, that as regards environmental regulation risk compensation, his study result ROEs are inflated relative to Empire's risk.

As an input in his DCF analysis, Dr. Vander Weide utilizes a market capitalization-weighted average ROE derived from his proxy group. (Ex. 30, Vander Weide Surrebuttal, p. 15, l. 14-19). However, Dr. Vander Weide urges for a small-capitalization premium, (Tr., Vol. 8, p. 483, l. 16 – p. 484, l. 11) as discussed above.[17] The inconsistency of these approaches is especially troublesome. In one instance, Dr. Vander Weide 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, (Tr., Vol. 8, p. 483, l. 16 – p. 484, l. 11) yet in another he 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. (Ex. 30, Vander Weide Surrebuttal, p. 15, l. 14 -19). The only apparent difference in these situations is the result Dr. Vander Weide was being paid to obtain by Empire.

In another demonstration of his lack of credibility, Dr. Vander Weide excluded natural gas utilities from his proxy group (Tr. Vol. 8, p. 464 l. 13-15), which he had included in the past. (Ex. 30, Vander Weide Surrebuttal, p. 5, l. 4-7). He justifies this

[17] This is problematic *ab initio*, given the exclusion of failed small-caps from the Ibotson study. *See* Ex. 504, Gorman Rebuttal @ p. 15.

with the statement that gas utility risks are no longer akin to electric utility risks. (Ex. 30, Vander Weide Surrebuttal, p. 6, l. 5-12). However, Dr. Vander Weide goes on to criticize Mr. Barnes for his proxy selection criteria of excluding those companies whose electric revenues comprise less than 70% of total revenue. (Tr. Vol. 8, p. 463 l. 5-9). Implicitly, if a company's revenues are primarily electric, they cannot be primarily gas. Thus, while he states that gas companies are not comparable to electric companies, he states that he does not consider the percentage of electric revenues to total revenues to be useful in the selection of a proxy group. Similarly, he excludes distribution-only electric utilities from his calculation of his industry average, (Tr. Vol. 8, p. 262, l. 23-25; Ex. 30, Vander Weide Surrebuttal, p. 9, l. 19 – p. 10, l. 2) while continuing to refuse to screen utilities whose revenues are not primarily derived from electric operations. (Tr. Vol. 8, p. 463 l. 5-9). However, while he recognizes that virtually all gas utilities are distribution-only (Tr. Vol. 8, p. 464 l. 23-25) 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. These inconsistencies in his selection of his study inputs demonstrate Dr. Vander Weide's result-oriented approach.

Finally, Dr. Vander Weide concedes that his failure to advocate the application of a financial risk adjustment for Empire in this case was because Empire requested he not do so.[18] While the Staff has opposed such increases in the past and would almost

[18] Dr. Vander Weide – testifying in Empire's last rate case – proposed an "adder" of 40 basis points to account "for the difference in the perceived financial risk of [the] proxy companies in the marketplace and the financial risk implied by [his] recommended capital structure for Empire." *In the Matter of The Empire District Electric Co.,* Case No. ER-2006-0315 (*Pre-hearing Brief of Staff of Public Service Commission,* Docket Item No. 191, filed September 6, 2006), p. 37 (*quoting* Vander Weide's Direct Testimony filed in that case, pp. 4 and 6). In this current Case No. ER-2008-0093, Ex. 28, Vander Weide Direct, p. 42 l. 1 - 19, Dr. Vander Weide testifies, first, that a financial risk adjustment is appropraitae for Empire, then, that he has not made such an adjustment because Empire so requested.

certainly have done so in this case, Dr. Vander Weide's willingness to cede a point he apparently considers essential as a financial expert demonstrates his willingness to do as he is told – as contrasted to Staff's independence and lack of a prerogative. Essentially, Dr. Vander Weide is highly compensated by Empire at $425/hr, (Tr. Vol. 8, p. 491, l. 12-18) and is so compensated to obtain the results Empire desires. Given his demonstrated inconsistencies, Dr. Vander Weide's recommendations cannot be viewed as credible.

Regulatory Environment & Regulatory Plan

Empire argues that it faces the risks attendant to a bad regulatory environment in Missouri, for which investors demand a premium. (Ex. 10, Overcast Rebuttal, p. 13. l. 4– p. 14, l. 8). Empire specifically argues that under Missouri's regulatory regime it faces a reduced potential to actually earn its authorized rate of return on equity, thus it should be allowed return on equity in excess of the other witnesses' recommendations to compensate for this purportedly above-average risk. (Ex. 10, Overcast Rebuttal, p. 14. l. 21 – p. 15, l. 17). Generally speaking, higher risks do dictate the need for a higher potential return. However, the simplicity of Empire's argument belies the complexity of utility regulation in general, and Empire's situation in Missouri in particular. Empire argues that the existence of its regulatory plan, including the ability to receive additional rate relief through the regulatory plan amortization mechanism, is irrelevant to assessing the level of regulatory risk faced by its equity shareholders. While it is true that Empire's regulatory plan amortization mechanism was created to primarily benefit its bondholders, that mechanism also provides significant benefit to Empire's equity shareholders[19] Empire's plan allows for an enhanced flow of cash, (Transcript Vol. 8, p. 491, l. 2-5)

[19] *See* Ex. 202, Oligschlaeger Surrebuttal, p. 10, l. 18 – p. 11, l. 5.

which can be paid out to equity holders in the form of dividends. In fact, Empire's dividend is paid in cash, (Transcript Vol. 8, p. 491, l. 6 -8) and has been paid out at a constant level, $1.28, since 1993. (Ex. 219, Barnes Surrebuttal, p. 5, l. 13-17). The record reflects that, in the past, Empire has had very high dividend payout ratios relative to its earnings. (Transcript Vol. 9, p. 820, l. 13 to p. 821, l. 12). In addition, in a data request response Dr. Overcast alleged that the regulatory plan amortization mechanism was inferior to other regulatory measures to benefit shareholders, such as inclusion of Construction Work in Progress (CWIP) in rate base (which is currently prohibited in Missouri. (Ex. 202, Oligschlaeger Surrebuttal, Schedule 1, DR 0282). However, Dr. Vander Weide opined on the witness stand that the regulatory plan amortization mechanism is "very similar" in concept to inclusion of CWIP in rate base. (Transcript Vol. 8, p. 495, l. 9-13). Thus, the presence of the regulatory plan compensates Empire for the risk they claim for the lack of the ability to recover on CWIP, and is a very relevant consideration in assessing Empire's level of equity risk to that of other electric utilities.

Also in the vein of regulatory risk, Dr. Vander Weide posits that "…one of the factors that make Empire risky is that they are more concentrated in natural gas generation than most other electric utilities, and natural gas prices have been moving up very rapidly just as gasoline and oil prices have been moving up. Without a fuel adjustment clause, Empire's always a step behind in recovering those costs. And that's one of the primary reasons why they have not been able to earn their allowed rate of return in recent years…." (Tr. Vol. 8, p. 471, l. 21 – p. 472, l. 5).

Logically, if the lack of an FAC is the primary driver of the alleged regulatory risk, that is, the risk that the utility cannot actually recover its authorized rate of return, then the granting of an FAC, as advocated by the Staff, (Ex. 204, Staff Cost of Service Report, p. 61) will greatly alleviate whatever regulatory risk may exist for Empire. Thus, it is neither appropriate to award a regulatory risk premium, nor to lean towards the upper margins of study results to compensate for alleged regulatory risk. Empire is simply arguing the worst of both worlds in an effort to obtain a ROE inconsistent with their investors' actual requirements.

Conclusion:

Despite Empire's "woe is me" attitude concerning the riskiness and gravity of their financial prospects in this case, the evidence supports the fact that Empire's witnesses greatly exaggerate both the company's risks and the requirements of its investors. Empire, via Dr. Vander Weide, lists extensive risks of electric utilities in general – for which equity investors demand a premium – but fails to explain how Empire is more risky – on net – than the other comparably risky companies used to determine an appropriate ROE for Empire.[20] In areas where adjustments are necessary, Staff's ROE recommendation of 10.26% takes these considerations into account. As a single, simple example, because Empire is BBB- and average of comparable companies is BBB, Staff witness Barnes adjusted the results of his DCF analysis up 12 basis points (Ex. 204, Staff Cost of Service Report, p. 16). Simply put, Staff's recommendation takes into account, but neither exaggerates nor ignores, the needs of Empire, its shareholders, and its ratepayers.

[20] *See*, Ex. 28, Vander Weide Direct, p. 11 l. 6 – p. 15, l. 18; Transcript Vol. 8, p. 485, l.6 – p. 487, l. 22.

Rate Base Issues

1. Asbury SCR: Should Empire's Asbury SCR equipment plant addition be included in Empire's rate base in this case? If yes, should it be included through an adjustment to Empire's revenue requirement or through a true-up procedure? If the Asbury SCR equipment is not included in Empire's rate base in this case, should any future emission revenue associated with that equipment flow through the FAC?

The Staff no longer opposes the inclusion of the Asbury SCR in Empire's rate base. Including the SCR adds approximately $31 million to Empire's rate base as of February 29, 2008. (Ex. 7, Mertens Direct, p. 8, l. 18).

Expense Issues

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

The Staff and Empire agree that $4.4 million total company is the appropriate amount to use as a base amount to offset Empire's cost of service in this case. (Tr. Vol. 5, p. 154, l. 3-4). Empire originally proposed a five year average of $3.4 million for this offset. Staff's proposal was to annualize Empire's off-system sales margins for the first six months of 2007 in order to capture Empire's current market environment including the Southwest Power Pool Energy Imbalance Service market and the Kansas City, Kansas BPU bilateral contract running from June 2007 to September 2007. The Staff's recommendation for off-system sales margin is conservative, in that it did not select the highest or lowest result available from its multi-year analysis. (Tr. Vol. 5, p. 187-188). The Staff's recommendation is higher than that originally requested by Empire, but lower than that level advocated by OPC. (Tr. Vol. 5, p. 160). OPC uses Empire's calendar year 2007 off-system sales margin amount of $5,955,336, but this overlooks the fact that this was the highest off-system sale amount achieved by Empire in at least nine years, and possibly longer. (Tr. Vol. 5, p. 171).

Staff also recommends that OSS margins be incorporated into any fuel adjustment clause pass-through mechanism that the Commission authorizes. (Ex. 214, Mantle Rebuttal, p. 4). If the Commission orders a fuel adjustment clause, then the actual off-system sales margins above or below the base amount would flow through the clause so rates would be adjusted accordingly. (Tr. Vol. 5, p. 154, l. 11-18).

4. Asbury SCR O&M Expenses: Should Empire's projected operating and maintenance expenses associated with the Asbury SCR equipment be included in Empire's cost of service?

Empire's projected operating and maintenance expenses associated with the Asbury SCR should be included in its cost of service. The total projected costs associated with the SCR's O&M in Staff's case is approximately $1,150,000. (Reconcilement/Reconciliation, line 13, filed May 2, 2008).

5. Asbury SCR Property Taxes: Should property taxes associated with the Asbury SCR equipment be included in Empire's cost of service?

The Staff believes that Empire is no longer seeking recovery of Asbury SCR property tax expense in this proceeding, as discussed in Staff's true-up direct testimony. (Oligschlaeger True-up Direct, p. 4).

In the event that Empire continues to seek recovery of this property tax expense, the Commission should note that notwithstanding the inclusion of the Asbury SCR in Empire's rate base, the property taxes associated with the Asbury SCR should not be included in Empire's cost of service. Empire will not incur or book any property tax expense related to the SCR project until January 2009 because the taxing authority assesses property taxes based on plant in service, materials and supplies, and construction work in progress as of the January 1 of each tax year. On January 1, 2008, the entire amount of Empire's investment in the Asbury SCR was booked to construction work in progress (CWIP). (Tr. Vol. 5, p. 77, l. 23-23 and p. 78, l. 1-2). Therefore, any property taxes assessed on the Asbury SCR on January 1, 2008, will be capitalized by Empire and recovered through depreciation expense once the Asbury SCR project is included in rate base. Empire's witness on this issue, Mr. Mertens, agreed that "whether the SCR is in rate base or not, the property taxes [for 2008] should not be included as an expense." (Tr. Vol. 5, p. 78, l. 16-21). No amount of property taxes attributable to the SCR project will be charged to expense by Empire until January 2009 at the earliest, so no recovery of property tax expense in this case associated with the Asbury SCR project is appropriate. (Ex. 207, Mapeka Surrebuttal, pp. 12-15).

6. Asbury SCR Depreciation Expense: Should Empire's depreciation expense associated with the Asbury SCR equipment be included in Empire's cost of service?

With the inclusion of the Asbury SCR in rate base, depreciation expense should be included in Empire's cost of service. Inclusion of depreciation expense for the SCR project will reduce the amount of additional amortizations from the regulatory plan amortization mechanism and is one of the reasons why the Staff's current/true-up calculation of the additional amortizations is now negative.

7. 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?

The Staff urges the Commission to include the projected costs of compliance with the pending vegetation management and infrastructure inspection rules as an expense in this proceeding. Under the provisions of these rules, Empire would have the ability to seek deferral and subsequent recovery of any incremental costs to comply with these rules that were not included in rates from this proceeding. Given this, the Staff believes 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. (Ex. 202, Oligschlaeger Surrebuttal, pp. 23-24).

Using Staff's two year average of estimated costs for the time period before the Empire rate case planned for 2010, the Iatan II rate case, the Staff calculates that about \$2.575 million in addition to the adjusted test year expense of \$6 million for rule compliance will be required. (Tr. Vol. 7, p. 415, l. 21-25). However, a "tracker" mechanism should be employed to protect customers in conjunction with upfront rate recovery of compliance costs. A tracker mechanism will compare Empire's actual expenditures for vegetation management and infrastructure inspection to the amount granted to it in rates 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 purpose. If Empire does not spend the required amount in each year rates from this case will be in effect, it must spend the shortfall in the next year with interest (calculated at Empire's short-term debt rate), along with its spending requirement for the next year. (Tr. Vol. 7, p. 414-415). If Empire spends more than the required amount for rule compliance in any year, under the Staff's approach there is no need for a deferral mechanism to capture the higher cost levels. (Tr. Vol. 7, p. 414).

OPC opposes Staff's recommendation of providing revenue upfront for Empire's rule compliance costs, notwithstanding its apparent support for a similar provision in AmerenUE's last rate case. OPC witness Robertson described the approximately $45 million rate allowance in the AmerenUE case as an "amount … in rates for vegetation management type stuff". (Tr. Vol. 7, p. 422, l. 4-13). He also stated that a letter sent by UE to the Staff indicated that UE was utilizing what it characterized as a tree trimming "tracker" as a result of an agreement in its last Missouri rate case.[21] Based upon this letter, Mr. Robertson admitted that UE has committed to operate its tracker in a similar fashion to what the Staff is proposing for Empire in this proceeding. (Tr. Vol. 7, p. 421). Empire presented testimony that compliance with the rules will cause Empire to more frequently trim its vegetation and inspect its infrastructure. (Tr. Vol. 7, p. 372, l. 5-23 and p. 428, l. 12-25). Such additional expenditures should result in Empire having a more reliable system. (Tr. Vol. 6, p. 249). Compliance with the new rules is certain to increase Empire's costs. The rules will take effect June 30, 2008, before this rate case is resolved. 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.

8. <u>Depreciation Rates:</u> 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?

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[21] *See* ER-2007-0002, Second Stipulation and Agreement as to Certain Issues, 3/26/07, p. 2 for the agreement regarding $45 million for vegetation management.

Empire's depreciation rates should not change in this proceeding because Empire is currently operating under the regulatory plan approved in Case No. EO-2005-0263. In KCPL's rate case, Case No. ER-2006-0314, the Commission determined depreciation rates should not change"… because KCPL would be allowed additional amortizations to meet the credit metrics agreed to in Case No. EO-2005-0329." (Report and Order, ER-2006-0314, p. 51). In the KCPL case, the Staff was seeking to reduce Empire's depreciation rates. In this proceeding, Empire is seeking to increase its depreciation rates. But the same rationale as expressed in the KCPL Order should apply here to Empire. Any change in depreciation rates, whether an increase or a decrease, will be offset with a corresponding decrease or increase in regulatory plan amortizations.

In addition, Mr. Roff's depreciation study relied upon inappropriate methodologies and unreliable data. Mr. Roff's study is only as good as the data it relies upon. (Tr. Vol. 6, p. 302, l. 3-9). In response to Staff's allegations of deficiencies in Empire's depreciation recordkeeping, Mr. Roff testified that his data was fine and that Staff must have received "different" data, that his were "more extensive". (Tr. Vol. 6, p. 304-305, l. 20-25 and 1-2). Neither Empire nor Roff ever bothered to explain why Empire would send data to the Staff that were "different" than the data it sent to Mr. Roff. If Empire had in fact sent depreciation data to the Staff in this case that was complete and in compliance with the Commission's rules, they surely would have demonstrated that fact in prefiled testimony or at the evidentiary hearings. Because that did not happen, Staff believes the best explanation for this unusual situation is that both Mr. Roff and the Staff received the same data from the Company, but Mr. Roff manipulated the data he received to meet his own ends and manufacture a depreciation study. Mr. Roff's study should be rejected by the Commission and Empire should redouble its efforts to comply with the Commission's rules on data retention. No change in Empire's depreciation rates should be contemplated until the Company can demonstrate it is in compliance with the Commission's rules regarding its depreciation data base recordkeeping.

REGULATORY PLAN AMORTIZATION

1. Ice Storm Costs: Should the expense amortization of the January 2007 and December 2007 ice storm costs be reflected in the regulatory plan amortization calculation? Has Empire raised this issue out of time?

Yes, the expense amortizations of the January and December ice storms should be reflected in the regulatory plan amortization (RPA). Empire conceded this issue at hearing and Empire's testimony on this issue was not offered The agreed upon treatment of these costs in the RPA mechanism can be found in the Second Stipulation and Agreement of Certain Issues filed May 15, 2008.

Amortization is a non-cash expense to Empire. Inclusion of ice storm amortizations in the RPA calculation increases Empire's cash flow and thus reduces the amount of the RPA that Empire would otherwise receive in rates.

FUEL COST RECOVERY

1. Fuel Adjustment Clause: Should the Commission authorize Empire to use a fuel and purchased power recovery mechanism as authorized by law?

   A. Is Empire barred by the terms of the Stipulation and Agreement in Case No. ER-2004-0570 from requesting a fuel adjustment clause while an interim energy charge is pending?

   B. If the Commission authorizes Empire to use a fuel adjustment clause (FAC), how should it be structured?

a. What proportion of future increases and decreases in fuel and purchased power costs (increases and decreases) from base rates should be assigned to Empire and what proportion to its customers?

b. What components of fixed and variable fuel and purchased power costs should be recovered through a FAC?

c. What heat rate testing of generation plants should be conducted?

d. What rate design should be applied to FAC charges?
   1. Should the base cost of fuel be determined by season?
   2. How should the actual $/kWh cost of fuel and purchased power energy be determined?
   3. How should the Cost Adjustment Factor be determined?

e. What incentive mechanisms, if any, should be included in the FAC?

f. Should off-system sales be included in the FAC?

g. Should the net cost of emissions (Account 509) costs be recovered through the FAC?

2. <u>Fuel and Purchased Power Expense:</u> Should Empire's recovery of fuel and purchased power expense be based upon its current adjusted expense levels, or on the rate allowance for this item ordered by the Commission in Case No. ER-2004-0570?

FUEL ADJUSTMENT CLAUSE (FAC)

Section 386.266, Senate Bill No. 179, Laws 2005, appears, in part, as follows, emphasis added:

> **386.266. 1.** Subject to the requirements of this section, any electrical corporation may make an application to the commission to approve rate schedules authorizing an interim energy charge, or periodic rate adjustments outside of general rate proceedings to reflect increases and decreases in its prudently incurred fuel and purchased-power costs, including transportation. The **commission may**, in accordance with existing law, **include in such rate schedules features designed to provide the electrical corporation with incentives** to improve the efficiency and cost-

> effectiveness of its fuel and purchased-power procurement activities.
>
> . . . .
>
> **4.** The **commission shall have the power to approve, modify, or reject adjustment mechanisms submitted under subsections 1 to 3 of this section** only after providing the opportunity for a full hearing in a general rate proceeding, including a general rate proceeding initiated by complaint. The **commission may approve such rate schedules after considering all relevant factors** which may affect the costs or overall rates and charges of the corporation, provided that it finds that the adjustment mechanism set forth in the schedules:
>
>> **(1)** Is reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity;
>>
>> . . . .
>>
>> **(4)** In the case of **an adjustment mechanism** submitted under subsection 1 or 2 of this section, **includes provisions for prudence reviews** of the costs subject to the adjustment mechanism **no less frequently than at eighteen-month intervals**, and shall require refund of any imprudently incurred costs plus interest at the utility's short-term borrowing rate.
>>
>> . . . .
>
> **7.** The **commission may take into account any change in business risk to the corporation resulting from implementation of the adjustment mechanism** in setting the corporation's allowed return in any rate proceeding, in addition to any other changes in business risk experienced by the corporation.
>
> **8.** In the event the commission lawfully approves an **incentive- or performance-based plan**, such plan **shall be binding on the commission for the entire term of the plan**. This subsection shall not be construed to authorize or prohibit any incentive- or performance-based plan.

The Staff will not repeat its Prehearing Brief other than offer a short summary in the opening paragraphs. Section 386.266.1 RSMo gives the Commission the authority to approve incentive programs as part of a fuel adjustment clause (FAC) to provide an electric utility with "incentives to improve the efficiency and cost-effectiveness of its fuel and purchased power procurement activities." It is the Staff's position that a 100% pass through of fuel and purchased power costs for Empire would only be correct for Empire if 100% of its fuel and purchased power costs were completely out of its control, which is not the case. There are actions that Empire can undertake, or not undertake, that affect the efficiency and cost-effectiveness of its fuel and purchased power costs. Being responsible for a portion of any increase in cost above or receiving the benefit of any savings below the base provides Empire an incentive to manage its fuel and purchased power costs.

In Aquila's recent rate case, Case No. ER-2007-0004, the Commission concluded that allowing Aquila to pass through 95% of its prudently incurred fuel and purchased power costs, above those included in its base rates, through its FAC would not violate Section 386.266.4(1), in that it would afford Aquila a sufficient opportunity to earn a fair return on equity. By passing through 95% of its fuel and purchased power costs, Aquila would be protected from extreme fluctuations in fuel and purchased power costs, and would retain a significant incentive to take all reasonable actions to keep its fuel and purchased power costs as low as possible.

It is Staff's position that the five percent (5%) level gives Empire very little serious incentive to manage its fuel costs efficiently. The Staff estimated that over the period 2003-2006 Empire absorbed approximately $85.5 million of fuel and purchased power costs between rate cases, which equates to allowing about 40% of the fuel and purchased power costs to flow through a FAC to Empire's ratepayers. Any pass-through greater than 40% would shift more of the fuel and purchased power risks to the ratepayers than the ratepayers had without a FAC in place in 2003-2006. In this proceeding, Staff is recommending a pass through to ratepayers of 70% of fuel and purchased power costs so that Empire still has an incentive to control and reduce fuel and purchased power costs.

Of the Commission's statements respecting Section 386.266, the most relevant is that found in *Re Union Electric Co., d/b/a AmerenUE*, Report And Order, Case No. ER-2007-0002, Mimeo at 17-18 (2007):

> While the new statute, Section 386.266, allows the Commission to approve a fuel adjustment clause, in effect, overturning a 1979 Missouri Supreme Court decision finding fuel adjustment clauses to be contrary to Missouri law,[20] the statute does not require the Commission to approve a fuel adjustment clause. Instead, it specifically gives the Commission authority to reject a proposed fuel adjustment clause after giving an opportunity for a full hearing in a general rate case.[21] The statute does not, however, provide specific guidance on when a fuel adjustment clause should be approved.
>
> . . . .
>
> [20] *State ex rel. Utility Consumers Council of Mo., Inc. v. Pub. Serv. Comm'n*, 585 S.W. 2nd 41 (Mo.banc 1979).
>
> [21] Section 386.266.4, RSMo Supp. 2006.
>
> A fuel adjustment clause is a powerful regulatory tool to be used with careful consideration. If a fuel adjustment clause is allowed in an inappropriate situation, the customers who pay for utility service can be forced to pay rates that are higher than they should be. In other circumstances, a fuel adjustment clause may be necessary to allow a utility an opportunity to earn a reasonable return on its investment.
>
> A fuel adjustment clause should be used cautiously because it runs contrary to some of the basic principles of traditional utility regulation. One such principle is the matching of expenses and revenues. Over time, certain expenses incurred by the utility may go up. For example, the wages the electric utility pays its linemen may increase, or a major industrial customer may close, causing a loss of income. At the same time, perhaps the utility saves money when the interest rate it must pay to borrow money goes down, or it adds revenue by serving new customers. The increased costs or

> decreased income in one area may be balanced by decreased costs or increased revenue in another area.
>
> In a traditional rate case, without a fuel adjustment clause, the Commission examines all the revenue and costs of the utility during a particular period known as a test year. The Commission then matches the revenue and costs, arriving at an amount the utility needs to recover from its ratepayers if it is to earn a reasonable return on its investment. If a fuel adjustment clause, or other tracking mechanism, is established, then the utility would be able to pass on increased costs in one area, in this case fuel and purchased power, without an examination of all the other areas in which its costs may have decreased or its revenues increased. As a result, ratepayers could be required to pay increased rates while the company enjoys increased profits.

The Commission used the following criteria in determining whether to authorize AmerenUE the use of a FAC:

> Whether the fuel and purchased power expenses are:
>
> 1. substantial enough to have a material impact upon revenue requirements and the financial performance of the business between rate cases;
>
> 2. beyond the control of management, where utility management has little influence over experienced revenue or cost levels; and
>
> 3. volatile in amount, causing significant swings in income and cash flows if not tracked.

(*Id.* at 20-21).

Empire sponsored as its principal witness on the FAC issue Dr. H. Edwin Overcast of Black & Veatch. The purpose of Dr. Overcast's testimony is to address Empire's proposed FAC, discuss the risks associated with the Empire capital program and the need to allow a return higher than that of a proxy group to compensate for the risks related to the capital program. (Ex. 9, Overcast Direct, p. 2, l. 10-17).

Dr. Overcast makes clear in his testimony that the only basis for nonrecovery of fuel and purchased power costs is imprudence:

> Q. What is the regulatory standard for cost recovery?
>
> A. The standard for cost recovery is that a utility is allowed to recover its prudently incurred costs. . . .
>
> Q. How does this standard apply to the fuel and purchased power FAC?
>
> A. This standard suggests that the FAC must be comprehensive to include all of the prudently incurred costs associated with the fuel and purchased power segment of the business. As a practical matter, this implies that **100% of the costs of fuel, purchased power . . . and carrying charges . . . at a minimum should flow through the FAC**. . . .
>
> Q. Does 100 percent recovery of fuel costs create incentives for the company to be wasteful or imprudent in managing fuel and purchased power expense?
>
> A. No. **The full recovery of cost is a fundamental right of the utility under regulation so long as the costs are prudently incurred.** . . .

(Ex. 9, Overcast Direct, p. 26, l.11 – p. 27, l. 11). As a consequence, Dr. Overcast characterizes the Staff's and the Industrial Intervenors' FAC proposals as assuming "improvident behavior:"

> Q. Please discuss the concept of assuming improvident behavior related to fuel costs as a basis for disallowing a portion of fuel costs.
>
> A. Both **the Staff and Mr. Brubaker assume that the existence of a fuel clause designed to allow recovery of variable and unpredictable fuel costs will cause Empire to be imprudent or wasteful in the purchase of fuel and power**. . . .

(Ex. 10, Overcast Rebuttal, p. 4, l. 7-12).

. . . .

> . . . . By assuming that the utility behaves inefficiently the FAC would not be designed to reasonably provide the utility with a sufficient opportunity to earn a fair return on equity as required of the Commission by the Missouri statute.

(*Id.* at 5, l. 3-6).

. . . .

> . . . . Further, as with Mr. Brubakers's proposal, **the Staff proposal penalizes prudent and efficient behavior because of factors beyond Empire's reasonable control and is not an incentive mechanism at all.** Thus, the Staff proposal produces rates that are unjust and unreasonable because they fail to allow Empire reasonable opportunities to earn the allowed return and represent a potential downside of around 2.65 percent of Staff's recommended equity return. . . .

(*Id.* at 11, l. 10-15).

> Q. Does the OPC provide evidence that Empire has or will be imprudent?
>
> A. No, and without such evidence **Empire is entitled to the recovery of its costs**. . . .

(Ex. 11, Overcast Surrebuttal, p. 10, l. 22 – p. 11, l. 1).

But Missouri case law identifies at least one additional basis for recovery of costs: the additional basis in Missouri case law is benefit to ratepayers. Missouri Courts of Appeals have held that this Commission may disallow recovery of prudent costs that are not of benefit to ratepayers: *State ex rel. Laclede Gas Co. v. Public Serv. Comm'n*, 600 S.W.2d.222, 228-29 (Mo.App. W.D. 1980), *appeal dismissed*, 449 U.S. 1072, 101 S.Ct. 848, 66 L.Ed.2d 795 (1981)(advertising expense and charitable contributions); *State ex rel. Southwestern Bell Telephone Co. v. Public Serv. Comm'n*, 645 S.W.2d 44, 55-56

(Mo.App. W.D. 1982)(license contract allocated share of AT&T antitrust legal fees). The Commission applies this criterion to all or certain categories of the following incentive compensation, advertising, charitable contributions, lobbying, rate case expense, economic development costs, transaction costs in a merger/acquisition, community development costs, among other expenses.

The Staff would also note the Missouri Supreme Court holding in *State ex rel. Hotel Continental v. Burton*, 334 S.W.2d 75, 80 (Mo. 1960):

> We make clear, however, that irrespective of the effect of the statutes conferring power on the commission to determine the propriety of rules, regulations, and practices, it was held in the West Plains case, supra, 310 S.W.2d 928[1-3], and we hold here, that the commission's express statutory power to determine and prescribe just and reasonable rates and to determine what rates will permit a fair return, includes the power to determine what items should be included in a utility's operating expense and what items should be excluded, and how excluded items, if any, should be handled and treated, in order that the commission may arrive at a reasoned determination of the issue of "just and reasonable" rates.

Commissioner Clayton asked Staff witness Mark Oligschlaeger whether the Staff believed that prudence reviews that occur after the fact are sufficient to encourage prudent fuel purchases. Mr. Oligschlaeger answered "No" because it is difficult for the Staff to carry the burden of proof given, among other things, that the Commission is reluctant to find that a utility acted imprudently.[22] (Tr. Vol. 9, 734, l. 24 – p. 735, l. 23).

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[22] Senate Bill No. 179 (SB 179) contains no language addressing burden of proof. Section 393.150.2 provides in relevant part as follows regarding burden of proof: "At any hearing involving a rate sought to be increased, the burden of proof to show that the increased rate or proposed increased rate is just and reasonable shall be upon the gas corporation, electrical corporation, water corporation or sewer corporation. . ." Section 386.430 provides as follows regarding burden of proof:

The extreme, far out nature of Empire's position is defined by Dr. Overcast's position that because Empire is in competitive markets for fuels – energy, it has no control over cost – prices. Dr. Overcast complained in his Surrebuttal Testimony: "No party to this proceeding has proposed any FAC 'incentive' that provides Empire with the opportunity to control its fuel costs." (Ex. 11, Overcast Surrebuttal, p. 2, l. 11-13). His statement in his Surrebuttal Testimony that "Empire needs a full tracking clause to have a reasonable and sufficient opportunity to earn its return" gives no recognition to the fact that Section 386.266 is a discretionary grant of single issue ratemaking authority to be fashioned by the Commissioners as they deem appropriate, not an entitlement of guaranteed cost recovery. (*Id.* at 3, l. 14-16). Only in the most begrudging manner does Dr. Overcast acknowledge that Empire does have some control:

> Q. Does management have the ability to control the fuel and purchased power costs?
>
> A. No. . . . management has little control over the actual fuel and purchased power costs. This conclusion is supported by the fact that both fuel and purchased power markets are competitive. In competitive markets, customers obtain resources only if they pay the market price. . . .

(Ex. 9, Overcast Direct, p. 12, l. 14-20).

. . . .

> Q. Dr. Overcast, do I understand your testimony correctly that Empire has very little control over the level of fuel and purchased power expense it incurs?

In all trials, actions, suits and proceedings arising under the provisions of this chapter or growing out of the exercise of the authority and powers granted herein to the commission, the burden of proof shall be upon the party adverse to such commission or seeking to set aside any determination, requirement, direction or order of said commission, to show by clear and satisfactory evidence that the determination, requirement, direction or order of the commission complained of is unreasonable or unlawful as the case may be.

> A. Well, to the extent that the markets that they purchase those in are competitive markets, they are a price-taker, okay? To the extent they purchase fuels in those markets, they basically have purchased them at prices that are set by the market, not by Empire. And Empire -- Empire does everything they can do to control those costs, and those are all facts that are in the case. But the result -- the ultimate result is that no matter how well you plan, something is going to be different and those costs are going to be different. And Empire does not have control over things like the price in the purchased power in the -- in the market because it's a competitive market.

(Tr. Vol. 8, p. 557, l. 5-23).

Exhibit 227, a page from Empire's 2007 Electric Resource Plan, provides an indication that Empire is not as helpless as it tries to depict itself as respecting fuel and purchased power costs. Section 2.3.2 Natural Gas Risk Management Policy from Volume III Supply-Side Resource Analysis, p.16 of Empire's 2007 4 CSR 240-Chapter 22 filing with the Commission states, in part, that "Empire originally enacted a Risk Management Policy (RMP) in 2001 that establishes the approach and internal policy that Empire will use to manage specifically its natural gas commodity risk. The policy is revised approximately each year to reflect increased knowledge and changes in markets and financial instruments. The RMP serves to minimize the exposure that Empire has to rising natural gas prices, such as those experienced in late 2005."

Finally and very importantly on this matter, there is an example in the True-Up Direct Testimony of Staff witness Mark L. Oligschlaeger of Empire's control over fuel and purchased power prices. The example is Empire's February 2008 unwinding of several contracts for future delivery of natural gas at $4.525

per dekatherm. Mr. Oligschlaeger states in part as follows at pages 8, line 16 to page 9, line 14 of his True-Up Direct testimony:

> Q. What is the Staff's other concern regarding Empire's unwinding actions?
>
> A. The Staff's is concerned that Empire's actions to unwind these contracts may not be in the long-term best interest of its customers. Empire, through its actions in the true-up period, has given up the contractual right to receive natural gas in the future at prices that are significantly below current market levels, in order to enhance its cash flow and to book a financial gain to shore up its income statement on a short-term basis. To the extent the gas Empire obtains to replace the "unwound" contractual volumes is higher-priced than the gas that would have been obtained through the contracts Empire canceled, then the Company's actions will ultimately be detrimental to its customers.
>
> Q. What does the Staff recommend on this matter?
>
> A. If the Commission orders a fuel adjustment clause (FAC) implemented for Empire in this case or subsequent rate cases, then the replacement cost of the gas for the contracts unwound by Empire will automatically flow through the FAC to customers, unless such costs are disallowed for recovery on prudency grounds. Therefore, the Staff recommends that the effects of Empire's unwinding transactions on future natural gas procurement costs be closely monitored in general rate proceedings or FAC audits, as the case may be, to ensure that higher prices that may be paid for replacement gas are not passed on to the Company's customers. As Empire's ratepayers will not receive any benefit in rates from the financial gain achieved by Empire from the unwinding transactions, neither should customers be burdened with higher rates as a direct result of the Company's decisions to unwind gas contracts.

Dr. Overcast even admits in one sentence in his Direct Testimony that fuel prices can decrease: "Fuel price changes occur both up and down over historic periods even though the general trend is upward." (Ex. 9, Overcast Direct, p. 10,

l. 1-2). Declining fuel costs have occurred for Empire several times in recent years. Staff witness Lena Mantle testified that in Case No. ER-2001-0299 Empire had to refund monies collected through an Interim Energy Charge because of declining fuel costs. (Ex. 215, Mantle Surrebuttal, p. 4, l. 15-17; Tr. Vol. 9, p. 661). In a more recent instance, Dr. Overcast identified Empire's historical level of fuel and purchased power costs for the 12 months ending June 2006 as being approximately $171.6 million. (Ex. 9, Overcast Direct, Schedule HEO-4, p. 1 of 2). At the hearings, Empire stipulated that its total Company test year (12 months ending June 2007) actual level of fuel and purchased power costs was approximately $160.0 million. (Tr. Vol 9, pp. 789-790).

The Western District Court of Appeals decision in *State ex rel. Midwest Gas Users' Assoc. v. Public Serv. Comm'n*, 976 S.W.2d 470 (Mo.App. W.D. 1998)(*MGUA*) which found the purchase gas adjustment clause (PGA clause) and related mechanisms to not be a violation of single issue ratemaking or retroactive ratemaking contrary to the Missouri Supreme Court's decision regarding the FAC in *State ex rel. Utility Consumers Council of Missouri, Inc. v. Public Serv. Comm'n*, 585 S.W.2d 45 (Mo. banc 1979)(*UCCM*) is most interesting given Dr. Overcast's prepared testimony regarding how utterly devoid of control Empire is regarding fuel costs. The Western District Court of Appeals in *MGUA* and the Missouri Supreme Court in *UCCM* did not find Missouri electrical corporations to be so devoid of control regarding fuel costs. First, the Western District Court of Appeals in MGUA in distinguishing the

PGA and natural gas from the FAC and electrical corporation fuel costs stated, in part, as follows:

> . . . because the **costs at issue in the FAC in *Utility Consumers Council* were subject to the control of the utilities, and included labor costs and other costs of producing the electricity**, and because the Court believed that the amount of money spent for fuel might affect the bottom line and could be offset by savings in other areas, the FAC was not approved.

976 S.W.2d at 480.

> The **FAC at issue in *Utility Consumers Council*** was found to come "dangerously close" to an abdication of the PSC's ratemaking authority because it permitted the electric utilities to simply pass on any amount they paid for fuel costs. Moreover, **the companies could control much of those costs**, for electricity, unlike natural gas, is not a natural resource. Its cost therefore is made up of the **cost of such things as labor, raw materials, and so forth**, costs which can vary greatly and **which the utilities can control**.
>
> By contrast, natural gas, by definition, is a naturally occurring commodity. The gas costs which the PGA mechanism allows the companies to pass on are almost entirely the cost of obtaining the gas itself; they do not include the type of labor and material costs used in making electricity. . . .

Id. at 482. In the *UCCM* decision, the Missouri Supreme Court did not find the electrical corporations devoid of control respecting fuel costs:

> . . . While fuel costs are to a large extent dependent on general market conditions and periodically fixed contract costs, **the utility does exercise control over its fuel costs when it negotiates fuel contracts or chooses what fuel to buy or burn in what generating unit**.[5] It also is possible to offset fuel costs with savings from efficiencies in other areas of operation, such as salaries, wages, taxes, depreciation and materials and supplies other than fuel. . . .

[5] In the May 30, 1979 edition of the Wall Street Journal, p. 10, it is reported that the Tennessee Valley Authority is considering cancelling a 6.5 percent, or $100 million, electricity rate increase scheduled to take effect in July because of reduced fuel cost estimates. Fuel cost estimates were said to be $137 million

> less than earlier projected for fiscal 1979 because of increased production by its hydroelectric plants and nuclear power plant.

The subject matter of Dr. Overcast's testimony requires a familiarity and understanding of the Stipulation And Agreement that is the Empire Regulatory Plan from Case No. EO-2005-0263. Dr. Overcast testified that he had looked at the Stipulation And Agreement in the past (Tr. Vol. 8, p. 546, l. 22 – p. 547, l. 25) but his degree of knowledge is not clear from his prepared testimony and the cross-examination. Starting at page 32 of his Direct Testimony, Dr. Overcast discusses the risks associated with a major construction program. Regarding rate base disallowance risk, Dr. Overcast states:

> . . . In the case of this risk, although Empire participates in the construction management for the plants and attempts to influence decisions and assure prudence, as a minority owner they have little direct control over project decisions. Further, Empire has given up its right to use that position as a response thereby facing this risk by proxy based on the final decisions of the plants [sic] primary owner. . . .

(Ex. 10, Overcast Direct, p. 33, l. 21 – p. 34, l. 3). The Empire Regulatory Plan Stipulation And Agreement which is Attachment 1 to the August 2, 2005 Commission Order Approving Stipulation And Agreement in Case No. EO-2005-0263 states at pages 5-6 of the Stipulation And Agreement, in relevant part, as follows:

> 7. Cost Recovery of Capital Investments in Iatan 1, Iatan 2, Asbury SCR and V84 CT
>
> . . . .
>
> If any party proposes the disallowance of Iatan 1 or Iatan 2 costs, Empire agrees not to seek to avoid such disallowance on the ground that such expenditures were the responsibility of KCPL and were not within Empire's control. Empire maintains the ability to litigate prudence issues related to these expenditures on any other basis.

Dr. Overcast testified that he did not know whether there is an Owners' Committee respecting Iatan 1 and Iatan 2. (Tr. Vol. 8, p. 549, l. 1-4).

Dr. Overcast states that the purpose for adopting the additional amortization provision of the Empire Regulatory Plan in Case No. EO-2005-0263 "is to permit Empire to maintain an investment grade for its debt financing related to its cost of new capacity additions." And then he asserts that "[m]aintaining the investment grade requires that Empire actually earn its allowed return in the Rate Effective Period since the rating agencies look at actual financial performance not the allowed return." Dr. Overcast gives no recognition to the relevant provisions in the Empire Regulatory Plan Stipulation And Agreement in Case No. EO-2005-0263 which even acknowledged the impending availability to Empire of a FAC under SB 179:

> 2. Amortizations To Maintain Financial Ratios.
>
> This agreement contains provisions that provide Empire the opportunity to maintain its debt at investment-grade rating during the period of the construction expenditures contained in this agreement. Empire understands that it is responsible to take prudent and reasonable actions to maintain Empire's debt at investment-grade levels and avoid actions that result in the downgrade. Empire further agrees that it will not seek to recover in Missouri jurisdictional rates any negative impact caused by:
>
> . . . .
>
> 3) its decision to create an additional risk by relying upon the as yet unknown implementation of SB 179 for recovery of fuel and purchased power costs in lieu of addressing recovery of those costs through this regulatory plan.
>
> Empire recognizes its obligation to continue prudently manage costs, continuously improve productivity, and maintain service quality in a reasonable manner during the Regulatory Plan. Empire further recognizes that any finding by the Commission that Empire has failed to prudently manage its costs, continuously

> improve productivity, and maintain service quality in a reasonable manner during the Regulatory Plan will negate the obligation of the Signatory Parties contained in this section.

(*Re The Empire District Electric Co.*, Case No. EO-2005-0263, Order Approving Stipulation And Agreement, Attachment 1, pp. 11-12 (2005)).

. . . .

> 6. Fuel And Purchased Power Cost Recovery
>
> Empire has expressly stated that it intends exclusively to rely upon the FPPCR [Fuel And Purchased Power Cost Recovery] mechanism of SB 179 for its recovery of fuel and purchased power costs. Accordingly, the Signatory Powers intentionally make no provision for any other fuel and purchased power cost recovery mechanism in this Agreement. However, should SB 179 fail to become law or the FPPCR mechanism be determined by the courts to be unlawful, this provision will not prohibit Empire from proposing an Interim Energy Charge (IEC) for the purposes of fuel recovery in a rate case. The Signatory Parties maintain the right to oppose any IEC proposal.

(*Id.* at 16).

In its Prehearing Brief in an attempt to add some perspective, the Staff related in some detail the 1979 Missouri Supreme Court *UCCM* decision which found that the Commission did not have the power to authorize a FAC. The Staff thought it would attempt to provide some additional perspective by relating an effort that was made in the 1980's to provide relief to electrical corporations respecting fuel expense even before interim energy charges were utilized in the years immediately preceding SB 179. When increases in fuel costs due to rampant inflation were a major concern in the late-1970's and the early- to mid-1980's, "forecasted fuel" was a mechanism developed to address the inability to utilize a FAC due to the Missouri Supreme Court's decision in the *UCCM* case, until the Commission directed the Staff to terminate that approach.. The

Commission chose to discontinue use of the forecasted fuel mechanism in the Kansas City Power & Light Company-Wolf Creek rate case, stating as follows:

> A joint recommendation was submitted by Staff and Company which sets forth the incremental portion of fuel expense to be included in the rates established in this case. As part of the revenue requirement allowed by the joint recommendation the Company is allowed an amount equal to the increased costs of coal and natural gas quantities required to generate electricity for the Company's Missouri retail use. The portion of rates which is based upon the additional revenue requirement associated with forecasted increases in the prices of coal and gas (unless it was excluded under paragraph 2 of the joint recommendation) will be subject to true-up (rate reduction) and refund. . . .
>
> Public Counsel opposes the joint recommendation and believes the Commission should deny any increment to the Company's fuel expense which is related to forecasted fuel. Public Counsel asserts the appropriate prices to be utilized for setting rates are the last known and measurable fuel expenses as trued up in this proceeding with other Company expenses. Public Counsel maintains that the Commission should no longer engage in a forecasted fuel procedure which allows a utility to change its rates after the operation of law date with consideration given to only one of several factors affecting those rates; i.e.: fuel costs.
>
> . . . . The Commission finds the allowance of forecasted fuel is an extraordinary remedy for highly inflationary times which protects the Company from paying costs which are beyond its control.
>
> The Commission finds that low inflation rates and stabilizing fuel prices indicate there is no need for forecasted fuel in the instant case. The Commission believes that fuel prices at this time are equally as likely to decrease as increase. . . .
>
> . . . .
>
> The Commission does not mean to infer by this decision that it will abandon forecasted fuel as a matter of regulatory policy. The Commission finds a fuel forecast is unnecessary based upon the facts of this case.

Re Kansas City Power & Light Co., Case Nos. EO-85-185 and EO-85-224, Report And Order, 28 Mo.P.S.C.(N.S.) 228, 403-04 (1986).

Missouri Power & Light Company (MPL) was a subsidiary of Union Electric Company serving, among other areas, Jefferson City. On April 25, 1980 MPL filed an electric general rate increase case. MPL proposed recovery of projected fuel costs. The Staff submitted testimony for the twelve month period ending June 30, 1980 updated for known and measurable changes through September 30, 1980. The Commission adopted a test year adjusted to known changes through September 30, 1980.

MPL was a distribution company generating only approximately 1% of its electricity sales. Approximately 92% of its requirements were purchased from UE and approximately 7% of its requirements were purchased from KCPL. The Commission noted that "[a]pproximately 35 percent of the Company's expenses result from fuel costs. Those costs have been increasing at an average of 22 percent for the years 1976 through 1980." *Re Missouri Power & Light Co.*, Case No. ER-80-286, Report And Order, 24 Mo.P.S.C.(N.S.) 257, 267 (1981). MPL proposed a refund at the prime rate of overcollection of fuel costs based on an audit one year after the effective date of the rates to be allowed. MPL assumed the risk of nonrecovery of any amount actually expended for whatever reason by MPL above its forecasted fuel amount. *Id.* at 268. The Commission held as follows:

> In the Commission's opinion the evidence of record establishes an experience of consistent accuracy in the UE's fuel cost forecast but the record is almost totally devoid of any support for such impression concerning the similar estimates of KCPL. . . . An allowance for budgeted fuel increase should be included in this case only to the extent supported by the UE fuel forecast contained in the evidence.

> Generally, the Commission has little willingness to resort to budgeted figures or allowances too distant from the test year to create an impression of reliability. Due to the peculiar circumstances of this case and of the Company involved, the Commission is persuaded to take a forward look at its fuel costs. . . .

Id. at 267.

In *Re Kansas City Power & Light Co.*, Case No. ER-82-66, 25 Mo.P.S.C.(N.S.) 229, 245 (1982) KCPL filed revised electric tariff sheets on August 26, 1981, and the Staff, OPC and KCPL entered into a Stipulation And Agreement on the issue of "forecasted fuel." The revenue requirement associated with forecasted increases in the prices of delivered coal and natural gas was forecasted to October 31, 1982, three months beyond the operation-of-law date of the rate case. The Stipulation and Agreement provided that if it was determined that KCPL had undercollected, KCPL could not recover the undercollection, but if it were determined that it had overcollected, it would refund with interest at the authorized overall rate of return set in Case No. ER-82-66 by the Commission. *Id.* at 245-47.

> In *Re The Empire District Electric Co.*, Case No. ER-83-42, Report And Order, 26 Mo.P.S.C.(N.S.) 58 (1983) there was an agreement respecting forecasted fuel. Prior to the current practice of the Staff filing on behalf of the parties a List/Order/Schedule Of Issues And Witnesses, the Staff would file a Hearing Memorandum which would serve basically the same purpose. The Hearing Memorandum executed by Empire, the Staff, OPC, Union Carbide Corp., Atlas Powder Co., FAG Bearings Co., Missouri Steel Castings Co., and Farmer's Chemical Co. was Exhibit 1 in Case No. ER-83-42 and, among many other things, it set out the forecasted fuel agreement that the Staff and Empire had reached.

The June 17, 1983 Report And Order states that the Staff and Empire agreed that $787,091 of the increase in revenue requirement represents forecasted fuel costs which are subject to refund if the actual unit prices for coal are less than the forecasted unit prices as reflected in Appendix A to Exhibit 1, the Hearing Memorandum. Pursuant to the request of the parties the Commission established in Case No. ER-83-42 a separate investigatory proceeding, Case No. EO-83-364, for the purpose of audit and verification of the forecasted fuel costs. The Report And Order stated that if it was determined after such investigation and a hearing to be held in April 1984 that Empire is obligated to refund amounts, it should do so with simple interest accruing on such amount beginning on January 1, 1984 until the date of credit or refund, if any, at a rate identical to the rate of return on Empire's investment authorized by the Commission in this case. *Id.* at 62, 76. The parties to Case No. EO-83-364 filed on July 6, 1984 a Stipulation And Agreement with the Commission and on July 19, 1984 the Commission issued a Report and Order approving the Stipulation And Agreement, which authorized Empire to refund $315,000.00 to its Missouri jurisdictional customers who received service during the period of July 1, 1983 through June 30, 1984. *Re The Empire District Electric Co.*, 27 Mo.P.S.C.(N.S.) 16, 18-19 (1984).

The OPC either joined in stipulation and agreements on forecasted fuel or did not oppose them until the KCPL rate increase case in 1983. OPC opposed the forecasted fuel Stipulation And Agreement entered into by the Staff and KCPL in *Re Kansas City Power & Light Co.*, Case No. ER-83-49, Report And Order, 26 Mo.P.S.C.(N.S.) 104, 127 (1983). Public Counsel James M. Fischer and Assistant Public Counsel Michael C. Pendergast raised forecasted fuel among a number of issues on a Writ Of Review to Cole County Circuit Court. But after Douglas M.

Brooks became Public Counsel, the case was not prosecuted further by the new Public Counsel and was eventually dismissed by the Cole County Circuit Court for want of prosecution.

B. If the Commission authorizes Empire to use a fuel adjustment clause (FAC), how should it be structured?

b. What components of fixed and variable fuel and purchased power costs should be recovered through a FAC?

The Staff identified in its Prehearing Brief the costs and revenues below that should be used to calculate Empire's base FAC rates. The line item "Purchased power" is shown below as including Southwest Power Pool Section 5.1 SPP Energy Imbalance Market Settlements and Section 5.2 SPP Revenues Neutrality Uplift Charges. Empire proposes to include Section 5.3 Under Scheduling Charges, Section 5.4 Over Scheduling Charges, and Section 5.5 Uninstructed Deviation Charges in the FAC whereas the Staff does not. (Ex. 4, Keith Surrebuttal, p. 2, l. 18 – p. 4, l. 19; Ex 214, Mantle Rebuttal, p. 4, l. 7-13; Ex. 215, Mantle Surrebuttal, p. 2, l. 11-12; Ex. 226). Empire witness Scott Keith testified that the charges for Sections 5.3, 5.4, and 5.5 are for when an electrical corporation is more out of balance than under Section 5.2. (Tr. Vol. 9, p. 630, l. 4-8). When asked if the charges under Sections 5.3, 5.4, and 5.5 are penalties he responded: "I don't know that I'd view them as penalties. It's hard to stay in balance when they ask you to dispatch your system and they have these -- these charges when you are out of balance a little bit. It's just part of their tariff and part of the EIS [energy imbalance service] market charges." (Tr. Vol. 9, p. 629, l. 13-18).

FUEL
Fuel
Gas Transportation – Fixed (including FERC Pipeline Transportation Costs)
Gas Transportation - Variable
Gas Capacity Release - Variable
Gas LUF at Cost of Gas
Total Fuel

FUEL RELATED COSTS

PURCHASED POWER ENERGY CHARGES
Purchased power (including SPP Energy Imbalance Market Settlements and Revenues Neutrality Uplift Charges (transmission costs))
Cost of off-system sales
Energy exchanged – Southwest Power Administration (SWPA)

OFF SYSTEM SALES MARGIN
A base level of off-system sales margin should be included in the FAC base. Actual off-system sales margin should be included in each six month accumulation period and the FAC rate should be adjusted on the basis of the difference of what was included in the base and the actual off-system sales margin.

(Ex. 215, Mantle Surr., p. 2 and Sched. 1; Ex. 214, Mantle Rebuttal, p. 4).

Finally, Dr. Overcast uses throughout his Rebuttal Testimony and Surrebuttal Testimony the term "penalize" to describe the Staff's FAC position. When asked to explain his use of that term he refused to do so. (Tr. Vol. 8, p. 551, l. 4 – p. 552, l. 19). Black's Law Dictionary (7th Edition 1999) defines the term penalty as follows:

> Penalty. 1. Punishment imposed on a wrongdoer, esp. in the form of imprisonment or fine. Though usu. for crimes, penalties are also sometimes imposed for civil wrongs. 2. Excessive liquidated damages that a contract purports to impose on a party that breaches. If the damages are excessive enough to be considered a penalty, a court will usu. not enforce that particular provision of the contract. Some contracts specify that a given sum of damages

is intended "as liquidated damages and not as a penalty" – but even that language is not foolproof.

Is Empire barred by the terms of the Stipulation and Agreement in CaseNo. ER-2004-0570 from requesting a fuel adjustment clause while an interim energy charge is pending?

It is the Staff's position that unless there is some judicial directive to the Commission to the contrary, the Commission must process Empires request for a FAC.

Respectfully submitted,

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, or transmitted by facsimile or electronic mail to all counsel of record this 18th day of June, 2008.

/s/ Steven C. Reed