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

<u>POST-HEARING BRIEF OF</u>
<u>THE EMPIRE DISTRICT ELECTRIC COMPANY</u>

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 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. The major factors driving Empire's rate increase request are: (1) the capital additions made by the Company to its electric system in 2007; specifically, the Riverton 12 generating unit and the Selective Catalytic Reduction, or SCR, at the Company's Asbury plant; and (2) the financial impact, including capital, expense, and cash flow related to the catastrophic ice storms that hit Empire's service area in 2007. (Ex. 1, Gipson Direct, p. 4)

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. The Company therefore, is requesting the authorization of a fuel adjustment clause, or FAC, pursuant to RSMo. §386.266. Empire has worked diligently to control the volatility associated with fuel costs through the use of a natural gas hedging program which has been in place since 2001, managing coal contracts effectively, purchasing coal fired power under purchased power contracts, and Empire has been pursuing wind generation, but Empire remains exposed to increased fuel cost risk. (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 herein.

With a true-up of the 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. With regard to these five issues, the evidence presented to the Commission supports: (1) the award of an 11.6 percent return on common equity ("ROE") for Empire, as explained by Empire witnesses Dr. James H. Vander Weide and Dr. H. Edwin Overcast; (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 depreciation rates should be changed during the duration of its Regulatory Plan, with Empire's proposed changes being adopted; and (5) the authorization of an FAC for Empire, as detailed by Empire witnesses Bill Gipson, Scott Keith, and Ed Overcast.

Revenue Requirement Issues

A. 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?

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. This recommendation is consistent with his proposals in Empire's two prior cases in which the Commission awarded the Company ROEs of 11 and 10.9 percent. Empire's financial circumstances since these cases were decided have not improved. In the event the Commission authorizes an FAC for Empire, the ROE should not be adjusted downward.

As fully set out in Empire's Statement of Positions and Prehearing Brief filed with the Commission on May 6, 2008, Empire witness Dr. James H. Vander Weide was retained by Empire to prepare an independent appraisal of Empire's cost of equity and to recommend to the Commission a rate of return on equity for ratemaking purposes. Dr. Vander Weide presented competent and substantial evidence in this regard. Additionally, Empire witness Dr. H. Edwin Overcast of Black & Veatch presented testimony regarding the additional risk Empire faces due to the lack of a fuel adjustment mechanism in Missouri and the risk associated with Empire's substantial construction program.

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 and will be touched on only briefly here. 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) Dr. Vander Weide utilized a large group of comparable companies because standard cost of equity methodologies require inputs of quantities that are not easily measured. Since these inputs can only be estimated, there is naturally some degree of uncertainty surrounding the estimate of the cost of equity for each company. The uncertainty in the estimate for an individual company, however, can be greatly reduced by applying cost of equity methodologies to a large sample of comparable companies. Intuitively, unusually high estimates for some individual companies are offset by unusually low estimates for other individual companies. (Ex. 28, Vander Weide Direct, pp. 3-4)

In utility regulation, the practice of using a group of comparable companies is further supported by the United States Supreme Court standard that the utility should be allowed to earn a return on its investment that is commensurate with returns being earned on other investments of similar risk. (Ex. 28, Vander Weide Direct, pp. 3-4, citing *Bluefield Water Works and Improvement Co. v. Public Service Comm'n.* 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company*, 320 US 591 (1944)) As explained by the courts, a utility's overall ROR, in order to be non-confiscatory and constitutional, must be "commensurate with returns on investments in other enterprises having corresponding risks" and "should be sufficient to assure confidence in the financial integrity of the [utility] enterprise, so as to maintain its credit and to attract capital." *Hope Natural Gas*, 320 US at 603.

It is these principles set out by the United States Supreme Court that must ultimately guide the Commission with regard to this issue. As the courts have acknowledged, it is not the exact methodology employed or adopted by the Commission, but the impact of the rate order which is significant. *State ex rel. Arkansas Power & Light v. Public Service Commission*, 736 S.W.2d 457, 462 (Mo.App. W.D. 1987) (*citing State ex rel. Associated Natural Gas Company v. Public Service Commission of Missouri*, 706 S.W.2d 870, 879 (Mo. App. 1985)). No particular methodology is statutorily prescribed, and ratemaking is an inexact science. *Arkansas Power & Light*, 736 S.W.2d at 462. Consequently, the Commission must sift through the expert testimony offered to it and ultimately reach decisions in this rate case which will produce a return for Empire which is commensurate with returns on investments in other enterprises having corresponding risks and which will be sufficient to assure confidence in the financial integrity of the Company.

As with the majority of rate cases brought before this Commission, with regard to the ROE issue, the Commission heard from Company experts urging an award on the high end of the spectrum, and the Commission heard from the Office of the Public Counsel ("Public Counsel") and customer witnesses who are conversely urging a return at the lower end of the spectrum. The Staff witness in this proceeding urges a return more toward the middle of the range. As is usually the case, the Commission is faced with a record which arguably supports a wide range of possibilities. Ultimately, however, the Commission should give the greatest weight to the testimony of Empire witnesses Dr. Vander Weide and Dr. Overcast, as their recommendations fit squarely within the ratemaking parameters enunciated by the courts.

Several years ago, the Commission concluded that the national average is a fair indicator of the capital market in which Missouri regulated utilities must compete for capital and thus began to look at the average allowed returns for the gas and electric utility industries and a "zone of reasonableness" as a tool in the setting of an authorized ROE. In the instant proceeding, conflicting testimony was presented regarding the boundaries of this "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, a witness for Explorer Pipeline Company, General Mills, and Praxair, Inc. (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)

In any event, looking at the issue somewhat more simplistically, in Case No. ER-2004-0570, Dr. Vander Weide supported an 11.3 ROE for Empire, Staff witness David Murray proposed a range of 8.29 to 9.29, and Public Counsel witness Travis Allen supported a range of 8.96 to 9.41 percent. In that case, the Commission concluded that an 11 percent ROE was appropriate. In Empire's next rate case, Case No. ER-2006-0315, Dr. Vander Weide came in with an 11.7 percent recommendation. Mr. King for the Public Counsel suggested 9.65 percent, and Staff witness Murray recommended a range of 9.5 to 9.6 percent. The Commission authorized a 10.9 percent return. As indicated, Dr. Vander Weide's 11.6 percent recommendation in the current case is consistent with his past proposals (except that he is not proposing a financial risk adjustment). Staff has increased its recommendation and supports a range of 9.72 to 10.8 percent. Mr. Gorman, the witness for the Industrials (with support from Public Counsel), has an ROE range of 9.5 to 10.3 percent, with a mid-point recommendation of 10 percent.

At the hearing in this matter, Staff witness Barnes clarified his recommendation and testified that he would be in agreement with an award of 10.8 percent. Industrial witness Gorman said he would not take issue with an award of 10.3 percent. (Tr. 514, 797-798) Interestingly, if the Commission considers Dr. Vander Weide's 11.6 percent recommendation, the high side of the Staff's range (10.8), and the high end of the Industrials' range (10.3), a simple average yields an ROE of 10.9 percent –the ROE authorized in Empire's last case. This is significant, because in the current case, the evidence clearly demonstrates that Empire's financial circumstances have not improved since the 10.9 percent was awarded. 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. Consequently, there is ample reason for the Commission to conclude that an award of anything below the previously-authorized awards of 10.9 or 11 percent would be inappropriate in this proceeding. If anything, the evidence suggests that the Commission, in order to conform to the mandates of *Hope Natural Gas* and *Bluefield Water Works*, should be moving in the other direction. It is also important to note that during the periods of time when Empire was operating with the 10.9 and 11 percent authorized returns, its actual earned returns were significantly lower. In fact, Empire's President and CEO testified that Empire's earned return was approximately nine percent in 2006 and seven percent in 2007. (Tr. 240)

Dr. Vander Weide found the cost of equity for his comparable companies to be 11.6 percent (the simple average of the cost of equity results), and Dr. Vander Weide is conservatively recommending that Empire be allowed a rate of return on equity equal to 11.6 percent. (Ex. 28, Vander Weide Direct, pp. 4, 40) His recommended cost of equity is conservative because: (1) Empire faces greater business risk than the selected comparable companies; and (2) the financial risk of the comparable companies is less than the financial risk implied by Empire's ratemaking capital structure. (Ex. 28, Vander Weide Direct, p. 4)

Empire has a significant capital program required to provide safe and reliable service to its customers. Over the next three years (2008-2010), Empire expects to spend over $200 million to add new generating capacity, almost $50 million on retrofits to existing plants, and over $150 million for transmission and distribution facilities to serve new and existing customers, for a total of almost $440 million in new capital for its regulated operations. New investment in the capital program will add over 40 percent to the existing plant investment, and, accordingly, the capital program represents a significant impact on the Company and its customers. (Ex. 8, Overcast Direct, p. 28) Empire's capital program must be funded by both internally generated funds and by external financing - both new equity issues and new debt issues. (Ex. 8, Overcast Direct, p. 29)

It is impossible to know exactly the required return needed to support the capital program and maintain an investment grade debt rating because of the risks associated with the construction program. It is important to note that the risks for Empire are significant despite the approval of the amortization provision of the Regulatory Plan previously authorized for the Company. This is particularly so because in calculating the amortization amounts for rate case purposes, the formula assumes revenues consistent with earning the allowed return from the rate case. (Ex. 8, Overcast Direct, pp. 29-30) Although it is impossible to know exactly how much earned return the Company needs during the period in which the new rates will be in effect ("Rate Effective Period"), the Commission has available several proxies that provide insight in the magnitude of the dollars of return at risk.

The Commission has two tools for addressing risk – compensation and mitigation, and these tools may be used separately or in conjunction with one another. Thus, the Commission may either grant the Company additional return to compensate for those risks, provide another means of mitigation through the ratemaking process, or adopt some combination of the two. With respect to any risk, the options for meeting the standard of a return commensurate with the risk always include both additional return and mitigation. Regulatory commissions commonly use regulatory models that incorporate both tools as a means of providing a reasonable opportunity of earning the allowed return. These models vary by jurisdiction and include the Rate Stabilization and Equalization (RSE) in Alabama that adjusts rates quarterly to fall within a dead band around the allowed ROE based on a forecast test year to Wisconsin that uses a forecast test year and permits a current return on 50 percent of construction work in progress. (Ex. 8, Overcast Direct, pp. 30-31)

Empire's construction program represents substantial risks for the Company. The long list of risks is particularly unique for Empire because of its limited financial flexibility and the size of the overall undertaking. (Ex. 8, Overcast Direct, p. 40) In terms of the estimated cost of equity for the comparable companies discussed by the rate of return experts in this rate case proceeding, Empire faces higher risk and thus requires additional risk compensation. Indeed, some of the comparable companies no longer have the responsibility to build additional generation. (Ex. 8, Overcast Direct, p. 37) The Commission, however, need not determine a specific adjustment to the cost of capital in order to recognize the construction program risks (or any of the other risks) that Empire faces that distinguish it from the comparable companies. Rather, the Commission may recognize the risk by awarding Empire its requested return of 11.6 percent. (Ex. 8, Overcast Direct, pp. 38-39)

If an FAC is authorized for Empire, an ROE adjustment should not be made, as suggested by the Staff and Mr. Gorman, a witness for the Industrials. Given the "comparable" companies used by both Mr. Gorman and the Staff, and the proposed fuel clauses that are recommended by the Staff and Mr. Brubaker, a witness for the Industrials, there is reason to believe that even with an FAC, Empire, because of its higher business risk, should be authorized a higher return relative to the comparable companies. Even with the approval of the Empire FAC proposal, the appropriate ROE should be at least as high as recommended by Empire witness Dr. Vander Weide. (Ex. 10, Overcast Rebuttal, p. 13)

The rationale for a higher return, relative to the determined cost of equity of the comparable company groups, may be found in an analysis of the different set of comparable companies used by Mr. Gorman and the Staff. In fact, at the hearing in this matter, Staff witness Matt Barnes testified as follows:

> Q: First of all, do you believe that a fuel adjustment clause lowers risk?
>
> A: yes, I do.
>
> Q: And is that something that should factor into the ROE calculation?
>
> A: I guess it depends on which witness you – you go with. In my analysis, 15 of the 17 companies already have some sort of mechanism in place to recover fuel costs . . . that risk has already been either adjusted or accounted for in the stock priced of – of those companies. And part of the DCF model is the

> current stock price, so I don't think an adjustment should be made to my recommendation.[1]

Rebuttal Schedule HEO-1 provides information relative to the treatment of fuel costs for the companies used by Mr. Gorman. Twelve of the fifteen companies have full tracking fuel adjustment clauses. For the three companies that do not have a full tracking clause – Ameren, Avista, and PNM Resources, Avista uses deferred accounting treatment for fuel costs in excess of those in base rates and has an opportunity to recover these costs after hearing, and Ameren and PNM have fuel clause recovery in one jurisdiction for each company. For Ameren, 61.5 percent of revenue is subject to a jurisdiction with a fuel clause based on data from 2006. For PNM Resources, less than 29 percent of revenue is earned in the jurisdiction without a fuel adjustment clause. These facts suggest that Mr. Gorman has used comparable companies for whom full recovery of fuel costs is the basis for investors' expectations regarding return. In addition, certain of the utilities in the sample have adjustment clauses that go beyond fuel cost recovery. (Ex. 10, Overcast Rebuttal, pp. 13-14) Additionally, many of the utilities have the opportunity to use a future test year or to have a test year that is closer in time to the Rate Effective Period than is available to Empire. During periods when costs are rising, this reduces the probability that these companies will fail to earn the allowed return. (Ex. 10, Overcast Rebuttal, p. 14)

[1] Tr. 527. Additionally, Rebuttal Schedule HEO-3 provides the status of fuel adjustment clauses for the Staff's comparable companies. Investor expectations of the sample include an expectation of fuel cost recovery in terms of the required equity return. Further, many of the Staff's comparable companies have other forms of adjustments that improve the opportunity to earn the allowed return relative to Empire, and Rebuttal Schedule HEO-4 shows that many of the companies have regulatory models that provide a reasonable opportunity to earn the allowed return. These comparable companies have test years that permit costs to be determined closer to the Rate Effective Period and or coincide with the Rate Effective Period. (Ex. 10, Overcast Rebuttal, p. 15)

Lastly, as a significant portion of the companies in the proxy groups presented in testimony in this proceeding have fuel adjustment clauses or similar mechanisms in place, the cost of equity recommendations of all witnesses on this topic already include the lower risk of having a fuel adjustment mechanism. Accordingly, if an FAC is not authorized for Empire as proposed by the Company, the cost of equity will need to be increased to account for the greater risk of not having a fuel adjustment mechanism. (Ex. 29, Vander Weide Rebuttal, p. 38) In conclusion, in conjunction with the authorization of an FAC for Empire, an ROE of 11.6 percent should be used for determining Empire's authorized ROR in this proceeding.

B. Rate Base Issues

1. <u>Asbury SCR</u>: 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?

Yes. The background of this issue was thoroughly briefed in Empire's Statement of Positions and Prehearing Brief filed with the Commission on May 6, 2008. Consequently, Empire will provide here a synopsis of the background of the issue. In response to the EPA's Clean Air Interstate Rule ("CAIR") in 2005 governing nitrous oxide and sulfur dioxide emissions from certain fossil fuel power plants, Empire acted quickly and began the construction of the Selective Catalytic Reduction ("SCR") Project at its Asbury power plant with the expectation that it would be completed and in service in the fourth quarter of 2007.

The project was tied into a major outage at Asbury.[2] This project had been anticipated and specifically addressed in the Company's experimental regulatory plan that was approved by the Commission in Case No. EO-2005-0263 which contemplated the development of in-service

[2] These occur approximately every five years. (Tr. 98 (Mertens))

criteria that must be met before the costs for that equipment could be included in Empire's rate base. Those criteria were thereafter established.

The Company filed for authority to increase its rates in early October 2007. There was a subsequent agreement to a test year to be updated through December 31, 2007. The SCR construction and tie-in was completed on November 18, 2007. Although Asbury's major outage was scheduled to be completed by the end of November 2007, it was extended to February of 2008 to address an unanticipated rewinding of Asbury Unit 1 generator, an event that was entirely unrelated to the completion of the SCR project.[3] As a consequence of the condition of the Asbury Unit 1 generator, performance testing of the SCR project, including a 120 hour continuous run, was not completed until February 29, 2008. The record reflects that the Company and Staff are in agreement that the Asbury SCR met all in-service criteria as of that date. (Ex. 6, Mertens Rebuttal, p. 3; Tr. 102 (Oligschlaeger); Ex. 206, Taylor Surrebuttal, p. 4) It is not in dispute, therefore, that Asbury SCR will have met the in-service criteria prior to the date that new rates go into effect. Also, it is not disputed that the Asbury SCR currently is in use in the provision of electric service to Empire's customers. (Tr. 102 (Oligschlaeger))

It is abundantly clear that but for the unanticipated necessity of the generator rewind, the Asbury SCR would have met the agreed to in-service criteria by December 31, 2007. Construction on the project was completed in November 2007. (Ex. 6, Mertens Rebuttal, p. 3) Empire witness Mertens testified that it is his belief that the equipment would have met the in-service criteria had the testing been done at that time. (Tr. 96-97) Actual events support Mr.

[3] Empire witness Mertens testified that the Company performed a comprehensive inspection of the generator and found that some insulation was suspect and worn. (Tr. 80) He testified that this condition could have caused an electrical short within the generator thus presenting safety and reliability concerns. (Tr. 82-83) The Company made the decision to move forward with performing the rewinding work at that time rather than put it back into service in its current condition.

Mertens' assessment in that Asbury SCR met all in-service criteria when the generator rewind work was completed and operational testing took place in February 2008. (Tr. 97 (Mertens))

Staff has recommended that the cost of the Asbury SCR project not be included in this case because it was not shown to be in-service as of December 31, 2007. This is based on Staff's belief that to do otherwise would violate its understanding of the Commission's policy to reach an early resolution of test year and true-up determinations in rate proceedings. (Ex. 201, Oligschlaeger Rebuttal, p. 6) Alternatively, Staff asserts that if the Commission decides to allow Asbury SCR costs in rates that it should order that a true-up audit be performed.[4]

Including the Asbury's SCR in rates does not violate whatsoever the idea behind the Commission's use of a historical test year. The purpose of the test year is to create a reasonably expected level of earnings, expenses and investments for the period of time during which the rates will be in effect and this plant addition unquestionably is in-service prior to the revised rate schedules that will be authorized in this case.

In reality, not including Asbury SCR in rates in this case will result in a patently unfair outcome. The Company will not earn a timely return on its substantial plant investment. Also, Staff concedes that Empire would not be compensated for any O&M expenses attributable to the Asbury SCR equipment until after its next rate case if the Commission adopts Staff's proposal in this case. (Ex. 201, Oligschlaeger Rebuttal, p. 7) Secondly, Staff is recommending that the revenues from the sale of emissions allowances be flowed through the Company's requested fuel adjustment clause. (Ex. 214, Mantle Rebuttal, p. 5) Empire agrees that this is the proper manner in which to handle this topic but it is important for the Commission to recognize that the addition

[4] Empire was of the opinion that a true-up was not necessary inasmuch as Asbury SCR is not a revenue producing item but it did not oppose the approach suggested by Staff. (Tr. 61, 65)

of the Asbury SCR directly affects the amount of nitrous oxide allowances that would be bought or sold to meet Empire's allowance requirements in the future.

The Commission should also give favorable consideration to the Company's request for two salient public interest reasons. First, by moving quickly to comply with new CAIR requirements, Empire saved its customers money because the project came in advance of the utility construction boom that has driven up costs thus keeping capital costs lower than they would have been had the Company delayed. (Ex. 6, Mertens Rebuttal, p. 5) Empire's CEO, Bill Gipson, testified that comparable projects were coming in now at about double the cost. (Tr. 245) Second, Empire put safety and reliability considerations ahead of its financial interests thus avoiding an expensive unscheduled outage or a subsequent and unnecessary new scheduled outage. (Tr. 81-83 (Mertens)) This dedication to public service should be encouraged, not punished.

Finally, this issue was effectively mooted by a combination of developments starting with the issuance on May 13, 2008, of an Order Scheduling True-up Hearing and Directing Filing (the "Order") pursuant to which the Commission ordered a true-up audit with an ending date of February 29, 2008. Subsequently, on June 10, 2008, Staff filed the true-up testimony of Mark Oligschlaeger stating on page 3 that:

> As a result of the Commission's Order for a true-up audit in this proceeding, which will allow for reflection of the Asbury SCR project in rates appropriately matched in time with other material changes to Empire's revenue requirement, the Staff no longer opposes inclusion of this plant addition in rates.

Anticipating this additional testimony will be offered and received into the record, at hearing or otherwise, the Commission will be able to consider all factors associated with including the Asbury SCR project in rate base as part of a true-up of its revenue, expense, rate base and rate of return components. This obviates any concerns about a possible mismatch of revenues and expenses if the costs of Asbury SCR are included in rates.

C. Expense Issues

1. <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?

Empire used a five-year average to estimate the margins it likely is to receive from the off-system sale of electric power during the period rates set in this case are in effect, which is the same method the Commission used to estimate off-system sales margins in Empire's last general rate case, Case No. ER-2006-0315. (Ex. 4, Keith Surrebuttal, pp. 6-9) In contrast, Staff based its estimate on the margins Empire actually realized for the six-month period January–June 2007 multiplied by two, and Public Counsel based its estimate on the off-system sales margins that the Company booked for calendar year 2007.

The uncontroverted evidence presented by both Empire and Staff show that, historically, the Company's off-system sales margins fluctuate wildly year-to-year. Data that Empire used to calculate its five-year average show the following fluctuations:

Twelve Months Ended	Gross Profit (Margin)
June 30, 2003	$5,645,701
June 30, 2004	$2,023,298
June 30, 2005	$1,903,970
June 30, 2006	$3,798,127
June 30, 2007	$3,920,823

(Ex. 4, Keith Surrebuttal, p. 9) Staff's data shows similar fluctuations:

Calendar Year	Net Sales Margins
1999	$2,378,042
2000	$2,443,844
2001	$ 832,651
2002	$5,116,368
2003	$3,016,910
2004	$1,687,445

2005	$3,502,169
2006	$3,441,831
2007	$5,955,336

(Ex. 209, Eaves Surrebuttal, p. 3)

Whatever else these historical data may show, one thing is clear: it is not possible to accurately predict a future year's off-system sales margins based on the margins the Company realized in the preceding year. Yet that is precisely what Public Counsel is asking the Commission to do. Moreover, the year that Public Counsel asks the Commission to use as a predictor of Empire's future off-system sales margins – calendar year 2007 – is the year in which the margins the Company booked were significantly greater than in any of the past nine years.

Public Counsel argues that its proposal is justified by the fact that factors that contributed to the increase in off-system sales margins during 2007 – such as the start of the Southwest Power Pool's EIS market and a new bilateral contract for the sale of energy to BPU – likely will continue into the future, thus making the margins booked in 2007 representative of what Empire likely will experience in the future. (Ex. 303, Kind Rebuttal, pp. 5-6) But this argument is unpersuasive for at least two reasons: first, as the historical data show, significant increases in off-system sales in one year *never* were sustained in the immediately following years; and second, almost a quarter of the off-system sales margins booked by Empire in 2007 were from a single power supply agreement that is due to expire shortly before the operation of law date in this case. (Ex. 4NP, Keith Surrebuttal, p. 7)

The significance of off-system sales margins to the determination of the Company's cost of service will be mitigated somewhat if the Commission authorizes a fuel and purchased power cost recovery mechanism for Empire and if off-system sales margins are included as part of that mechanism. If that occurs, year-to-year fluctuations in off-system sales margins will be flowed-through the adjustment mechanism, thereby minimizing the effect of any estimation errors on the amount of off-system sales margins that are included in base rates. But the Commission should still keep in mind: off-system sales margins represent an offset to energy costs; therefore, including too high an estimate of those margins in base rates may necessitate future, energy-related rate increases to be larger than otherwise would have been the case should actual off-system sales margins fall below estimates.

4.[5] **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?**

Yes. The outcome of this issue is derivative of the outcome of issue B.1 (Asbury SCR in rate base). In other words, if the Asbury SCR is placed in rate base as part of the true-up through February 29, 2008, the associated O&M expenses should be included as a legitimate cost of service. (Tr. 111-112 (Oligschlaeger)) Staff witness Oligschlaeger has prefiled true-up testimony to the effect that Staff no longer opposes inclusion of the Asbury SCR in rates. Consequently, associated O&M expenses of $1,292,500 should be included in Empire's cost of service as well. (Tr. 131; Ex. 5, Mertens Direct, p. 14)

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

No. Empire has dropped its request that property taxes associated with Asbury SCR for the year 2008 be included in its cost of service.

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

[5] Empire is using in this post-hearing brief the issue numbering from the list of issues which was presented to the Commission in Staff's filing of May 5, 2008.

Yes. As with issue C.4 (Asbury SCR O&M Expenses), the outcome of this issue is derivative of the outcome of issue B.1 (Asbury SCR in rate base). In other words, if the Asbury SCR is placed in rate base as part of the true-up through February 29, 2008, the associated depreciation expenses should be included as a legitimate cost of service. (Tr. 111-112 (Oligschlaeger)) Staff witness Oligschlaeger has prefiled true-up testimony to the effect that Staff no longer opposes inclusion of the Asbury SCR in rates. Consequently, the associated annual depreciation expense of $510,000 should be included in Empire's cost of service. (Tr. 131; Ex. 6, Mertens Rebuttal, p. 16)

7. <u>Commission Rules/Tracker</u>: 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 purpose of using a test year is to create or construct a reasonably expected level of earnings, expenses and investment during the future period during which the rates to be determined herein will be in effect. All of the aspects of the test year operations may be adjusted upward or downward to exclude unusual or unreasonable items, to arrive at a proper allowable level of all of the elements of the Company's operations." *In re Southwestern Bell Telephone Company*, 23 Mo.P.S.C. (N.S.) 374, 377 (1980). *See also State ex rel. Missouri Power & Light Co. v. Public Service Com.*, 669 S.W.2d 941 (Mo.App.W.D. 1984) ("The test year is a period past, but is employed as a vehicle upon which to project experience in a future period when the rates determined in the case will be in effect.”).

The Commission has promulgated new vegetation management and infrastructure 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*. The rules will become effective on or about June 30, 2008, approximately two months prior to the operation of law date in this case (August 28, 2008). Empire will experience actual costs related to compliance in the month of June 2008, as additional personnel will be in place to address the rule requirements and increases in the frequency of cutting (and, therefore, the costs) will be evident. (Tr. 380-381)

The Commission rules provide that a utility may submit a request to the Commission regarding the deferral and tracking of the additional costs associated with the rule. (Ex. 4, Keith Surrebuttal, p. 14) The rules state:

> In the event an electrical corporation incurs expenses as a result of this rule in excess of the costs included in current rates, the corporation may submit a request to the commission for accounting authorization to defer recognition and possible recovery of these excess expenses until the effective date of this rule, using a tracking mechanism to record the difference between the actually incurred expenses as a result of this rule and the amount included in the corporation’s rates, or if there is no identifiable amount included in the corporation’s rates, the amount reflected in the appropriate [uniform system of accounts account for vegetation management] [accounts for infrastructure inspection and maintenance] . . . .

Commission Rules 4 CSR 240-23.020(4) and 4 CSR 240-23.030(10).

Empire believes that it will ultimately incur on average an additional $4 to $6 million per year to comply with the new vegetation management and infrastructure rules. (Ex. 3, Keith Rebuttal, p. 11) If these additional costs are not addressed in some fashion in this case, the resulting rates will not be reasonably designed to address the costs that will be experienced by Empire during the period the rates will be in effect and again reduce the allowed return.

Empire proposes that the Commission establish a regulatory tracking mechanism to address this issue. Empire's proposal is that the annual expenditure target be initially set at $9.9 million on a total company basis. This equates to $8.9 million on a Missouri jurisdictional basis ($6.1 million for ongoing tree trimming and $2.8 million for compliance with the vegetation and infrastructure rules) for the purpose of developing rates in this case. (Ex. 4, Keith Surrebuttal, p. 13)

Empire's estimates are appropriate because they are based on its previous experience. Empire made significant changes to its tree trimming program beginning in 2005. (Tr. 370) At that time, the Company implemented a very aggressive trimming program that will put it in a position to comply with the new rules. (Tr. 372) The difference between the new rules and Empire's existing program is found in the cutting frequency. (*Id*.) Currently, Empire utilizes a ten year cycle, while the rules would require a six year cycle on rural circuits and a four year cycle in urban areas. (Tr. 372, 385) The adjustment that will have to be made will be the addition of crews in order to trim more miles of circuits per year and extra reporting requirements. (*Id*.)

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 Commission Staff similarly proposes to address this issue through a regulatory tracking mechanism. Staff proposes a tracker whereby "Empire would be required to spend a total of $8.4 million in Missouri for its tree trimming and infrastructure inspection activities in Year 1, and $8.725 million in Year 2 for these activities. If Empire does not spend the required amount each year, it must spend the shortfall in the next year with interest added. Under the Staff's proposal, no deferral of amounts expended by Empire over the rate allowance amount or the individual year requirements would be allowed." (Ex. 202, Oligschlaeger Surrebuttal, p. 23)

Staff and Empire worked from the same set of estimates to develop the target for this tracker. (Tr. 401-402) The only difference is that Staff used a two year average of those annual expenses in developing its target, while Empire utilized a three year average. (*Id.*) The difference between the parties revolves around how long one believes that the rates from this case will be in effect before the conclusion of Empire's next rate case that will include its Iatan 2 investment. (Tr. 416)

Public Counsel argues that no provision should be made for these rule compliance costs because it believes they are not "known and measurable." It further argues that the tracking mechanism is flawed in that it essentially requires Empire to expend a certain amount of money and in that it does not test whether the costs were expended prudently.

Here, the Commission is not dealing with a brand new category of expense. Empire incurred expenses during the test year associated with both tree trimming (vegetation management) and infrastructure inspection. (Tr. 397) Empire and the Staff both believe that these costs will increase as a result of the Commission's new vegetation and infrastructure rules. (Tr. 400) Even Public Counsel witness Robertson believes that Empire will incur some amount of additional costs in order to comply with the new Commission rules. (Tr. 428) Further, Staff has reviewed Empire's estimates and believes that those estimates are reasonable projections of Empire's added costs. (Ex. 201, Oligschlaeger Rebuttal, p. 9; Tr. 400-401)

The Commission is being asked to use the known information to develop rates that will be appropriate for the future period in which they will be in effect. This is not something that is unique in the ratemaking process. In fact, the Commission rarely knows what the expense level will be for any expense in a future period. Because of this, known, test year information is commonly modified in order to find a reasonable level of expense for the purpose of setting rates.

An example of this is found in the use of "normalization." Normalization is a process by which test year amounts are adjusted to a level that is thought to be representative of normal operations. (Tr. 399) Revenues are commonly normalized for weather to reflect the best guess as to what the weather will be as opposed to the weather that was actually incurred in the test year. (*Id*.)

Expenses are also normalized. Staff witness Oligschlaeger explained that a company's maintenance expense is commonly normalized because it is tied to unplanned and irregular outages or maintenance problems at the facilities. (*Id*.) Thus, any one year's maintenance expense is not likely to be repeated from year to year and could be said to be unknown. Rather than ignoring maintenance expense, as Public Counsel's known and measurable argument would suggest, the Staff will normalize those expenses by averaging several years of cost information. (Tr. 400)

The regulatory tracking mechanism actually reduces the need for precision in this area of estimated costs. In a traditional situation, once a cost amount is included in rates, there is no protection for the customer if a company ultimately spends less than projected. The tracker allows for an assessment of the company's performance and consequences if the actual expenses are less than projected.

Public Counsel also expressed concern that Staff's tracker would mandate a level of spending that might not be warranted. If the Commission is concerned about this possibility, that concern may be 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. The current pension (FAS 87) and OPEB (FAS 106) trackers work in this fashion. (Tr. 403) The assets and liabilities would then be netted against one another. (*Id*.) 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)

Public Counsel's final argument that somehow the proposed tracker would eliminate a prudence review is just not accurate. Staff witness Oligschlaeger indicated that prudence of Empire's expenditures would be reviewed in the next rate case and appropriate actions taken in that context. (Tr. 411)

In conclusion, the Staff has stated that "Empire taking immediate action to increase the scope of its tree trimming activities would be in the public interest." (Ex. 202, Oligschlaeger Surrebuttal, pp. 23-24) With that goal in mind Empire should be provided the financial resources necessary to accomplish this task. Empire's proposed regulatory tracking mechanism would provide Empire with the needed resources, as well as provide protection for its customers if costs turn out to be less than projected.

8. 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.[6] This is the same Donald Roff who 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.[7]

The Commission should adopt the depreciation rates shown in column 6 of table 1 of Mr. Roff's Schedule DSR-3. Application of these rates to December 31, 2006 depreciable balances results in an increase in annual depreciation expense of approximately $1.38 million. The two principal elements that account for this are (1) longer lives (which have the effect of <u>decreasing</u> annual depreciation expense) and (2) the effect of negative salvage (which has the effect of <u>increasing</u> annual depreciation expense). (Ex. 25, Roff Direct, pp. 1-3) The Commission should also adopt Mr. Roff's recommendation and implement "vintage amortization" accounting proposal which has been approved by FERC and numerous state public utility commissions.[8] The use of vintage amortization accounting results in a systematic and rational process for certain General Plant categories in that it eliminates the need for tracking thousands of small dollar items and it provides an orderly process for retiring and amortizing these asset categories. (Ex. 26, Roff Rebuttal, p. 6)

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

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

[8] *See* Ex. 25, Roff Direct, pp. 20-21, Table 1A.

Staff asserts that no change should be made to existing depreciation rates. Staff's contention that the Commission has a policy of not changing depreciation rates during the term of a regulatory plan is simply not borne out by a reasonable reading of the order upon which Staff relies. Staff points to KCPL 2006 rate case order in Case No. ER-2006-0314. Empire respectfully suggests that the Staff's reading of that order is just wrong.

It should be noted that the two cases are factually distinguishable in a number of ways. First, in the KCPL rate case, the utility relied on the depreciation rates that had been agreed to in the context of its experimental regulatory plan docket. Empire's experimental regulatory plan, by way of contrast, contains no similar provisions. Second, the Commission in the KCPL case rejected a Staff-sponsored depreciation study as seriously flawed so the Commission was not persuaded to move away from the *status quo*. Mr. Roff's depreciation study, on the other hand, does not contain the same flawed assumptions that were contained in Staff's analysis. Finally, Staff in the KCPL case proposed a <u>decrease</u> in depreciation rates (which would have decreased funds from operations) whereas Empire has proposed an <u>increase</u> of its depreciation rates (which will increase funds from operations).

Importantly, the Commission did not state that change in depreciation rates was not justified because KCPL's experimental regulatory plan was in place. The Commission simply noted that the practical result of its decision (i.e., standing pat on existing depreciation rates) had no impact on customer rates because the regulatory plan amortization would take up the cash flow slack.[9] This was a generally accurate statement concerning KCPL because of its substantial financial commitment to the Iatan 2 project. It does not necessarily follow, however, that Empire's financial circumstances are similar to those of KCPL. A plain reading of the Commission's Report and Order in the KCPL rate case shows that the language upon which Staff relies was not intended to send a signal that setting proper depreciation rates is not relevant or appropriate during the term of an experimental regulatory plan.[10]

The amortizations contemplated by Empire's experimental regulatory plan are not intended to act as a substitute for legitimate cost recovery in a traditional rate case. There is no language in the stipulation of Empire's regulatory plan case (Case No. EO-2005-0263) or the order approving the stipulation in that case, that supports Staff's position.

Also, it makes no practical sense to argue that any item that might otherwise increase funds from operations should be ignored because the Commission can always fall back on Empire's regulatory plan amortization. This distorts the limited purpose of the experimental regulatory plan which is to provide a tool to support investment grade financial metrics for a period of time. (Ex. 4, Keith Surrebuttal, p. 16) Also, retaining existing depreciation rates simply because of the regulatory amortization plan has no basis in depreciation theory, practice or policy. (Ex. 26, Roff Rebuttal, pp. 6-7)

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[9] Staff's testimony in this case is that an increase in Empire's depreciation rates will increase funds from operations and will decrease the amount of the regulatory plan amortization. From a regulatory perspective, this puts the cart (i.e., consideration of credit metrics) before the horse (i.e., determination of fair and reasonable rates). Beyond its obvious flaw as poor regulatory policy, it assumes that Empire will need a regulatory plan amortization in this case, which may not be so.

[10] Staff points to this one sentence at the end of the depreciation issue discussion on page 52 of the Report and Order: "What is more, any decrease in depreciation rates would likely not affect rates in this case, because KCPL would be allowed additional amortization to meet the credit metrics agreed to in Case No. EO-2005-0329."

Moreover, Staff witness Oligschlaeger observed that the determination of whether or not a regulatory plan amortization is justified takes place after the completion of the traditional rate making process. (Tr. 270) It cannot yet be said whether Empire will need a regulatory plan amortization. In fact, Staff concedes that one may not be necessary. (Tr. 347 (Oligschlaeger)) In such a circumstance, the revision to Empire's depreciation rates would have an effect on customers' rates notwithstanding the terms of the experimental regulatory plan. (*Id.*) As such, the fundamental premise of Staff's argument (i.e., that increased depreciation rates will not impact customer rates) is flawed.

As to Mr. Roff's depreciation study, the sum and substance of Staff's principal challenge to it appears to be some plant ledger entries in 2005 which tend to show a negative cost of removal which is somewhat counterintuitive. (Tr. 310-311 (Roff)) Staff uses this one isolated item to cast doubt on the adequacy of Empire's property records. Mr. Roff explained, however, that this was an anomaly caused by a unique transaction that had occurred that year and it was recorded in a "special fashion" to account for it properly. (Tr. 311) He further explained there was a generating unit that was placed in inventory and it was accounted for as a credit to cost of removal as a way to remove that amount from accumulated depreciation. (Tr. 334) It certainly is no indication of a fundamental recordkeeping deficiency on the part of Empire.

In conclusion, the Commission should consider Empire's proposal for revised depreciation rates in this case on its merits without regard to the terms of Empire's experimental regulatory plan. The Commission should adopt the depreciation rates shown in Column 6 of Table I of Schedule DSR-3 based on the fact that Mr. Roff, a qualified depreciation expert, has conducted a comprehensive depreciation study, giving appropriate recognition to historical experience, recent trends and Company expectations. The data provided by the Company was accurate and reliable and the procedures used were consistent with prior depreciation studies. The results of Mr. Roff's depreciation study provide a fair and reasonable level of depreciation expense which will provide Empire with adequate capital recovery for the time the depreciation rates are in effect and until such time as a new study indicates a need for a change. The Commission should adopt the deprecation rates that Mr. Roff has recommended and, also, authorize the Company to use vintage amortization accounting for certain of its General Plant categories.

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?

Staff's Cost of Service Report (Ex. 204) in this case notes that in Aquila, Inc.'s most recent rate case, Case No. ER-2006-0004, the Commission cited three criteria as the basis for its approval of an FAC in that case:

1. fuel and purchased power must be 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.

Based on these criteria and its analysis of comparable data for Aquila and Empire, Staff's report concludes that Empire's need for an FAC is even greater than Aquila's. Accordingly, the report states that Staff "recommends the Commission approve a FAC for Empire." (Ex. 204, p. 61)

By Staff's own estimate, during the six-year period 2002-2007 Empire absorbed approximately $85.5 million in fuel and purchased power costs. (Ex. 204, p. 61) That means that although the Company was required to produce and purchase energy to fulfill its obligation to provide safe and reliable electric service, Empire's customers, the beneficiaries of those activities, paid only a fraction of the actual cost of the energy they consumed. The burden of paying the balance of that cost fell, instead, to the Company's shareholders. The funds used to pay this balance came directly from income – income that otherwise would have been available to provide a return to shareholders. In the end, the return that shareholders actually received during that period was significantly less than the Commission had found to be fair and reasonable in each of the three rate cases that have been decided since 2002.[11]

Dr. Edwin Overcast illustrated this phenomenon in his direct testimony, where he shows the impact the actual increases in energy costs that the Company experienced for the period 2000-2006 would have had on the return on equity that Empire is requesting in the current case. As shown on page 8 of Exhibit 8, energy cost fluctuations, alone, would have reduced earnings between 12-65 percent; indeed, the energy cost increases that Empire incurred in 2006 exceeded the total amount of the return on equity that the Company is requesting in this case, which would have wiped-out earnings altogether.

The scenario illustrated by Dr. Overcast – where Empire's return is eroded or eliminated altogether because of increases in fuel costs that are beyond the Company's control – will be repeated in the future unless the Commission approves a reasonable fuel and purchased power cost recovery mechanism – a fuel adjustment clause – for Empire in this case.

Although new to Missouri, automatic cost recovery mechanisms date back to the early years of the twentieth century. But as fuel and energy costs began to increase during the 1970s, the use of such mechanisms expand greatly. It is estimated that regulatory commissions in 27 of the 29 non-restructured states, and 42 states altogether, currently allow electric utilities to employ some form of automatic fuel and purchased power cost recovery mechanism. Regulators have widely embraced these mechanisms for two primary reasons: 1) the regulators recognize

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[11] *See* Tr. 240. Empire's President and Chief Executive Officer testified that the Company's earned rate of return was approximately 9 percent in 2006 and 7 percent in 2007.

that utilities are legally entitled to recover prudently-incurred fuel and purchased power costs, and 2) the regulators realize that traditional modes of regulation are inadequate to provide full recovery of such costs in an environment of volatile and/or increasing fuel and energy costs.[12]

The Virginia State Corporation Commission explained the need for automatic adjustment mechanisms as follows:

> [T]he main purpose of the escalator clause is procedural: When prices are rising, the time that necessarily elapses between the date when earnings fall below the permissible minimum rate of return and the date when the commission enters its order allowing increased rates, is a time during which the utility earns less than a fair and reasonable return. . . .
>
> The inevitable delay between the happening of an event that entitles a party to legal relief and the date when he gets relief, makes it impossible in some kinds of cases for law and equity to do complete justice. Ever since Hamlet mentioned "the law's delay" as on of the things that made him wonder whether it would be better "to be or not to be, " lawyers and legislators have sought ways of overcoming so far as possible the time lag in the machinery of justice. One purpose of the fuel clause in electric rate schedules and the escalator clause in natural gas rate schedules is to keep the mere lapse of time from operating in favor of or against either the stockholders or the consumers.

Lynchburg Gas Co., 6 P.U.R. 3d 33, 35-36 (1954).

For almost thirty years – since the Missouri Supreme Court's 1979 decision in *State ex rel. Util. Consumers Council of Missouri v. Pub. Serv. Comm'n.*[13] – Missouri's electric utilities were denied the use of automatic rate adjustment mechanisms to ensure timely recovery of their prudently-incurred fuel and purchased power costs. But with the passage of SB 179, later codified as Section 386.266, RSMo. 2005, the Missouri General Assembly removed the legal obstacles that had prevented the Commission from authorizing energy cost recovery mechanisms for electric utilities. Now the Commission is free to "approve rate schedules authorizing an

[12] *See* generally, Sydney Jerald Martin, Comment, The Fuel Adjustment Clause and Its Role in the Regulatory Process, 47 Miss. L. J. 302 (1976).

[13] 585 S.W. 2d 41

interim energy charge, or periodic rate adjustments outside of general rate proceedings to reflect increases and decreases in [a utility's] prudently incurred fuel and purchased power costs."[14] And by authorizing automatic cost recovery mechanisms for Missouri's electric utilities, the Commission can re-join the regulatory mainstream where federal and state regulators, alike, have found such mechanisms to be a tool that is both useful and necessary to enable those regulators to fulfill their legal obligation to set rates that allow electric utilities to both recover their prudently-incurred operating costs and earn a fair rate of return.

In Case No. ER-2006-0004, the Commission first exercised its authority under §386.266 by approving an FAC for Aquila. Following the Commission's lead in that case, Empire proposed an FAC that closely mirrors Aquila's, including the aspect of Aquila's FAC which limits to 95 percent the amount of any future increases in fuel and purchased power costs that the Company can recover from its customers (and limits to 95 percent the amount of any future decreases which would be refunded to customers). That aspect of Aquila's FAC is currently on appeal, and there is a question as to whether it is lawful for the Commission to prohibit an electric utility from recovering a portion of its prudently-incurred energy costs through an FAC. Accordingly, although Empire continues to support its filing, the Company would have no objection to the Commission exercising its authority under §386.266.4 to modify the Company's request and approve an FAC for Empire that provides for recovery of 100 percent of its prudently-incurred energy costs.

The evidence presented during hearings on this issue clearly establishes: 1) that Empire's request for an FAC complies with all requirements of both Section 386.266, RSMo 2005, and the Commission's FAC-related rules; 2) a properly-structured FAC would protect the legitimate

[14] RSMo. Section 386.266(1)

interests of both Empire and its customers; and 3) the Company requires an FAC because traditional modes of ratemaking have not allowed Empire a reasonable opportunity to fully and timely recover its prudently-incurred fuel and purchased power costs or to earn a fair rate of return, as required 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?

In Empire's last general rate case, several parties argued that the Stipulation and Agreement approved by the Commission in Case No. ER-2004-0570 required the Company to continue an Interim Energy Charge ("IEC") in place until March 2008. After due consideration, however, the Commission rejected that argument. At pages 43-44 of its December 21, 2006, *Report and Order* and at pages 50-51 of its March 26, 2008, *Report and Order Upon Reconsideration*, the Commission found that "the 2005 Stipulation does not allow sufficient recovery of Empire's prudently incurred fuel and purchased power costs," and further concluded, "[t]his Commission cannot abrogate its duty to both the utility and its customers simply because some of the parties have previously reached a Stipulation and Agreement . . . Given our statutory mandate, the Commission must ignore the Stipulation and Agreement as it pertains to fuel cost recovery . . .."

Acting in accordance with those findings and conclusions, the Commission terminated the IEC then in place for Empire and ordered the Company to file tariffs, which the Commission subsequently approved, that allowed Empire to recover its fuel and purchased power costs through base rates.

Several parties have appealed various aspects of the Commission's December 21st *Report and Order* in Case No. ER-2004-0315, but while those appeals are pending, the *Report and*

Order and all findings and conclusions made therein remain in full force and effect. Section 386.270, RSMo, states that all orders and actions of the Commission are "prima facie lawful and reasonable until found otherwise in a suit brought for that purpose pursuant to the provisions of this chapter." In addition, Section 386.520.1, RSMo, states that "[t]he pendency of a writ of review shall not of itself stay or suspend the operation of the order or decision of the commission during the pendency of such writ . . .." And although Section 386.520.1, RSMo, provides a means for them to do so, no appellant has sought or obtained a stay or suspension of the Commission's *Report and Order* in Case No. ER-2006-0315.

In light of these facts and their legal consequences, the Commission must reject the argument that the Commission is barred from considering an FAC in this case because that argument proceeds from a fundamentally false premise: that the IEC approved for Empire in Case No. ER-2004-0570 remains in effect. As stated above, in its *Report and Order*, and again in its *Report and Order Upon Reconsideration*, the Commission terminated the IEC that was approved in Case No. ER-2004-0570 and in so doing removed any impediment that may have existed to Empire's request for an FAC in the current case.

The Commission also should reject the aforementioned argument because it constitutes an improper collateral attack on the Commission's *Report and Order* in Case No. ER-2006-0315. Section 386.550, RSMo, states that "[i]n all collateral actions or proceedings the orders and decisions of the commission which have become final shall be conclusive." Courts interpreting that statute have found it to be indicative of the law's desire that judgments be final,[15] and have required parties who want to ask the Commission to determine if a prior ruling

[15] *State ex rel. Harline v. Pub. Serv. Comm'n.*, 343 S.W.2d 177, 184 (Mo.App. 1960)

is still in the public interest to assert a significant change in circumstances.[16] Otherwise, the collateral challenge to the previous ruling is considered to be an unlawful.

The current case is collateral to Empire's last rate case, at least insofar as it concerns issues related to the Company's previous IEC and Empire's ability to request an FAC. Moreover, no party has alleged or presented evidence that circumstances have changed significantly from the Company's last rate case – the sole exception to the general rule that prohibits collateral attacks on Commission orders.

The appeal of the Commission's *Report and Order* that was issued in Empire's last rate case continues, and the challenges raised therein to the Commission's decision to disregard portions of the Stipulation and Agreement in Case No. ER-2004-0570 will be decided in due course. But unless and until an appellate court determines that the Commission acted unlawfully when it terminated Empire's IEC, the *Report and Order* in Case No. ER-2006-0315 remains in full force and effect. Accordingly, because no IEC currently is in effect for Empire, the Company is not barred from requesting an FAC in the current case.

B. If the Commission authorizes Empire to use a Fuel Adjustment Clause, how should it be structured?

As it considers whether Empire should be authorized to implement an FAC and how that FAC should be configured, the Commission should remember that although it has discretion as to decide whether an FAC should be approved in the first place, any FAC that is approved must comply with applicable principles of law. For example, Section 386.266, RSMo 2005, specifically prescribes four minimum requirements that must be satisfied by any FAC approved by the Commission. Those requirements are:

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[16] *State ex rel. Ozark Border Electric Cooperative v. Pub. Serv. Comm'n.*, 924 S.W.2d 597, 601 (Mo. banc 1996)

- the FAC must be reasonably designed to provide the utility a sufficient opportunity to earn a fair return on equity;[17]

- the FAC must include provisions for an annual true-up to address under- or over-collections, including interest at the utility's short-term borrowing rate;[18]

- the FAC must include provisions requiring the utility to file a general rate case with the effective date of new rates no later than four years after the effective date of the FAC;[19] and

- the FAC must provide for prudence reviews of costs subject to the clause no less frequently than every 18 months.[20]

Section 386.266, RSMo 2005, also vests the Commission with the discretion to include incentive features as part of any approved FAC, but only if those features are "designed to provide the electrical corporation with incentives to improve the efficiency and cost-effectiveness of its fuel and purchased power activities."[21]

Any FAC that fails to satisfy all of these statutory requirements, or any of the other legal requirements that govern the regulatory and ratemaking processes more generally, is unlawful and therefore subject to reversal on appeal. As noted, although Empire continues to support its filing in this regard, the Company would have no objection to the Commission

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[17] Section 386.266(4)(1), RSMo. 2005

[18] Section 386.266(4)(2), RSMo. 2005

[19] Section 386.266(4)(3), RSMo. 2005

[20] Section 386.266(4)(4), RSMo. 2005

[21] Section 386.266.1, RSMo. 2005

exercising its authority under §386.266.4 to modify the Company's request and approve an FAC for Empire that provides for recovery of 100 percent of its prudently-incurred energy costs.[22]

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

The FACs proposed by the parties to this case vary widely in terms of the proportion of future increases and decreases in fuel and purchased power costs that should be passed through to customers and the proportion that should be absorbed by Empire and its shareholders. As noted earlier, the Company's proposal calls for five percent of those costs to be borne by Empire; Staff's proposal calls for 30 percent; Public Counsel's for 40 percent; and the Industrials for a percentage ranging from 100 percent to 10 percent, depending on the amount of the increase. (Ex. 10, Overcast Rebuttal, p. 2)

There are numerous compelling reasons, each rooted in sound regulatory policy, why the Commission should refuse to authorize any FAC that prohibits Empire from collecting a significant portion of its prudently-incurred fuel and purchased power costs:

- such proposals all but guarantee that Empire will under-recover its prudently-incurred energy costs for the foreseeable future;

[22] In fact, there is legal support for the position that the Commission must allow Empire the opportunity to recover 100 percent of said costs. *See Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("(I)t is important that there be enough revenue *not only for operating expenses* but also for the capital costs of the business." (emphasis added)); *see also Mississippi River Fuel Corporation v. FPC*, 163 F.2d 433, 427 (1947) ("Expenses . . . 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."); *Southern California Edison Co. v. Pub. Util. Comm'n*, 576 P.2d 945, 947 (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.' . . ."); *Daily Advertiser v. TransLa*, 612 So.2d 7, 53 (1993) ("Automatic 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 recoupment devices designed to permit *dollar-for-dollar recovery* of fluctuations in fuel costs." (emphasis added)).

- prohibiting recovery of a significant portion of Empire's prudently-incurred cost of service will deny the Company its legal right to a reasonable opportunity to earn a fair rate of return;[23] and

- compulsory "sharing" of a significant portion of energy costs between customers and shareholders is contrary to the legislative intent embodied in Section 386.266, RSMo 2005, which was enacted to allow electric utilities to recover their actual, prudently-incurred costs – no more and no less – and was never intended to provide a windfall to either the utility or its customers.

The second point listed above is particularly noteworthy because it directly relates to one of the requirements set out in Section 386.266, RSMo 2005, for any FAC that is authorized by the Commission. As stated in subsection 4(1) of that statute, any FAC approved by the Commission must be "reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity." The testimony in this case conclusively establishes that the FACs proposed by Staff, Public Counsel, and the Industrials do not satisfy that requirement of the statute.

The reason these proposals would not allow Empire a "sufficient opportunity to earn a fair return" is that they ignore a basic principle of finance and accounting: return on investment comes from net income, and the Company does not produce any net income until after it covers all of its operating costs. Dr. Overcast described this fundamental flaw in the FACs proposed by the other parties as follows:

> Since the proposals from the Staff and Mr. Brubaker cause Empire to absorb a significant portion of increased costs out of the equity return, there is no reasonable opportunity for the Company to earn the allowed return. It is axiomatic that if a utility is prevented from recovering its prudently incurred costs, there is

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[23] *See Final Order of Rulemaking*, Case No. EX-2006-0472 (4 CSR 240-20.090) (September 21, 2006), p. 4 (addressing proposals by lay commenters that electric utilities should be required to bear a portion of their prudently-incurred fuel and energy costs, the Commission stated that such a requirement "would not allow for the setting of just and reasonable rates that allow a utility a reasonable return.").

> no reasonable opportunity to earn a fair return provided by the Commission. The dollars that provide a return exit only after the bills are paid.

(Ex. 9, Overcast Rebuttal, pp. 5-6)[24]

The critical inter-relationship between the recovery of costs and a utility's ability to earn a rate of return was described throughout Dr. Overcast's testimony in this case. His observations regarding that relationship included the following:

- "The standard for cost recovery is that a utility is allowed to recover its prudently incurred costs." (Ex. 8, Overcast Direct, p. 26)
- "The full recovery of cost is a fundamental right of the utility under regulation so long as the costs are prudently incurred." (*Id*. at 27)
- "Without the reasonable opportunity to recover actual, prudently incurred expenses, the concept of an allowance of a return on investment over and above expenses loses all meaning." (Ex. 9, Overcast Direct Schedules, p. 3), and
- "[W]hen the proposed fuel adjustment clause provisions result in a significant under recovery of prudently incurred fuel costs . . . no reasonable opportunity of earning the allowed return in provided." (*Id*. at 5)

But in spite of the governing principles of finance discussed above, as well as the requirement of the statute that Empire be allowed an opportunity to earn a fair rate of return, the FACs proposed by Staff, Public Counsel, and the Industrials each would *prohibit* Empire from recovering from its customers a significant portion of the Company's prudently-incurred fuel and purchased power costs. In turn, these proposals would force Empire's shareholders to pay the

[24] Although Dr. Overcast's statement refers only to the proposals made by Staff and Mr. Brubaker, his criticism applies equally to Public Counsel's proposal. The details of that proposal were first described in the rebuttal testimony of Ryan Kind, which is why Dr. Overcast did not mention Public Counsel by name in his own rebuttal testimony.

difference from earnings that otherwise would be available to pay a return on investment. That is not what the General Assembly had in mind when it vested the Commission with the power to authorize energy cost recovery mechanisms that would, at long-last, allow electric utilities to timely recover their prudently-incurred costs. Indeed, had the General Assembly been satisfied with the status quo – wherein regulatory lag forced utility shareholders to bear, year after year, a portion of energy costs incurred to provide electric service to customers – then it would not have been necessary to enact Section 386.266, RSMo 2005, at all.

The potential impact on Empire's earnings of Staff's and Public Counsel's proposals can easily be illustrated using the $85.5 million in energy cost increases that the Company was unable to recover from customers for the period 2002 – 2007. If Staff's proposal had been in place during that period, Empire would have been forced to "share" almost $27 million in earnings with its customers; if Public Counsel's proposal had been in place, the "sharing" would have been more than $34 million. Surely it is obvious that forcing Empire to divert such large amounts of its earnings – earnings that otherwise would have been used to provide a return to shareholders – to the payment of operating expenses denies the Company any hope of earning a fair rate of return. In contrast, Empire's proposal would have resulted in the diversion of only slightly more than $4 million over the same, six-year period.

Of the four FAC proposals made in this case, only Empire's will satisfy the requirements of Section 386.266, RSMo 2005, and provide the Company with an opportunity to earn a fair return on equity. Although under Empire's proposal its shareholders would continue to bear five percent of any future energy cost increases, that amount is manageable and would not likely have a significant, negative impact the Company's earnings. That certainly would not be the case if the Commission decides to maintain the status quo and rejects Empire's request for an FAC altogether or if it adopts one of the proposals made by Staff, Public Counsel, or the Industrials. Each of those options virtually assures that the nightmares of Empire's past – wherein the Company was forced to absorb tens of millions in energy cost increases – will be repeated in the future.

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

Based largely on the Commission's decision in Case No. ER-2006-0004, wherein Aquila was authorized to implement an FAC, Empire proposes to flow-through its FAC all actual, Missouri-jurisdictional costs recorded in FERC Accounts 501, 547, and 555, including the costs/benefits associated with the Company's fuel hedging program. In addition, net emission allowance costs (sulfur dioxide), which are recorded in FERC Account 509, also will be included in the FAC. (Ex. 2, Keith Direct, p. 21) And although Empire initially proposed to not include off-system sales as a component of the FAC, the Company has changed its position and now supports reflecting fluctuations in off-system sales margins in the FAC as well, provided the level of such margins that is included in base rates is set at a reasonable level. Empire is concerned that if the amount of off-system sales margins included in base rates is set at too high a level, future changes in actual off-system sales could cause FAC-related rate increases to be larger than otherwise would be the case.[25]

The Industrials oppose flowing through the FAC unit train and fuel handling costs, which they claim are not sufficiently variable to warrant inclusion in the FAC, and emissions allowances, which the they argue should be dealt with through an environmental cost recovery mechanism.

[25] The issue of the appropriate level of off-system sales to include in base rates is discussed supra at pages 17-19.

Empire's testimony regarding the proposed exclusion of unit train and fuel handling costs notes that because both of these costs are components of the coal costs that flow through fuel inventory to the Company's income statement, breaking them out so that they can be excluded from the FAC would be very complicated, from an administrative standpoint. (Ex. 3, Keith Rebuttal, p. 7) These administrative burdens would recur each time Empire came to the Commission for an adjustment of its FAC-related rates, thereby complicating the review process. And because these costs constitute only about one percent of overall energy costs, the complication that excluding these costs would add to the review process would far outweigh any actual or perceived value to be realized from their exclusion. (*Id*.) Exclusion of costs associated with fuel handling also would create problems in reconciling the Company's general ledger with costs being flowed through the FAC – again, with little or no purpose or benefit.

But perhaps the most compelling reason for rejecting the Industrial's proposal to exclude unit train and fuel handling costs comes from the language of Section 386.266, RSMo. As stated in subsection 1 of that statute, any FAC approved by the Commission should "reflect increases and decreases in [a utility's] prudently incurred fuel and purchased-power costs, *including transportation*. (emphasis added)

As for the Industrials' proposal to exclude emissions allowances from the FAC, Empire has pointed out that no alternative mechanism for the recovery of environmental costs currently is in place to deal with those allowances. The Company can only speculate as to when such a mechanism will be available and if it will include provisions for dealing with the emissions allowances here at issue. Therefore, in the interim, it is both reasonable and appropriate to deal with the emissions allowances through an FAC. But notwithstanding the lack of a separate mechanism for the recovery of environmental costs, Empire believes that the net emissions costs/allowances here at issue are the types of energy-related costs that should be included in an FAC instead of base rates. As Dr. Overcast testified:

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

(Ex. 9, Overcast Direct Schedules, pp. 10-11)

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

The Commission's rules, specifically 4 CSR 240-3.161(2)(P), require that a proposed schedule, testing plan, and written procedures for heat rate or efficiency tests of a utility's generating facilities accompany any request for an FAC. As noted in the direct testimony of Blake A. Mertens, the Company's Manager of Strategic Projects, Empire monitors performance of its generating units on an ongoing basis and routinely records data to determine the heat rate efficiency of each of those units. (Ex. 5, Mertens Direct, p. 17) Additionally, Empire worked diligently with Staff to develop heat rate testing procedures and a testing schedule for all of its generating units in order to comply with this rule. (Ex. 7, Mertens Surrebuttal, p. 6)

Staff has reviewed the Company's heat rate testing program and the data that program produces and has determined that both are satisfactory. (Tr. 725-27)

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 be determined?

3. How should the cost adjustment factor be determined?

The FAC proposed by Empire is described in detail in exemplar tariff sheets that have been designated as Schedule WSK-3 of Exhibit 2. As set forth therein, the Company's proposed FAC would operate as follows:

- the base cost of fuel would be established at $0.03075 per kilowatt hour sold;
- two changes in the FAC would be made annually, one in June and the other in December;
- these two changes would be based on increases or decreases in fuel and purchased power costs actually incurred by the Company during two annual accumulation periods: September through February and March through August;
- over/under recoveries of Missouri-jurisdictional energy costs would be refunded/collected every six months;
- to provide an audit trail for use during true-up and prudence reviews, over/under recoveries would be recorded in the Company's books in appropriate FERC accounts using an asset/liability account to track over/under recoveries on the balance sheet and an offsetting expense account would be maintained to reflect the over/under recoveries on the income statement;
- carrying costs on any energy costs deferred as part of the operation of the FAC would be calculated on a monthly basis using Empire's embedded cost of short-term debt as the interest rate, with interest accumulating starting with the first month the FAC is in effect; and
- periodic prudence reviews would be conducted at least once every eighteen months.

(Ex. 2, Keith Direct, pp. 21-22)

The Company's proposed methods for determining its actual cost per Kwh for fuel and purchased power and for then converting those costs to a Cost Adjustment Factor also are spelled out in the exemplar tariff sheets, Schedule WSK-3. As proposed by Empire, the actual cost of fuel, purchased power, and allowances (FERC Accounts 501, 547, 555, and 509) for the Missouri retail jurisdiction would be accumulated over a six-month period. The actual recovery of fuel, purchased power, and emission costs in base rates would then be determined by multiplying the amount of fuel costs included in base rates ($0.03075/Kwh) by actual Missouri jurisdictional sales during each six-month accumulation period. The difference between energy cost and energy cost recovery during each accumulation period would then be the amount of over/under recovery of energy costs. Any over/under recovery would then be divided by the Missouri-jurisdictional sales during the accumulation to arrive at the average cost of under/over recovery per Kwh. Expansion factors would then be introduced to arrive at the average cost per Kwh that would be applied to customers' bills. In subsequent accumulation periods, the calculation would also take into account a true-up of any under/over recovery from prior accumulation periods.

Staff proposes to adjust Empire's base cost of fuel by season, but the Company does not believe any such adjustment is warranted or necessary. Although the cost of fuel can vary season-to-season, historically that variance has been extremely small: on average, the Company's summer fuel costs are only approximately $3 per Mwh greater than in winter. This difference – which amounts to approximately 2.7 percent of an average summer electric bill – is insignificant and does not warrant a requirement that base fuel costs be calculated seasonally for purposes of an FAC. (Ex. 3, Keith Rebuttal, pp. 3-5)[26]

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

Earlier in this brief, Empire described the legal requirements for an FAC in Missouri, and in that discussion the Company acknowledged that §386.266.1 authorizes the Commission to include as part of an FAC "features designed to provide the electrical corporation with incentives to improve the efficiency and cost-effectiveness of its fuel and purchased-power procurement

[26] Although the Company does not believe that a seasonal adjustment to energy cost is necessary, Empire is willing to accept an FAC that is reflected in the exemplar tariff that Staff prepared (and which was received into evidence as Exhibit 31), provided the sharing requirement is the 95/5 customer/Company expense split proposed by Empire.

activities." But, as the language of the statute makes clear, the Commission's discretion in this area is narrowly prescribed: any incentive mechanism that is included in an FAC *must* be designed to improve efficiency and cost-effectiveness in a utility's energy procurement activities. In addition, implicit in the limitation imposed by the language of the statute is a second requirement: the objectives of the incentive mechanism – improvements in efficiency and cost-effectiveness – *must be achievable*.

Staff, Public Counsel, and the Industrials each has proposed a so-called incentive mechanism for adoption as part of any FAC authorized by the Commission in this case. The "incentive" offered in each of these proposals would prohibit Empire from recovering a portion of any future increases in fuel and purchased power costs. Staff's proposed "incentive" would deny recovery of 30 percent of any such increases; Public Counsel proposes to deny 40 percent; and the Industrials propose to deny an amount ranging from 100 to 10 percent based on a complicated formula that would tie the amount of recovery that is denied to the amount of the increase in energy costs.

In reality, however none of these so-called incentive mechanisms provides any real incentive to Empire. More importantly, none of these proposals satisfies the two requirements of the statute. This is obvious from the fact that each of the proposed mechanisms would only deny fuel and purchased power costs that already have been determined to have been prudently-incurred. This simple fact raises two questions that go to the heart of the so-called incentives that the proposals of Staff, Public Counsel, and the Industrials purport to provide: If costs already are prudently-incurred, how would these mechanisms make Empire more efficient and cost-effective in its energy procurement activities? Moreover, what level of performance above prudent performance would the Company be able or expected to achieve if any of the so-called "incentive" mechanisms is adopted?

Section 386.266, RSMo. 2005, and the Commission's own rules governing fuel cost recovery mechanisms already provide sufficient incentives to ensure that Empire acts efficiently and cost-effectively in its procurement of fuel and purchased power in the event an FAC is approved in this case. For example, 4 CSR 240-3.161(5) and (6) would require Empire to submit monthly reports and quarterly Surveillance Monitoring Reports, each with an affidavit attesting to the veracity of the information contained therein. Each of these reports must contain a wealth of detailed, specifically-prescribed information regarding energy-related costs as well as the budget and overall financial results and condition of the Company. Before Empire can implement any FAC-related rate increase, it also must make a formal filing with the Commission and support that filing with a substantial amount of information specified in the Commission's rules.[27] In addition, the Company would be subject to annual true-up reviews,[28] as well as a comprehensive prudence review that must be held no less frequently than once every eighteen months.[29] Each of these reviews would require Empire to submit even more information regarding its energy-related costs and overall financial performance to the Commission and to the parties to the periodic prudence review – which includes all parties to any rate case in which an FAC is authorized or renewed, and all such parties would also have the right to engage in discovery and to present witnesses.

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[27] 4 CSR 240-3.161(7)

[28] 4 CSR 240-3.161(8)

[29] 4 CSR 240-3.161(10)

Yet Staff, Public Counsel, and the Industrials argue that the comprehensive oversight that is provided by the Commission's rules is not sufficient because, they claim, evaluating Empire's energy procurement activities during the periodic prudence reviews is simply too difficult and burdensome a task for the parties or the Commission to reasonably be expected to accomplish. Empire, however, is confident that this Commission can satisfactorily perform prudence reviews, as it has done for many years for gas utilities operating in this state with purchased gas adjustment mechanisms. Staff's late-filed Exhibit 231 illustrates just how effective those Actual Cost Adjustment ("ACA") reviews have been. Of the 41 ACA reviews listed on that exhibit, 15 – or approximately 37 percent – involved a claim that the utility in question had acted imprudently. Thus, Exhibit 231 clearly shows that prudence reviews can and do work in Missouri and that the parties engaged in those reviews have been able to ferret-out imprudent actions and bring those actions to the attention of the Commission. There is no reason to believe prudence reviews for electric companies will be any less effective.

As it evaluates the concerns expressed by the other parties regarding how prudently Empire will act in procuring energy if an FAC is approved in this case, the Commission must keep in mind three significant facts. First, there is no evidence that Empire has behaved imprudently in the past and no evidence that the Company will do so in the future. Dr. Overcast explained this fact as follows:

> There is no evidence that Empire has been imprudent. On the contrary, there is ample evidence that empire has and continues to manage its fuel and purchased power costs prudently. The assumption that allowing full recovery of a cost will somehow cause Empire to behave imprudently is not justified because Empire earns no additional profit through such behavior.

(Ex. 10, Overcast Rebuttal, p. 4)

Second, 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) The best evidence of this fact is the energy cost increases that Empire was forced to absorb during 2002 – 2007 when no FAC was in effect. Under such circumstances, it must be assumed that the Company was doing everything it could do to keep its energy costs as low as possible. *Yet despite its best efforts, Empire's fuel and purchased power costs increased by more than $85 million.*

Finally, Empire similarly has no control over other factors that will determine the future level of energy costs, such as sales growth, weather, the price of hedging agreements, or the Company's ability to obtain hedging agreements from third parties. As noted by Dr. Overcast:

> Empire has no ability to limit the production of electricity to the test year level and normal growth alone increases the Rate Effective Period costs even if fuel and purchased power prices remain unchanged. In addition, Empire has no ability to control the weather events that impact customer usage. Furthermore, Empire has no control spot prices for fuel and purchased power since these prices are determined in the market. Beyond the current price hedges that Empire has in place, Empire has no control over the market prices for the hedge positions they take. More importantly, if Empire's credit position slips further Empire may not be able to find counterparts that will take the credit risk for a fixed price contract or Empire may be required to provide credit that will increase Empire's costs.

(Ex. 10, Overcast Surrebuttal, pp. 2-3) Yet despite the fact that Empire has no control over these factors, each of the FACs proposed by Staff, Public Counsel, and the Industrials would require the Company to bear a significant portion of any cost increases caused by these factors.

It is easy to see that none of the so-called incentive mechanisms proposed by Staff, Public Counsel, or the Industrials will provide any real incentive to enhance or improve the efficiency or cost-effectiveness of Empire's fuel and purchased power procurement activities. Under such circumstances, denying recovery a significant portion of costs that Empire prudently incurs to obtain energy necessary to meet the needs of its customers for electricity is not an incentive, it's a *penalty*, and §386.266 does not authorize the Commission to impose penalties on a utility for prudently procuring energy. So regardless of what term they use to describe their proposals or what arguments they muster to rationalize them, one thing remains clear: not one of the so-called incentive proposals made by Staff, Public Counsel, or the Industrials satisfies that requirements of §386.266.1, and, for that reason – as well as the many others discussed elsewhere in this brief – those proposals cannot lawfully be included in any FAC authorized by the Commission in this case.

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

As noted previously in this brief, although Empire originally did not propose to include off-system sales margins as part of the FAC, it has reconsidered the issue and now has no objection to including such margins, provided that the amount of off-system sales margins included in base rates is set at a reasonable level. The Company is concerned that if amount of off-system sales included in base rates is set too high, a significant drop in those revenues in the future could result in larger increases in FAC-related rates than otherwise would be necessary.

The appropriate method for calculating off-system sales margins that will be included in base rates is discussed at pages 17-19 of this brief.

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

As discussed earlier in this brief, Empire proposes that the net cost of emissions, which are booked in FERC Account 509, be included as part of any FAC adopted by the Commission in this case.

2. 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 by the Commission in Case No. ER-2004-0570?

This question is related to the previously discussed question regarding whether the Stipulation and Agreement that the Commission approved in Case No. ER-2004-0570 bars Empire from seeking an FAC in this case. As discussed earlier in this brief, in Empire's last general rate case the Commission rejected the Stipulation and Agreement that was approved in Case No. ER-2004-0571 insofar as it prohibited the Commission from adopting rates that were not sufficient to allow Empire to recover its prudently-incurred fuel and purchased power costs. As the Commission stated in both its *Report and Order* and its *Report and Order on Reconsideration* in Case No. ER-2006-0315, "[t]his Commission cannot abrogate its duty to both the utility and its customers simply because some of the parties have previously reached a Stipulation and Agreement . . . Given our statutory mandate, the Commission must ignore the Stipulation and Agreement as it pertains to fuel cost recovery . . ..."

The fuel and purchased power costs that the Commission uses to set rates in this case should be based on Empire's current, adjusted levels of those costs and *not* on cost allowances ordered by the Commission in Case No. ER-2004-0570, which were based on the Stipulation and Agreement. There is no legal basis for any party to the current case to argue that fuel and purchased power costs that are used for ratemaking in this case should be limited as specified in the Stipulation and Agreement approved in Case No. ER-2004-0570.

Conclusion

Pursuant to the competent and substantial evidence presented to the Commission in this proceeding, there should be a true-up of the case through February 29, 2008, with Empire's Asbury SCR being included in rate base and the related expenses being included in Empire's cost of service. Further, a fair and reasonable return on equity should be awarded to Empire, as explained by Empire witnesses Dr. James H. Vander Weide and Dr. H. Edwin Overcast, and the

Commission should authorize an FAC for Empire, as detailed by Empire witnesses Bill Gipson, Scott Keith, and Ed Overcast.

The Commission should also hold 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, 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, and that Empire's proposed depreciation rate changes should be adopted. Empire requests such other and further relief as the Commission deems just and proper.

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
Facsimile: (573) 634-7431
E-Mail: DCarter@BrydonLaw.com

Attorneys for The Empire District Electric Company

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 18th day of June, 2008.

/s/ Diana C. Carter