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Issues:	Fuel & Purchased Power
Witness:	Matthew J. Barnes
Sponsoring Party:	MO PSC Staff
Type of Exhibit:	Surrebuttal Testimony
File No.:	ER-2011-0004
Date Testimony Prepared:	April 28, 2011

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY OPERATIONS DIVISION

SURREBUTTAL TESTIMONY

OF

MATTHEW J. BARNES

THE EMPIRE DISTRICT ELECTRIC COMPANY

FILE NO. ER-2011-0004

Jefferson City, Missouri
April 2011

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	))))))	File No. ER-2011-0004

AFFIDAVIT OF MATTHEW J. BARNES

STATE OF MISSOURI)
) **ss**
COUNTY OF COLE)

Matthew J. Barnes, of lawful age, on his oath states: that he has participated in the preparation of the following Surrebuttal Testimony in question and answer form, consisting of 12 pages of Surrebuttal Testimony to be presented in the above case, that the answers in the following Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true to the best of his knowledge and belief.

Matthew J. Barnes

Matthew J. Barnes

Subscribed and sworn to before me this 27th day of April, 2011.

SUSAN L. SUNDERMEYER
Notary Public - Notary Seal
State of Missouri
Commissioned for Callaway County
My Commission Expires: October 03, 2014
Commission Number: 10942086

Susan L Sundermeyer

Notary Public

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THE EMPIRE DISTRICT ELECTRIC COMPANY

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Q. Please state your name and business address?

A. My name is Matthew J. Barnes and my business address is Missouri Public Service Commission, P.O. Box 360, Jefferson City, MO 65102.

Q. What is your position with the Staff of the Missouri Public Service Commission (Commission or Staff)?

A. I am a Utility Regulatory Auditor IV in the Energy Resource Analysis Section of the Energy Department of the Utility Operations Division.

Q. Are you the same Matthew J. Barnes that filed rebuttal testimony on April 18, 2011, and contributed to the Staff's Revenue Requirement Cost of Service Report (COS Report) filed on February 23, 2011 and the Staff's Rate Design Class Cost of Service Report (CCOS Report) filed on March 16, 2011?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to address the rebuttal testimony of The Empire District Electric Company (Empire or Company) witnesses Messrs. Todd W. Tarter and/or W. Scott Keith regarding: a) fuel and purchased power costs in the Company's Fuel Adjustment Clause (FAC); b) Staff's recommendation to change the FAC sharing mechanism from a 95%/5% sharing mechanism to a 85%/15%

sharing mechanism; and c) specific changes contained in Staff's exemplar FAC tariff sheets in the Staff's CCOS Report.

Staff's Response to Mr. Tarter's Rebuttal Testimony

Q. Please respond to Mr. Tarter's rebuttal testimony on page 2, lines 4 through 11:

> Empire is recommending the continuation of a fuel adjustment clause ("FAC"). In its direct filing, Empire recommended no change to the base fuel and purchased power rate in the FAC. Empire presented a model run that showed that a slight increase in the FAC base was warranted, but efforts were being made to limit the issues and streamline the rate case process as much as possible since this case so closely followed Empire's last electric rate case, Case No. ER-2010-0130. Empire has now made an updated model simulation run with more current data, and believes it appropriate to update the FAC base using Empire's updated fuel and energy information.

A. Empire is now aligned with Staff on the need to rebase fuel and purchased power cost in each rate case. Regardless of the amount of time between Empire's rate cases, the FAC base cost of fuel and purchased power net of off-system sales revenues must be reset in every rate case to send the most accurate price signal to Empire's customers as soon as possible even if the base cost of fuel and purchased power in this rate case is close to the base cost of fuel and purchased power in the previous rate case.

Q. Mr. Tarter's rebuttal testimony states that Staff did not include costs associated with a natural gas storage contract (signed June 17, 2010 for the term of April 1, 2011 until April 1, 2016) in Staff's FAC base costs. (Tarter Rebuttal Page 8, Lines 9 through 13). How does Staff respond?

A. Staff has not yet determined if it supports inclusion of any costs associated with the natural gas storage contract in this rate case, since the start of the contract term is outside of the test year period for this rate case. However, even if Staff supports inclusion of costs associated with the natural gas storage contract in this case, it is Staff's position that any natural gas storage contract costs which are fixed costs should not be allowed to flow through the FAC since the FAC is intended to include only variable fuel and purchased power costs and off-system sales revenues.

Q. Mr. Tarter's rebuttal testimony states that Staff did not include in its FAC base energy costs the operation and maintenance (O&M) costs associated with the Plum Point 50 MW purchase power agreement (Tarter Rebuttal Page 8, Line 16 through Page 9 Line 1). Should these O&M costs be included in the calculation of Empire's FAC base energy cost?

A. Yes. Because these are costs that vary with the energy generated, they should be included in the FAC. Staff will include the O&M costs in the calculation of Empire's FAC base energy costs on an ongoing basis in this rate case.

<u>Staff's Response to Mr. Keith's Rebuttal Testimony</u>

Q. Mr. Keith states in his rebuttal testimony that Staff's sharing mechanism proposal will deny or penalize Empire the opportunity to earn their authorized return on equity (Keith Rebuttal Page 7, Lines 4 through 10). What is Staff's response?

A. Staff believes that a 95%/5% sharing mechanism shifts too much risk to Empire's customers and does not provide enough incentive for the Company to keep its fuel and purchased power costs down. Shifting the sharing mechanism from 95%/5% to 85%/15% would incentivize Empire to reduce its fuel and purchased power costs and net emissions costs and to increase its off-system sales revenue.

Staff's recommendation is not intended to penalize Empire. Instead, it is intended to provide Empire with appropriate incentives designed to accomplish what the Commission has described as "to keep its fuel and purchased power costs down." Staff's sharing mechanism recommendation is primarily intended to provide Empire with more incentive to file to reset the base energy cost in its FAC to match the base energy cost used to set rates in the rate case. It is also intended to incent Empire to keep its fuel and purchased power costs down by developing and managing an effective energy procurement process that minimizes energy costs and at the same time manages the risk of losing energy supplies. It is also intended to create a sufficient risk of revenue loss that Empire would not absorb and use that loss to obtain a larger increase in its general rates. Empire demonstrated with its initial filing that started this case it is willing to absorb that loss by not filing in this case to match the base energy fuel and purchased power cost used to set rates.

Q. Mr. Keith states in his rebuttal testimony that Staff's proposal has the potential to be detrimental to Empire's credit rating (Keith Rebuttal Page 9, Lines 11 through 24). Does Staff agree with his testimony?

A. The FAC is just one component that credit rating agencies use to determine Empire's credit rating. Specifically with Standard and Poor's (S&P), there are two major risk factors that are used to determine a company's credit rating, business risk and financial risk. Business risk consists of the following components: country risk, industry risk, competitive position, and profitability/peer group comparisons. Financial risk consists of the following: accounting, financial governance, cash flow adequacy, capital structure/asset protection and liquidity.[1] The FAC falls under both business and financial risk, specifically industry risk and cash flow adequacy. Staff would be speculating, as Mr. Keith is, in stating S&P or any other credit rating agency would lower Empire's credit rating due to a change in the sharing mechanism.

Q. What is Empire's current credit rating by S&P?

A. Empire's current credit rating as reported March 17, 2011 by S&P is BBB- with an Excellent business profile and an Aggressive financial risk profile.[2] Business risk profiles are ranked from Excellent, Strong, Satisfactory, Fair, Weak, and Vulnerable with Excellent being the highest. Financial risk profiles are ranked from Minimal, Modest, Intermediate, Significant, Aggressive, and Highly Leveraged with Minimal being the highest.

Q. What was Empire's S&P credit rating prior to the implementation of the FAC?

A. Empire's S&P credit rating prior to the implementation of the FAC as reported June 12, 2008 was BBB- with a Strong business profile and an Aggressive financial risk profile.[3]

Q. What changed in Empire's credit rating before the implementation of Empire's FAC as compared to after the implementation of the FAC?

A. Empire's business risk profile improved after the implementation of the FAC from Strong to Excellent and the financial risk remained the same at Aggressive.

[1] Standard and Poor's RatingsDirect, Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, dated May 27, 2009.
[2] Standard and Poor's Global Credit Portal, RatingsDirect, Empire District Electric Co., dated March 17, 2011.
[3] Standard and Poor's Global Credit Portal RatingsDirect, Empire District Electric Co., dated June 12, 2008.

Q. Was the improvement of Empire's business risk profile due to the approval of the FAC?

A. As mentioned previously there are many factors that affect Empire's credit rating, so it is difficult to determine if the FAC was the sole factor that improved Empire's business risk profile, but it is obvious that Empire's credit rating of BBB- did not change because of the approval of an FAC.

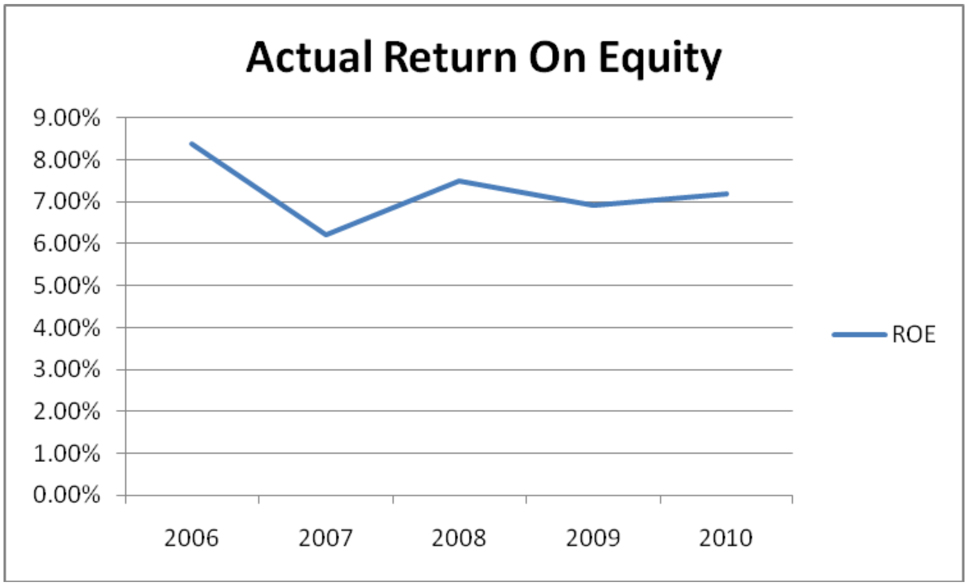
Q. Mr. Keith states that Empire's actual return on equity (ROE) for 2009 and 2010 averaged 7.05% (Keith Rebuttal page 10, Line 15 through Line 18). Do you agree with his statement?

A. Yes. Empire's ROE for 2009 and 2010 was 6.90% and 7.20% respectively, which is an average of 7.05%.

Q. Prior to the implementation of Empire's FAC what were the actual ROE's?

A. Prior to the implementation of Empire's FAC the actual ROE's for 2006, 2007, and 2008 were 8.38%, 6.20%, and 7.50% respectively, which is an average of 7.36%. The graph below illustrates Empire's actual ROE for the past five years:[4]

[4] Empire's Annual Reports for 2006, 2007, 2008, 2009, and 2010.



Q. Would you please summarize the graph above?

A. Yes. Empire's FAC began September 1, 2008. Empire's average actual ROE for 2009 and 2010 is 7.05% or .31% less than the average actual ROE for 2006, 2007, and 2008 of 7.36%. As the graph above shows, Empire's actual ROE has remained fairly steady for the last two years since the implementation of Empire's FAC.

Q. Mr. Keith states that Staff's recommendations will result in a further erosion of Empire's ROE (Keith Rebuttal Page 10, Line 22 through Page 11 Line 1). Does Mr. Keith provide any support for his statement?

A. No, Mr. Keith does not provide any analysis or evidence that would prove that Staff's recommendations would result in a lower ROE. However, based on the graph above, Staff is not convinced that Staff's recommendations would further erode Empire's ROE. There are many factors that affect Empire's ROE.

Q. What other factors other than fuel and purchased power costs affect Empire's ROE?

A. As shown in the graph above Empire's ROE was 8.38% in 2006 and 6.20% in 2007, a decrease of 2.18%. During 2007, Empire's service area suffered from two of the worst ice storms the Company has experienced in its history. Also, there was a longer than expected outage at Empire's Asbury coal plant. These incidents increased Empire's costs by approximately $17.6 million giving significant negative impact to earnings per share.[5] These are examples of incidents other than fuel and purchased power costs that can cause swings in Empire's ROE.

Q. Mr. Keith states that Empire's four other jurisdictions in which it operates - Kansas, Arkansas, Oklahoma, and the Federal Energy Regulatory Commission - allow the recovery of 100% of fuel and purchased power costs (Keith Rebuttal Page 11, Line 23 through Page 12 Line 10). Does Staff's agree with his testimony?

A. Staff has not had the opportunity to verify if those four jurisdictions allow 100% recovery of fuel and purchased power costs, but Staff has no reason to doubt Mr. Keith's testimony.

Q. Are there other states that have an approved FAC sharing mechanism with less than 100% of costs included in the FAC?

A. Yes. The Public Service Commission of Utah (Utah Commission) recently released a *Report and Order* dated March 11, 2011 for PacifiCorp d/b/a Rocky Mountain Power approving an Energy Cost Adjustment Mechanism (ECAM) with a 70%/30% sharing mechanism.[6]

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[5] Empire's Annual Report for 2007, Page 2.

[6] Public Service Commission of Utah, Docket No. 09-035-15 *Report and Order* dated March 11, 2011. The entire *Report and Order* can be located in the hyperlink below. Staff will provide the entire order in its workpapers.
http://psc.utah.gov/utilities/electric/09docs/0903515/71328Report%20and%20Order.pdf

Q. Is there a difference between the ECAM in Utah verses the FAC in Missouri?

A. There are differences between the ECAM in Utah verses the FAC in Missouri. One major difference between the ECAM in Utah and the FAC in Missouri is that Utah uses forecasted prices and Missouri uses historical prices, but the intention of both sharing mechanisms is to give the utility an incentive to keep fuel and purchased power prices low.

Q. What sharing mechanism did the Utah Commission approve for PacifiCorp's ECAM?

A. The following is from the Utah Commission's *Report and Order* beginning with the last paragraph on Page 73 through the first paragraph of Page 75:

> Parties proposing risk sharing recommend, at a minimum, a 70-30 percentage sharing between customers and shareholder, respectively, of differences between the forecasted and actual net power cost which are subject to the balancing account mechanism. Based on the arguments presented in this case, *we agree* (Emphasis added). We find this design component provides an appropriate sharing of risk for the pilot period based on the principle of gradualism, especially given the difficulty in identifying controllable and uncontrollable components of net power costs. Currently, when using forecasted net power costs to set rates, both customers and shareholders face 100 percent of the risk that actual costs will differ detrimentally and substantially from forecasted costs. This is a zero sum game, where all benefits flow to one group (customers or shareholders) at the expense of the other. A balancing account designed to include the 70-30 sharing component described above for the approved net power costs will dampen this risk and improve the fairness of outcome for both customers and shareholders. We will review this level of sharing at the conclusion of the pilot period to determine whether it continues to be reasonable.
>
> We agree with UAE, in addition to the current ratemaking method, an EBA with sharing will improve the Company's opportunity to recover net power cost. Contrary to the Company's

> view, providing an improved opportunity to recover costs is *not punitive* (Emphasis added). Also as noted by UAE, ratemaking is not simply cost reimbursement. Approved base rates provide a reasonable opportunity for full recovery of prudent test period costs, including a return on rate base. Failure of the Company to achieve its authorized return under current ratemaking practice does not constitute a disallowance of prudently-incurred costs. This will continue to be the case after the EBA is implemented.
>
> We also agree with UAE, the Company is incorrect in suggesting the Energy Balance Account statute prohibits a cost sharing component to the EBA design. Rather, the statute does not prescribe a particular design and is silent on the detailed operation of an energy balancing account. Further, it is not unusual for states to include cost-sharing features in energy balance account mechanisms. For example, the Company's energy balancing accounts in Wyoming and Idaho have sharing elements. Finally, if the ratemaking process can properly assign 100 percent of the risk or benefit of net power cost deviations to the Company between rates cases, as has been the case for decades, it can now also properly assign 30 percent of such risk to the company.

Q. Does Staff still recommend an 85%/15% sharing mechanism for Empire's FAC?

A. Yes. Staff is not persuaded by the rebuttal testimony of Mr. Keith and still recommends an 85%/15% sharing mechanism for Empire's FAC to increase the incentive for the Company to keep its fuel and purchased power cost down while managing the risk of losing its energy supply.

Q. Mr. Keith states concerns with Staff's proposed wording changes on tariff sheet 17h are not required (Keith Rebuttal Page 13, Line 15 though Page 14, Line 3). How does Staff respond?

A. Staff will continue to have discussions with Mr. Keith on the appropriate title and language concerning eligible fuel and purchased power costs that should be included in Empire's FAC.

Q. Mr. Keith states other concerns with Staff's proposed wording changes on tariff sheets 17i and 17k (Keith Rebuttal Page 14, Line 4 though Page 15, Line 10). Does Staff agree with Mr. Keith on his proposed changes?

A. Yes.

Q. Would you summarize your surrebuttal testimony?

A. Staff proposes an 85%/15% sharing mechanism and a base fuel and purchased power cost less off-system sales revenues of $0.00270 per kWh for Empire's FAC. Staff will true-up the base fuel and purchased power cost through March 31, 2011 for known and measurable changes.

Q. Has the Commission approved a true-up for this case?

A. Yes. The Commission approved a true-up for known and measurable changes through March 31, 2011.

Q. Will Staff's true-up fuel run likely indicate different base fuel and purchased power costs net of off-system sales for calculating Empire's FAC base energy cost rates?

A. Yes. However, the fuel and purchased power costs used to determine the true-up revenue requirement should be the same costs used to determine the FAC base cost of fuel and purchased power used when calculating Empire's FAC base energy cost rates.

Recommendation

Q. What does the Commission need to include in its Report and Order to effectuate Staff's recommendation for Empire's FAC?

A. The Commission needs to include in its Report and Order to effectuate Staff's recommendation for Empire's FAC, a sharing mechanism of 85%/15% and a base fuel and purchased power cost net of off-system sales based on Staff's fuel model updated for known and measurable changes through March 31, 2011 and should be included in the Commission's Report and Order.

Q. Does this conclude your surrebuttal testimony?

A. Yes it does.