**BEFORE THE PUBLIC SERVICE COMMISSION**
**OF THE STATE OF MISSOURI**

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| In the Matter of the Tariff Filing of The Empire District Electric Company to Implement a General Rate Increase for Retail Electric Service Provided to Customers in its Missouri Service Area. | )<br>)<br>)<br>)<br>) | Case No. ER-2006-0315 |

# STAFF'S POST-HEARING BRIEF

**COMES NOW** the Staff ("Staff") of the Missouri Public Service Commission ("Commission"), and respectfully submits its Post-Hearing Brief in the above-captioned proceeding. The issues are addressed in the order in which they appear in the List Of Issues, filed August 28, 2006. The Staff incorporates by reference its Prehearing Brief, filed August 31, 2006.

## REVENUE REQUIREMENT

### Rate of Return Issues

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

2. Capital Structure: What quantification of total long-term debt and preferred stock should be used in determining Empire's capital structure for ratemaking purposes?

Staff urges the Commission to reject the unique methodologies used by Dr. Vander Weide to arrive at a bloated ROE recommendation. In Empire's last rate case, the Commission considered Dr. Vander Weide to be the most credible rate of return witness, evidently because the Commission believed he was the only witness that had "performed the sort of risk-based, comparative analysis required by Hope and Bluefield." However, Dr. Vander Weide is a "hired gun" who has testified in more than one case each month over the past 25 years. (Tr. 9:252-3.) His peculiar methodologies have been created solely to support high recommendations for the

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utility companies that employ him.

In the instant case, Staff witness Murray and OPC witness King based their recommendations on a logical application of the DCF model to a carefully-constructed comparable group of companies. Dr. Vander Weide also based his recommendation on a cost-of-common-equity analysis of a group of comparable companies, but he did not select his proxy group appropriately. Many of his companies are diversified energy companies rather than vertically-integrated, electric utility companies like Empire. (Tr. 9:261.) Staff, by contrast, limited its comparable group to such vertically-integrated, electric utilities. Vander Weide applied five different cost-of-common-equity approaches using three models. Although Vander Weide had already arrived at a relatively high cost of common equity of 11.3 percent for his proxy companies, he then applied an "adder" to take his cost- of-common-equity recommendation even higher. (Tr. 9:253-254.)

Staff urges the Commission to reject Vander Weide's analytical methodology. Indeed, Staff suggests that Vander Weide's testimony does not merit any weight in this case. Vander Weide admitted that he does not personally know of even a single regulatory Commission that has adopted his methodology. (Tr. 9:239.) Staff witness Murray demonstrated in his rebuttal testimony (Murray Rebuttal, p. 22, ll. 10-19) that the use of Dr. Vander Weide's methodology would require AmerenUE's ROE to be 12.86 percent, despite the fact that AmerenUE's capital structure has more common equity than Empire's capital structure. However, if Dr. Vander Weide's methodology was actually consistent with well-established risk-and-return principles, AmerenUE's ROE would have to be lower than the ROE for Empire. Vander Weide thereby violated one of the most fundamental principles of financial analysis. This fundamental violation necessarily calls all of Vander Weide's testimony into question. It is noteworthy that, when

Vander Weide had an opportunity to respond to Murray's criticism in his surrebuttal testimony, he did not do so. His silence on this crucial point demonstrates that Vander Weide was simply unable to defend the fatuous approach that he has concocted simply to inflate his ROE recommendation even higher.

**Revenue Issue**

3. Off-system Sales: What amount should be included in Empire's revenue requirement for off-system sales?

The appropriate level of off-system sales margin in this case is the level actually experienced by The Empire District Electric Company ("Empire") during the historical twelve months ending June 30, 2006, which is the end of the true-up period ordered by the Commission. The Office of the Public Counsel ("Public Counsel") proposes that the Commission use a five-year unadjusted average of Empire's actual off-system sales levels, while Empire proposes an adjusted five-year average, excluding transactions involving the resale of electricity purchased from American Electric Power ("AEP Transactions"), which took place from December 2001 through June 2003. (Fischer Rebuttal pp. 2-3; Smith Direct, Ex. 81, p. 15) [1]. As reflected in its true-up testimony, Empire also is now excluding as an additional adjustment to the five-year average of off-system sales, the refund that has been ordered by the Federal Energy Regulatory System ("FERC"). (Keith True-Up, p. 9). In dollar terms, the Staff's recommendation for off-

[1] In contrast to these citations, the first of which includes a quotation from Empire's response to Staff Data Request No. 230, testimony adduced during the hearing and prefiled testimony (Keith Rebuttal, Ex. 21, pp. 11-12) indicated that these transactions took place over the thirteen month period from June 2002 through June 2003, although Empire has removed margins occurring from December 2001 through May 2003 from its five-year average calculation. (Fischer Rebuttal, Ex. 40, p. 3).

system sales margin exceeds that of the Company by about $1.0 million on a Missouri jurisdictional basis[2]. (Keith True-up, p. 9).

Contrary to the suggestion of Empire witness Scott Keith (Keith Rebuttal, Ex. 21, p. 8; Tr. 1070), the Staff's recommendation to calculate off-system sales margins on the basis of the most recent twelve months of data, as opposed to its use of a five-year average in Empire's previous rate case (Case No. ER-2004-0570), was not driven by an attempt to obtain a higher recommended amount for off-system sales margin. Staff witness Janis Fischer lists three other recent Empire cases (Case Nos. ER-2002-424, ER-2001-299 and ER-97-81) in which the Staff also used a recent twelve-month period. Moreover, Staff's use of a five-year average in Case No. ER-2004-0570 actually *reduced* test year revenues in that instance. (Fischer Surrebuttal, pp. 5-6).

Following a review of seven years of off-system sales data (Fischer rebuttal p. 2), the Staff decided to use Empire's actual margin amounts for twelve months ending with the end of the ordered update period (March 31, 2006) (Fischer Rebuttal p. 2), and subsequently the end of the ordered true-up period (June 30, 2006) (Oligschlaeger True-up, p. 2 ). The Staff's proposal is based on a number of considerations, including: (1) better matching of this level of off-system sales to the levels of all other generation-related costs included in the Staff's revenue requirement (Fischer Rebuttal pp. 4-5); (2) recent coal supply constraints, which are expected to continue for an indefinite period and which have provided Empire with an opportunity to increase both the price and the level of its off-system sales prices (Fischer Rebuttal p. 5-6); (3) stronger short-term (January 2005 through March 2006) than long-term (1999 through March 2006) correlation among off-system sales revenues, costs and margins (Fischer Rebuttal, Ex. 40,

[2] Prior to the true-up phase, despite using different methodologies, the Staff was only about $101,000 higher than and Public Counsel (Reconciliations filed August 25, 2006). It appears that Public Counsel did not file true-up testimony on off-system sales.

p. 6; Schedule 2); and (4) the pronounced increase in natural gas and purchased power costs over the last five years. (Tarter Direct, Ex. 15, pp. 7-8).

The Staff's use of a recent twelve-month period of off-system sales data brings another advantage. In 2005, the Company entered into a long-term contract to purchase all of the output from the Elk River Wind Farm. In late 2005, Empire began to purchase electricity from the wind farm. Some of the late 2005 purchases were sold off-system, and the Company can be expected to continue to do so on a going forward basis. (Tr. 1075-1076). With its focus on the most recent one year's worth of off-system sales data, the Staff's methodology accords more appropriate recognition to this new and ongoing contractual arrangement than does a methodology that uses five years of historical data.

The Staff would point out that, while both Company and Public Counsel are proposing different forms of a five-year average, no party to this case is suggesting use of a multi-year average for determining the level of Empire's fuel and purchased power expense. (Fischer Surrebuttal, Ex. 41, p. 7). Given that many trends in the energy marketplace that influence a utility's overall fuel and purchased power expense will also directly affect both the quantity and the prices of the utility's off-system sales transactions, it makes little sense to use dramatically different time periods in developing recommendations for each.

Consideration of multi-year averages to set rate allowances for a revenue or expense item is appropriate when the item in question tends to fluctuate from year to year, which Empire's off-system sales margin has done. (Tr.1084-1087) However, in this case, the closeness of the unadjusted five-year average of off-system sales margin to the test year results (Tr. 675-676) demonstrates that Empire's current off-system sales margins are in line with recent historical experience, and are an appropriate basis on which to set rates in this proceeding for off-system sales.

In the event that the Commission decides to reject the Staff's approach to deriving off-system sales margin, the Staff believes Public Counsel's approach is clearly preferable to Empire's. The main difference between those two approaches is Empire's exclusion of the aforementioned AEP Transactions and the FERC ordered refunds when calculating its five-year average. Empire argues that the AEP Transactions were unusual (Keith Surrebuttal, Ex. 22, p. 8) because they involved a single entity and generated over 71 percent of Empire's gross profit on off-system sales from 2001 to 2003. (Fischer Rebuttal, Ex. 40, p. 3; Smith Rebuttal, Ex. 82, p. 15). The Staff disagrees that the dollar values associated with the AEP Transactions are somehow abnormal or out of line. (Fischer Rebuttal, Ex. 40, p. 3).

Rate treatment of off-system sales is properly focused upon the level of margin dollars a utility should be able to achieve on an ongoing basis. Regardless of the alleged unusual nature of Empire's 2001-2003 AEP Transactions, the record evidence clearly demonstrates that Empire was able to replace the AEP Transactions over the long term with other off-system sales opportunities that provided it with a similar level of overall margin. On this basis, the level of margin dollars Empire was able to achieve from the AEP Transactions was not abnormal or non-recurring at all.

The Staff would also note that Empire's 2006 budget for off-system sales margins is set at $4,077,839. (Tr. 681). While the Staff did not determine its proposed ratemaking allowance for off-system sales in this proceeding by relying on Empire's budget, the Staff's proposed amount is far more in line with Empire's current expectations for off-system sales than the Company's proposed ratemaking allowance.

It is interesting to note that in its last rate case (Case No. ER-2004-0570), Empire did not see fit to exclude the AEP Transactions from its proposed five-year average of its actual off-system sales levels. (Fischer Surrebuttal, Ex. 41 p. 6). The record in the instant case is devoid of any evidence as to why transactions deemed normal by the Company less than two years earlier for ratemaking purposes suddenly became abnormal for purposes of this rate proceeding.

The Staff would note also that the Commission would not need to address the issue of the proper treatment of the AEP-related off-system sales margins if it opted for the Staff's methodology, which uses a time period (twelve months ending June 30, 2006) in which there was no similar AEP activity.

Empire asserts that the FERC is requiring the Company to make refunds of certain off-system sales made during the test year[3]. (TR. 1091; Keith True-up, p. 9). However, the FERC ordered refunds have not yet been remitted to customers, and in fact may represent refunds to wholesale customers, which are not accounted for as part of off-system sales but rather as on-system sales. Furthermore, Empire has requested rehearing of the FERC order. Given the lack of certainty as to whether the refunds relate to the Company's off-system sales, and even as to whether the refunds will ultimately be paid (Tr. 1091-1093), the Commission should disregard this matter in its decision regarding off-system sales.

For the reasons stated, the Staff recommends that the Commission adopt the Staff's true-up recommendation for off-system sales margins. If, however, the Commission decides to opt in favor of a five-year averaging approach, the Staff would recommend adoption of Public Counsel's proposal, which does not reflect improper and arbitrary adjustments to Empire's actual

[3] See Exhibit 139, Empire response to Staff DR No. 229 (including attached FERC order issued August 15, 2006 in FERC Docket Nos. ER99-1757-008, ER99-1757-009, ER99-1757-010 and EL05-67-000).

off-system sales margin to exclude the AEP Transactions or FERC ordered refunds for the five-year period examined.

**Regulatory Plan Amortizations**

> 4. Should Empire's revenue requirement include regulatory plan amortizations? If so, (i) how should Empire's off-balance sheet obligations be valued for purposes of the amortizations, and (ii) should the amortized amount be subject to an income tax gross-up?

The Staff incorporates by reference pages 22-24 on off-balance sheet obligations in the section on Regulatory Plan Amortizations in the Staff's August 31, 2006 Prehearing Brief in Case No. ER-2006-0315.

The Staff believes that the issues that remain among the Staff, Empire and OPC regarding Regulatory Plan Amortizations are limited to whether the Elk River Wind Farm Contract should be treated as an operating lease or a purchase power agreement and what risk factor should be assigned to Empire's off-balance sheet obligations, which are comprised of the Empire unit train operating lease, the Western Resources, Inc. Jeffrey Energy Center Purchase Power Agreement and the Plum Point Power Plant Purchase Power Agreement, in addition to the Elk River Windfarm Contract.

The Staff and Empire treat Empire's agreement to obtain wind energy from the Elk River Windfarm in Kansas over a 20-year period as an operating lease, while OPC treats it as a purchase power agreement (PPA). Operating leases and PPAs are treated by credit rating agencies, such as Standard & Poor's (S&P) as off-balance sheet obligations, and credit rating agencies include off-balance sheet items in their analysis of a utility's debt levels for purposes of calculating leverage and coverage ratios. (Ex. 55, Oligschlaeger Supplemental Direct, pp. 8-9; Ex. 56, Oligschlaeger Rebuttal, p. 3).

OPC witness Ted Robertson had originally excluded Empire's Plum Point PPA from

OPC's determination of Regulatory Plan Amortization's PPA debt equivalent on the basis that the Plum Point PPA was not entered into until April 2006, which is after the end of the test year known and measurable period authorized by the Commission. (Ex. 80, Robertson Surrebuttal, p. 9). Mr. Robertson subsequently was able to review the first quarter of Empire's 10-Q and therein the Plum Point PPA is identified as being finalized during the first quarter 2006. As a consequence, Mr. Robertson agreed that the Plum Point PPA should be included in the amortization calculation. (Vol. 12, Tr. 633).

Regarding how S&P has treated the Elk River Windfarm Contract, either as an operating lease or a PPA, Mr. Robertson said that he believed the May 2006 S&P report referred to by Mr. Oligschlaeger, in, and attached to, Mr. Oligschlaeger's supplemental direct testimony, and S&P in discussions with Ms. Walters of Empire mentioned it as an operating lease. (Vol. 12, Tr. 631; Ex. 55, Oligschlaeger Supplemental Direct, Schedule 3).

Empire produced at hearing an S&P research report dated May 8, 2003, entitled "'Buy Versus Build': Debt Aspects Of Purchased-Power Agreements." The S&P research report states in part as follows:

> Standard & Poor's Ratings Services views electric utility purchased-power agreements (PPA) as debt-like in nature, and has historically capitalized these obligations on a sliding-scale known as a "risk-spectrum." Standard & Poor's applies a 0% to 100% "risk factor" to the net present value (NPV) of the PPA capacity payments, and designates this amount as the debt equivalent.
>
> . . . .
>
> As a generic guideline for utilities with PPAs included as an operating expense in base tariffs, Standard & Poor's believes that a 50% risk factor is appropriate for long-term commitments (e.g. tenors greater than three years). . . .

(Ex. 109). On cross-examination by Empire, Mr. Robertson expressed frustration, which the Staff understands, as he related that he had submitted data requests to Empire seeking information respecting S&P's determination of a risk factor, and he explained that he had unsuccessfully tried to contact S&P personnel to ask his questions directly. (Vol. 12, Tr. 637-38).

The Staff has quantified the debt equivalent amount associated with Empire's off-balance sheet obligations at the total value given in an S&P research report entitled "Empire District Electric Co.," dated May 18, 2006, a copy of which is attached to Staff witness Oligschlaeger's supplemental direct testimony as Schedule 3. Since S&P provided in this document a total valuation of $72 million (total Company) as being Empire's current debt equivalent amount associated with its off-balance sheet obligations, the Staff believes this valuation is the most accurate and appropriate quantification of this item to use in the Regulatory Plan Amortizations calculation. (Vol. 12, Tr. 625).

The Staff notes that OPC's position that a 10% risk factor should be applied to off-balance sheet obligations results in a quantification of Empire's debt equivalent amount that is far less than S&P's own quantification of this item. (Robertson Surrebuttal, Schedule TJR-1, p. 1, l. 54; Ex. 55, Oligschlaeger Supplemental Direct, Schedule 3)

**Expense Issues**

5. Fuel and Purchased Power Expense: What is the appropriate level of on-system fuel and purchased power expense Empire should be allowed to recover in rates?

This issue only arises under the scenario in which the existing Interim Energy Charge ("IEC") is terminated per Empire's request. If the Commission decides that the current IEC should not be terminated, the amount of fuel and purchased power is already fully specified pursuant to the Commission's March 27, 2005 Report And Order in Case No. ER-2004-0570.

If, however, the Commission decides to order the termination of the IEC, the only dispute regarding fuel and purchased power expense concerns the overall price of natural gas to be used in arriving at the Company's revenue requirement. Most of the difference between the positions of the Staff and Empire is due to the different weights each party assigned to the hedged natural gas prices and, to a lesser extent, spot market and hedged prices they used in determining their overall recommended natural gas cost for Empire. (Fischer Surrebuttal, Ex. 41, p. 13; Sched. 2). The overall price is normally arrived at by first determining a price for natural gas purchases on the "spot market" and a price for "hedged" natural gas purchases[4], and then weighting the two prices in accordance with the Company's anticipated annual usage of each. Consistent with its past practice, the Staff's recommendation is based on Empire's actual experience during the historical twelve months ending June 30, 2006, the end of the ordered true-up period. (Fischer Direct, Ex. 39, pp. 20-27; Oligschlaeger True-up, pp. 2, 4).

With regard to the appropriate spot price, the Staff has updated its recommendation to **______** per MMBtu, based on the twelve months of actual spot purchases ending June 30, 2006, the ordered true-up date in this proceeding. (Oligschlaeger True-up, p. 4). This represents a slight increase over the previously recommended spot price of **______** per MMBtu (Fischer Surrebuttal, Ex. 41, Sched. 2), which was based on the twelve months of actuals ending March 31, 2006. It appears that Empire did not true up its "spot" price, which, in its rebuttal filing, actually had morphed from a NYMEX futures-based price (with basis adjustment) into a kind of weighted hypothetical hedged price (Tarter Rebuttal, Ex. 17, p. 11). Instead, the Company appears to have updated only for load growth. (Keith True-up, p. 9). In their true-up filing, intervenors Praxair, Inc. and Explorer Pipeline Company ("Praxair / Explorer") used actual natural gas prices for the period January to September, 2006 and NYMEX futures prices (adjusted for basis) for the balance of 2006. (Brubaker True-up, p. 2).

[4] Empire's natural gas hedging program is intended to reduce the risk associated with natural gas price volatility. By purchasing natural gas for future delivery, Empire can "lock-in" the price for part of its future natural gas needs. (Fischer direct, p. 25).



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In contrast to Empire, Public Counsel, and Praxair / Explorer, the Staff does not support the use of the futures market as a predictor of future actual natural gas prices because there is no significant correlation between futures prices and the actual spot market price one year later. (Choe Rebuttal, Ex. 69, pp. 4-5). Empire agrees that "natural gas prices cannot be predicted with any degree of certainty." (Tarter Surrebuttal, Ex. 18, p.2). It is the Staff's position that the average price Empire paid for spot natural gas during the twelve months ended June 30, 2006, best reflects the spot natural gas prices that the Company will pay annually for spot natural gas in the near future, while rates from this case are in effect.

As noted above, Empire abandoned the use of NYMEX futures pricing in favor of some price quotes as of July 10, 2006 on deliveries of natural gas from potential suppliers for calendar year 2007 (Tarter Rebuttal, Ex. 17, p. 11), well beyond the update and true-up period in this case. The Company proposes a price of **______** per MMBtu (Tr. 721). **________

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_____________________________________________________.** (Tr. 736-737). Nonetheless, Empire apparently continued to use these prices right through the true-up phase of this proceeding. The Commission should reject this approach.

The Commission should also reject Empire's claim that the Staff's methodology is biased because the twelve-month period selected by the Staff to determine its spot natural gas price includes an unusually warm January 2006, during which the Company made no spot natural gas purchases. (Tarter Rebuttal, Ex. 17, pp. 5-6). While Empire witness Todd Tarter correctly pointed out that natural gas prices are generally higher in January, he failed to mention the offsetting realities that applied during the twelve months ending in March 31, 2006 (June 30,

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2006, following true-up). For example, that period also included the heavy air conditioning months of June (July, following true-up) through September of 2005, which also were warmer than normal (Lange Direct, Ex. 44, p. 2), and thus put upward pressure on the actual spot natural gas prices paid by Empire and used by the Staff. Also ignored was the fact that events such as Hurricanes Katrina and Rita increased spot market prices for a number of months following those disasters, which occurred in late August and late September of 2005, respectively. The Staff did not attempt to adjust out of the case the detrimental impacts of these events on Empire's spot natural gas costs and purchased power costs included in test year expense. Therefore, when the Staff's calculation is examined thoroughly, Empire's claim of an improper downward bias in the Staff's fuel and purchased power recommendation in this case is without merit. (Fischer Surrebuttal, Ex. 41, p. 10).

While the Staff continues to support the methodology it employed in developing a spot market purchase price of natural gas in this proceeding, the difference between the Staff's and Empire's recommended price is actually quite small and accounts for only a small fraction of the total dollar difference in their positions regarding the overall price of natural gas. (Fischer Surrebuttal, Ex. 41, schedule 2). The really significant differences between the Staff's and the Company's recommendations are related to the manner in which each developed a hedged natural gas price, as well as to the amount of weight each assigned to the hedged natural gas and the spot purchased natural gas component prices. The weighting alone accounts for some two-thirds of the natural gas price difference between the Staff and Empire. (Fischer Surrebuttal, Ex. 41, p. 13).

In order to calculate its current average hedged natural gas price of **______** per MMBtu, the Staff used actual hedging contracts covering deliveries in the period from July 2006

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through December 2007, a period when, for the most part, rates from this case likely will be in effect. (Fischer Direct, Ex. 39, pp. 23-24; Oligschlaeger True-up, pp. 2, 4). This represents an increase over Staff's earlier price of **$5.886** per MMBtu. (Fischer Surrebutal, Ex. 41, Sched. 2), which was based on hedging contracts from April 2006 through December 2007. Thus, the Staff has consistently used hedge contract information that was known and measurable. The Staff believes that it is the most reasonable approach to developing a price the hedging portion of overall natural gas price.

The hedged natural gas price Empire used (**______** per MMBtu) is based upon the Company's calendar year 2007 hedges in place as of July 10, 2006. (Tarter Supplemental Direct, Ex. 19, p.5). Both the Staff's and the Company's recommended spot natural gas prices in this proceeding are approximately $1.85 - $2.10 per MMBtu below their recommended hedged natural gas prices.

At the hearing, Empire witness Tarter testified that the Company had entered into hedged transactions in August 2006 that raised the average hedged price of natural gas for 2007 from **______** (Fischer Surrebuttal, Ex. 41, Sched. 2) to **______** per MMBtu. (Tr. 728). Because this price is above the Staff's recommended hedged natural gas price of **______** per MMBtu in this case, the implication is that the Staff's recommended hedged natural gas price will be difficult or impossible for Empire to attain during the period rates will be in effect. The Staff would respond as follows: First, citing to a natural gas price of **______** relating to July-August natural gas hedging transactions in no way demonstrates that the hedged price for 2007 natural gas Empire will ultimately pay will be greater than the Staff's recommended hedged natural gas price, as Empire will have the ability to enter into hedging transactions for 2007 from now until the last months of 2007. (Fischer Surrebuttal, Ex. 41, p. 13) Second,



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hedging transactions entered into after the end of the true-up period of this case are out-of-period, and should not be used in the ratemaking process. Third, if the Commission is, in fact, interested in the trend of natural gas prices after June 30, 2006, the Commission should note that NYMEX natural gas futures prices have dramatically decreased since July 10, 2006, as noted in the true-up testimony of Praxair / Explorer witness Maurice Brubaker. (p. 4). In recent years, Empire has been able to hedge natural gas at prices that are lower than prevailing spot market prices. (Fischer Surrebuttal, Ex. 41, p. 14).

To derive its overall natural gas price, the Staff determined a reasonable weighting of hedged natural gas costs and spot market natural gas costs, on the basis of Empire's past practice. Empire's current "Energy Risk Management Policy" requires Empire to hedge between 60% and 80% of its anticipated natural gas needs. (Tarter Direct, Ex. 15, Schedule TWT-1, p. 9) According to Empire's response to Staff DR No. 270, for anticipated natural gas needs in 2006, Empire exceeded its maximum percentage, and has more than **___** of its anticipated natural gas needs hedged. (Fischer Surrebuttal, Ex. 41, p. 12). At the time of its rebuttal filing, Empire had **___** of its expected natural gas needs hedged for the period April 2006 to December 2007. (Tarter Rebuttal, Ex. 17, p. 7). Additionally, as of September 1, 2006, Empire had **___** of its anticipated natural gas needs in 2007 hedged (Tr. 723-724), and the Company is considering additional hedges to increase that 2007 percentage up to **___**. (Fischer Surrebuttal, Ex. 41, p. 12). Based upon Empire's recent historical natural gas purchasing practices, the Staff believes it is reasonable to assume that 80% of Empire's natural gas purchases will eventually be hedged and that the remaining 20% will be purchased on the spot market.

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Based upon this weighting and the average actual hedge price and spot price the Staff derived, the Staff recommends an overall natural gas price of **_____** per MMBtu. (Fischer Direct, Ex. 39, p. 24; Oligschlaeger True-up, pp. 2, 4). This represents a slight increase over the **______** per MMBtu that the Staff was recommending prior to the true-up.

Empire's overall natural gas price is based upon its calendar year 2007 hedges in place as of July 10, 2006. At that time, only **___** of its expected gas usage in 2007 was hedged, leaving the remaining **___** of the Company's gas usage for 2007 to be valued by Empire at its much higher "spot" gas price of **______** per MMBtu. (Fischer Surrebuttal, p. 11; Sched. 2). Given that Empire has hedged over **___** of its natural gas usage in 2006, and has already hedged **___** for 2007, Empire's assumption that only 61% of its 2007 natural gas usage will be hedged is clearly unrealistic, and serves only to overstate the Company's true natural gas costs.

For the reasons stated, the Staff urges the Commission to adopt its recommended overall natural gas price in this proceeding, which is based upon known and measurable information, and is appropriately matched in time with all of the other expense, revenue and rate base components of the Staff's case.

6. <u>Fuel and Purchased Power Expense Recovery Method:</u> What method should be used for recovery by Empire of its fuel and purchased power expense?

alternatively,

<u>IEC Continuation</u>: Should the Commission continue to enforce the 3-year term of the Interim Energy Clause that was approved by the Commission in Case No. ER-2004-0570?

The Staff has no position on this issue; however, Staff witnesses Oligschlaeger and Fischer have provided testimony on potential impacts to the Staff's revenue requirement

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recommendation for Empire under both and IEC continuation scenario and an IEC termination scenario.

7. Gain from unwinding forward natural gas contract: Should Empire's gain from unwinding a forward natural gas contract during the test year offset test year fuel and purchased power expense? If so, should the entire gain be an offset in the test year, or should it be amortized and only a portion of the gain be applied as an offset in the test year?

During the test year, Empire elected to "unwind" (or cancel) a forward natural gas contract with British Petroleum, resulting in a recognized gain to Empire in excess of $5 million, which it used to reduce test year fuel/purchased power expenses. (Fischer Direct, Ex. 39, pp. 19-20; Tr. 1041-1042). The contract was for purchases of natural gas during July and August of the years 2009-2011. (Fischer Surrebuttal, Ex. 41, p. 17). The Staff regards this contract as a routine hedging contract. As such, any benefits that flow from the unwinding should go to the ratepayers.[5] However, due to the exceptionally large gain Empire recognized from unwinding that contract in 2005, for ratemaking purposes, the Staff recommends that this gain be "smoothed out" by amortizing it over a five year period, and the annualized amount netted against Empire's annual fuel expense. (Fischer Direct, Ex. 39, pp. 19-20; Surrebuttal, Ex. 41, pp. 14, 16). In contrast, Empire's position is that the gain should be excluded altogether (Keith Rebuttal, Ex. 21, p. 5), while Praxair / Explorer recommend that the full amount of the gain be used as an offset to Empire's annual fuel expense. (Brubaker Direct, Ex. 85, p. 11).

Empire argues that the gain should be excluded as a "highly unusual and non-recurring" transaction. (Keith Rebuttal, Ex. 21, p. 4). However, the record amply demonstrates that Empire does not regard such an unwinding transaction as particularly unusual. **_______________

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[5] Empire routinely includes in its generation costs other gains and losses upon physical delivery of hedged natural gas. (Fischer Surrebuttal, Ex. 41, p. 18).

____________________** (Tr. 737-741, 1056-1057; Fischer Surrebuttal, Ex. 41, p. 16). Clearly, although its magnitude may have been larger than normally expected, the transaction that led to the $5 million dollar gain is, from Empire's perspective, hardly unusual or unforeseen. (Fischer Surrebuttal, Ex. 41, p. 16)

In addition, from an accounting perspective, an event must both be extraordinary---*i.e.*, of an unusual nature and infrequent in its occurrence---in order to be treated differently, and further, such items must be treated differently on a company's income statement. Specifically, such extraordinary items "should be segregated from the results of ordinary operations and be shown net of taxes in a separate section of the income statement." (Fischer Surrebuttal, Ex. 41, p. 15). However, Empire's accounting statements filed with the SEC do not show that this gain was given such accounting treatment. Likewise, PriceWaterhouseCoopers, Empire's external auditor, did not reflect the unwinding transactions as an extraordinary item on the Company's financial statements for 2005, the year in which the unwinding transaction occurred. "Rather the transaction was included appropriately with the accumulated gains and losses from hedges realized during calendar year 2005." (Fischer Surrebuttal, Ex. 41, p. 15).

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Empire witness Scott Keith spoke of Empire's concern that if it were ever to do another unwinding transaction of a physical hedge contract, the Company would no longer be able to exclude such purchases from "FAS 133" accounting, which he also labeled "derivative accounting" and "mark to market accounting."[6] According to Mr. Keith, Empire has been so advised by PriceWaterhouseCoopers. (Tr. 1034-1036). Mark to market accounting would introduce a lot of volatility into Empire's financial statements. According to Mr. Keith on cross-examination: "It would sort of defeat the purpose of our hedging policy." (Tr. 1036-1037). Nevertheless, Mr. Keith indicated that it was still possible that Empire would enter into a similar transaction in the future. "It would most certainly depend upon the circumstances at the time." (Tr. 1037). Moreover, as illustrated above, unwindings have been, and remain, an available tool for Empire's management.

Empire purchased the natural gas under the contract it subsequently unwound, at an attractive price (** ______** per MMBtu). (Fischer Surrebuttal, Ex. 41, p. 17). The Staff is concerned about the price the Company will end up having to pay when eventually it purchases natural gas for July and August of the years 2009 through 2011. At that time, Empire anticipates being able to avail itself of a fuel adjustment-type mechanism in light of the passage in 2005 of Senate Bill 179. As Empire witness Keith acknowledged, absent a prudency disallowance, any such additional costs will be borne solely by Empire's customers. (Tr. 1038-1039). Given the uncertainty concerning future natural gas prices and the future regulatory practices applicable to Empire, amortizing the unwinding gain as the Staff suggests will at least provide Empire's customer with a tangible benefit from the 2005 test year unwinding transaction to offset the potentially higher cost of gas that customers may have to pay in 2009-2011.

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[6] Mark-to-market accounting requires that the price or value of all natural gas hedges be recorded each quarter. That price or value is determined by calculating profits and losses from the hedge contract dates to the ending date of the company's financial statements. (Fischer Surrebuttal, Ex. 41, pp. 16-17).

Empire argues that the gain from the unwinding will help offset any under-recovery of fuel costs as a result of the "cap" imposed by the current IEC. However, the argument ignores the fact that Empire is requesting termination of the IEC in this proceeding, and that if Empire prevails, rates will be set with its actual test year fuel and purchased power costs as a starting point. It would not be fair to ignore, in that process, offsetting gains from transactions such as the one at issue. (Fischer Surrebuttal, Ex. 41, pp. 19-20).

Empire is confusing ratemaking treatment of the unwinding gain under two different scenarios: <u>one</u>, under the terms of the IEC; and <u>two</u>, under normal ratemaking. Clearly, under the IEC, this gain flows into the overall computation of fuel expense made to determine whether customer refunds are appropriate or not. However, this gain was booked as an offset to test year fuel expense in a case in which Empire is seeking to terminate the IEC. Like any financial event in a test year, this gain was audited to determine whether it should be included in whole or in part in setting ongoing rates. In the course of its audit, the Staff appropriately determined that the unwinding transaction should not be excluded from the determination of Empire's fuel and purchased power expense on a going forward basis.

The Staff would also note that even if the Commission were to find that this transaction and resultant gain were extraordinary (unusual and non-recurring), there is precedent for including it in rates. Accounting authority orders ("AAOs") are frequently sought by utilities so that they might preserve purportedly extraordinary costs incurred outside of a test year for possible inclusion in rates in connection with their next rate case. Empire sought an AAO for flood damage expenses in 1993 (Case No. EO-94-149). It appears that the Company believes that its customers should help finance unusual and non-recurring costs, but that extraordinary gains should be enjoyed only by Empire's shareholders. Such a position is both inconsistent and unfair. (Fischer Surrebuttal, Ex. 41, p. 19).

For the reasons stated, the Commission should reject Empire's proposal to exclude for ratemaking purposes the recognized gain from the unwinding of its contract with BP. Likewise, the Commission should reject as excessive the proposal of Praxair / Explorer to include the entire amount of the gain in rates. Instead, the Commission should adopt the Staff's proposal to amortize the amount of the 2005 unwinding gain over five years. This approach appropriately recognizes that ratepayers support in rates Empire's hedging program, and allows both the shareholders and customers of Empire to share in the gain from the unwinding transaction. (Fischer Direct, Ex. 39, p. 20).

8. <u>Incentive Compensation</u>: Are all the costs of Empire's incentive compensation plan an expense Empire should recover from Empire's ratepayers? If not, what costs should be recovered?

The Staff incorporates by reference the section on Incentive Compensation in the Staff's August 31, 2006 Prehearing Brief in Case No. ER-2006-0315.

When the Staff witness Ms. Amanda C. McMellen took the stand she made a few corrections to her direct testimony, Exhibit 48. One will be repeated because that correction needs to be reflected in the Staff's Prehearing Brief. The second sentence in the first full paragraph on page 34 of the Staff's Prehearing Brief should show a material increase in the upper bound of the amounts paid out from the Empire's discretionary compensation award pool. The sentence should have appeared and should appear as follows: The amounts paid out per person range from **________________________.** (Vol. 8HC, Tr. 118).

Empire presented one witness on Incentive Compensation, Dr. Gene E. Bauer of Hay Group, Inc. Dr. Bauer was highly critical of the Staff and urged Commissioner deference to the



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Empire Board of Directors Compensation Committee:

> Q. Are you aware of any expertise possessed by the Staff that would justify its recommended elimination in the rate setting process of the compensation payments that were established by the Compensation Committee and that you have discussed?
>
> A. No. . . . Further, the Commission should be extremely circumspect and careful when asked to substitute its judgment for that of the Committee on what should be a goal for incentive compensation.

(Ex. 1, p. 12). No member of the Empire Board of Directors Compensation Committee submitted testimony. In fact, other than the name of the Chairman of the Compensation Committee, Randy Laney, Dr. Bauer could not remember the names of the other members of the Compensation Committee or how many members of the Board of directors comprise the Compensation committee. He said that he did not know whether any of the present members of the Compensation Committee have any formal training in the areas of compensation, compensation plans or incentive compensation. He said that he is not familiar with any formal training being required regarding the areas of compensation, compensation plans or incentive compensation for being nominated or elected a member of the Empire Board of Directors. (Vol. 7, Tr. 99-100).

In essence Empire is asserting that the Staff and (implicitly) the Commission do not possess sufficient expertise in compensation matters to make judgments regarding the rate treatment of Empire's incentive compensation expense. The Staff has assessed whether Empire's test year incentive compensation costs meet applicable ratemaking principles for inclusion in rates. (Vol. 7, Tr. 180). Knowledge of and expertise in ratemaking are important to making this assessment. Ms. McMellen and the Commissioners have this expertise. (Vol. 7, Tr. 124-125). (Ms. McMellen testified that when she was assigned to the Empire rate case, she requested the issue areas of payroll and incentive compensation and that she worked under the guidance of senior auditors Janis Fischer and Mark Oligschlaeger. (Vol. 7, Tr. 186-87).) As will be discussed, certain portions of Empire's incentive compensation program do not meet the applicable ratemaking principles, and should not be allowed cost recovery in Missouri retail rates.

Upon cross-examination, Staff witness McMellen made a couple of corrections to her testimony. She corrected her surrebuttal testimony stating that share price appreciation is not the triggering mechanism for stock options. (Vol. 7, Tr. 129). She corrected her direct testimony stating that the purpose of the dividend equivalents is to keep the executive officer recipients of the stock option grants whole during the period of time prior to the vesting of the stock options. (Id., Tr. 130).[7] The correction of these two statements by Ms. McMellen does not cause any change in Staff's position or adjustments. The points sought to be made by the Staff are made by Empire in its March 20, 2006 Proxy Statement, Exhibit 91, pages 13-15, in the section entitled "Compensation Committee Report On Executive Compensation" wherein it is stated that incentive compensation is tied to the interests of Empire's stockholders and the utility's financial performance:

> Our executive compensation policies are designed to enable us to attract and retain high caliber individuals for key positions while at the same time linking their compensation to the interests of our stockholders, our financial performance and their own performance. . . . In no event will any incentive compensation be awarded unless we pay dividends per share of common stock at least equal to the dividends per share paid the in the preceding year.
>
> . . . .
>
> The other three types of incentive compensation–stock options, dividend equivalents performance-based restricted stock–are intended to motivate executive officers over the long-term to respond to our business opportunities and challenges in the furtherance of if the interests of our stockholders and to align the interests of the executive officers with those of our stockholders. . . .

[7] The Staff's Prehearing Brief at page 32, the fourth sentence of the full paragraph on that page, and the second sentence of the last paragraph on that page, reflect these two statements of Ms. McMellen's that she subsequently indicated were not correct and corrected.

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(Vol. 8HC, Tr. 152-59, 197-98).

Respecting the disallowances that the Staff made in this case, the issue is not whether the utility should be engaged in the objective or goal for which incentive compensation is being provided by the utility. The issue is whether Missouri retail ratepayers should be required to fund the utility goal or objective as being appropriate for incentive compensation by Missouri retail ratepayers, e.g., objectives or goals (i) above normal job responsibilities and (ii) of direct benefit to Missouri retail ratepayers. The Empire senior executive goals and objectives for which the Staff made disallowances fail to meet the Commission's current criteria for inclusion of incentive compensation in rates. If Empire incurred costs related to these activities outside of the area of incentive compensation, it may reasonably be presumed that such costs would not be authorized recovery in electric rates in this jurisdiction. There is no reason to allow these costs in rates simply because these costs fall under the heading of "incentive compensation expense."

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[redacted].** (Vol. 8HC, Tr. 163-65).

**[redacted]

> [redacted]**

(Vol. 8HC, Tr. 169). Ms. McMellen testified that the Staff looks at each piece of the total compensation package – base salary and incentive benefits, and in regards to base pay she looks at whether increases are reasonable. She was asked how she determined whether increases were reasonable, and she responded as follows:

> I talked with the company and reviewed all of their analysis that they use when they go through lists -- they look at the job market and I believed their analysis to be reasonable and then I looked at the increase and it seemed reasonable.

(Vol. 7, Tr. 190).

Ms. McMellen was cross-examined regarding the direct ratepayer benefit standard and whether employees' efforts designed that the utility earn its authorized rate of return meets the direct ratepayer benefit standard:

> Q. The Commission will also set an appropriate rate of return for the company. If an employee devotes his or her efforts to earning that appropriate rate of return, is there a direct ratepayer benefit from that?
>
> A. Yes.

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Q. And are those the criteria that you applied in excluding incentive compensation in this case?

A. Yes, that's correct.

Q. So if an employee worked to improve the company's earnings, those were appropriate activities because they directly benefited ratepayers?

A. Could you repeat the question, please?

Q. Efforts by the company's management to improve the company's earning or its rate of return, those were appropriate activities that provided direct ratepayer benefit?

A. Not all activities related to earnings.

Q. Well, how did you distinguish between some earnings that were acceptable and other earnings that weren't?

A. As related to incentive comp, the earnings goals had to be -- there had to be some kind of goal that was beneficial to the ratepayer.

Q. But you just told me that earning the authorized rate of return was beneficial to the ratepayer.

A. Yes. But not earnings goals relate to the -- the allowed rate of return.

(Vol. 7, Tr. 184-85). As Ms. McMellen endeavored to indicate, the answer is not necessarily a simple "yes" or "no." In fact, the Commission addressed the question in the quotation from the 2004 Report And Order in Re Missouri Gas Energy, Case No. GR-2004-0209, 12 Mo.P.S.C.3d 581, 606-07 (2004) in the Staff's Prehearing Brief. One has to look at the specific activity that is being prompted by the financial incentive to determine whether there is a direct ratepayer benefit. One cannot look in the abstract. Thus, the Commission used the example of a utility improving its bottom line by the elimination of customer service personnel or by a large rate increase as chiefly benefiting shareholders and not ratepayers. See Re Missouri Gas Energy, Case No. GR-96-285, Report And Order, 5 Mo.P.S.C.3d 437, 458 (1997) and other cases cited in Staff's Prehearing Brief.

The evidence in the record amply demonstrates why Empire's position on incentive compensation in this proceeding, urging the Commission to allow all such expense as long as the Company's total compensation package appears to be reasonable, is ill-advised. If such a policy is implemented in this proceeding, the Staff has demonstrated that it would lead to Missouri ratepayer subsidization of Empire's gas and nonregulated operations, as well as Empire's electric operations in other states. Also, the incentive compensation paid to Empire's senior executives tied to financial goals and objectives would be recovered from Missouri retail ratepayers. These goals and objectives are approved by the Empire Board of Directors Compensation Committee whose own charter (Exhibit 93) is explicit that the purpose of the incentive compensation offered to senior executives is to tie their compensation to the interests of Empire's shareholders. There is no reference to Empire's ratepayers' interests in the portions of the Board of Directors Compensation Committee Charter that discusses executive compensation. (Tr. 193). For all of these reasons, there is simply no substitute for detailed examination of regulated utilities' incentive compensation plans.

In this case, the Staff has made such a detailed review of Empire's incentive compensation plans, based upon the criteria set forth by the Commission for such review in a number of past proceedings. The Staff has proposed to disallow the portion of the Company's incentive compensation costs which fail to meet the Commission's stated criteria for recovery of incentive compensation in rates. The Staff requests that the Commission maintain its current and well-founded position on ratemaking for incentive compensation costs in this proceeding, by adopting the Staff's position on this issue.

> 9. and 10. <u>Low-Income Assistance Program and Unspent Funding of Current Energy Efficiency and Affordability Programs</u>: Should Empire's Experimental Low-Income Program (ELIP) be continued with changes? If so, what should those changes be, should the Customer Program Collaborative (CPC) determine those changes and have

> oversight responsibility respecting the program, and how should the cost of the program be included in Empire's cost-of-service for collection from ratepayers? What should be done with unspent ELIP funds?
>
> What should be done with unspent funds from the current energy efficiency and low income weatherization programs? What should be the amortization amount respecting the demand side management (DSM) regulatory asset account?

Staff's position on these issues is presented in the Rebuttal Testimony of Staff witness Lena Mantle. Staff does not agree with OPC witness Meisenheimer's recommendation that the ELIP program continue with modifications. Staff recommends that the ELIP program be terminated. Staff witness Mantle suggests that funding for the low-income weatherization program that came out of the last rate case should be increased. The funds allocated to that program are being fully spent and fully utilized.

In the event that the Commission determines to continue the ELIP, Staff recommends that the CPC, the customer collaborative, should determine what modifications should be made to the program design. Staff does agree with Ms. Meisenheimer that the funding should be modified. Staff witness Mantle proposes that 50% of the expenses be recovered in a manner similar to how costs of affordability, energy efficiency and demand response program costs are recovered. Only 50% would be recovered because, of course, the program should continue to be funded half by the ratepayers and half by the shareholders. The part recovered from the ratepayers would be accumulated in a regulatory asset and amortized over a 10-year period.

Ms. Mantle further is going to testify that it was not envisioned that Project Help would receive such a large amount of unspent funds. So she proposes that the difference between the amount collected from ratepayers for ELIP and one-half of the amount actually spent should be placed into the demand side program account as a negative amount making these funds available for future programs. Ms. Mantle proposes that the same thing be done with funds that have been collected but not spent for the appliance and HVAC rebate program.

**CLASS COST OF SERVICE/RATE DESIGN**

11. Rate Design/Cost of Service: How should any revenue increase for Empire that results from this case be implemented in rates?

    (1) A sub-issue: What level of revenue credits should be recognized for purposes of allocating any revenue requirement increase?

On September 13, 2006, the Staff, Public Counsel and Praxair, Inc. and Explorer Pipeline Company filed their Non-Unanimous Stipulation And Agreement Regarding Rate Design Issues ("Stipulation And Agreement"), which resolves among them all of the rate design issues listed as item 11 under "**CLASS COST OF SERVICE/RATE DESIGN"** in the List Of Issues, filed August 28, 2006. Those issues also appear immediately above. On September 20, 2006, Empire filed a Notice stating that it does not oppose the Stipulation And Agreement and that it does not request a hearing thereon. No other party to this proceeding filed a pleading requesting a hearing on the Stipulation And Agreement. Accordingly, pursuant to 4 CSR 240-2.115(2), the Commission may treat the Stipulation And Agreement as unanimous.

**WHEREFORE**, for all the foregoing reasons, the Staff respectfully requests that the Commission issue its Report And Order adopting the Staff's position on each of the contested issues in this case.

Respectfully submitted,

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## Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record this **16th day of October, 2006.**

/s/ Kevin A. Thompson