Exhibit No.:	
Issues:	*Fuel, Purchased Power* *Interim Energy Charge* *Income Tax*
Witness:	*John P. Cassidy*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*SurrebuttalTestimony*
Case No.:	*ER-2004-0570*
Date Testimony Prepared:	*November 24, 2004*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

JOHN P. CASSIDY

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2004-0570

Jefferson City, Missouri
November 2004

TABLE OF CONTENTS OF

SURREBUTTAL TESTIMONY

OF

JOHN P. CASSIDY

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2004-0570

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

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.	)))))	Case No. ER-2004-0570

AFFIDAVIT OF JOHN P. CASSIDY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

John P. Cassidy, being 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 16 pages 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 and correct to the best of his knowledge and belief.

John P. Cassidy

John P. Cassidy

Subscribed and sworn to before me this 23d day of November 2004.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

D. Suzie Mankin

Notary

SURREBUTTAL TESTIMONY

OF

JOHN P. CASSIDY

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2004-0570

Q. Please state your name and business address.

A. John P. Cassidy, 1845 Borman Court, Suite 100, St. Louis, Missouri 63146.

Q. By whom are you employed and in what capacity?

A. I am employed by the Missouri Public Service Commission (Commission) as a Regulatory Auditor.

Q. Are you the same John P. Cassidy who has previously filed direct testimony in Case No. ER-2004-0570?

A. Yes.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of this surrebuttal testimony is to respond to the rebuttal testimony of Company witness Brad P. Beecher and Office of the Public Counsel (OPC) witness James A. Busch with regard to the areas of fuel and purchased power expense and Interim Energy Charge (IEC). My surrebuttal testimony will also address the rebuttal testimony of Company witness L. Jay Williams regarding the rate base treatment of deferred taxes related to alternative minimum tax (AMT) and postretirement benefits other than pensions (PBOP).

<u>FUEL, PURCHASED POWER AND IEC</u>

Q. What positions did the Company propose in their direct testimony filing regarding the recovery of fuel and purchased power costs?

A. The Company previously proposed three recovery alternatives: (1) a fuel adjustment clause (FAC); (2) implementation of an Interim Energy Charge (IEC); and (3) a single base rate inclusion. When the legislation for a FAC failed in Missouri, the Company directed its focus towards the implementation of an IEC, or in the alternative a single point permanent base rate inclusion. In direct testimony, Company witness Jill Tietjen (Tietjen Direct page 15 lines 3-23) and Brad Beecher (Beecher Direct page 15, lines 21-27) supported a $105 million floor and a $125 million ceiling, creating an IEC band of $20 million. Alternatively, if this was not accepted, Company witness Beecher indicated that Empire would require approximately $123 million of annual fuel and purchased power costs, absent an IEC (Beecher Direct page 15, lines 28-31 and page 16 lines 1-9). The natural gas portion of this calculation was based on an overall $4.60 / MMBtu forecasted gas price. This $4.60 forecasted natural gas price was based on an average of 2005 New York Mercantile Exchange (NYMEX) gas futures prices, as of April 21, 2004, which was $5.44 / MMBtu and Empires hedged gas position for 2004 and 2005 at $4.15 / MMBtu.

Q. What is Empire's current position?

A. Empire now supports permanent base rates of $140,840,180 based largely on an overall $6.02 / MMBtu forecasted natural gas price. This forecasted gas price was based on an average of NYMEX gas futures for 2005 and 2006, as of October 27, 2004 (Beecher Rebuttal, page 2, lines 7-14 and page 3, lines 1-20). The average of NYMEX gas futures for 2005 and 2006, on that particular date, was $7.50 / MMBtu. The Company weighted the NYMEX gas futures cost with its 2005 gas hedged position to determine an overall $6.02 / MMBtu gas cost.

Alternatively, on page 2, lines 12-14 of his rebuttal testimony, Company witness Beecher states, "We continue to support a properly crafted IEC mechanism which would be designed to allow Empire to recover all of it's prudently incurred fuel and purchased power charges." However, Mr. Beecher's rebuttal testimony does not offer any evidence concerning what boundaries, specifically dollar amounts for a floor and a ceiling, that he believes would be appropriate for such an IEC.

Q. Does the Staff agree with Mr. Beecher's position that permanent base rates should include $140,840,180 for fuel and purchased power, based on NYMEX natural gas futures prices?

A. No. The Staff does not believe that the NYMEX gas futures proposed by the Company should be relied upon by this Commission to make an objective decision in determining an appropriate single base rate fuel and purchased power inclusion in rates, nor should it be used to establish the proper boundaries for an IEC.

Q. Please explain.

A. NYMEX gas futures are published in the Wall Street Journal each business day. These futures represent what traders speculate that natural gas commodities will cost in the future and as a result can vary significantly over very short periods of time. On page 71, lines 5-6, of Company witness Beecher's deposition, taken on November 10, 2004, he admits that, "NYMEX is volatile. It changes on a daily and hourly basis." To rely on a market indicator, on a single day, that can swing dramatically in very short time periods is dangerous. Furthermore, Mr. Beecher even admits on page 85, line 17, of his deposition, that the natural gas market, "…did hit a high point around October…" which represents the time frame Mr. Beecher has chosen as the basis for his proposal. To look only at a single snapshot as Mr. Beecher has done by selecting October 27, 2004 is certainly inappropriate. Furthermore, NYMEX gas futures are not intended to be a forecasting tool. Staff's witness Kwang Choe, of the Commission's Procurement Analysis Department, filed surrebuttal testimony in this case addressing the problems surrounding Mr. Beecher's reliance on NYMEX gas prices. Please refer to Dr. Choe's surrebuttal testimony for a more complete discussion of this area.

Q. Has Mr. Beecher developed his permanent base rate inclusion of $140.8 million using the NYMEX gas futures that even he recognizes as volatile?

A. Yes. Mr. Beecher develops a base rate calculation of $140.8 million by relying on a forecasted NYMEX gas futures average price of $7.50 / MMBtu to represent "current NYMEX pricing." Mr. Beecher arrived at the $7.50 average of NYMEX gas price by taking an average of NYMEX gas futures prices for the years 2005 and 2006 based on the gas futures that existed as of October 27, 2004. However, NYMEX gas futures prices are volatile and can change daily and even hourly. The $140.8 million amount is the level of forecasted fuel and purchased power Empire now supports to be included in permanent rates, absent an IEC.

Q. What source has the Staff relied upon to predict prevailing natural gas prices into the future?

A. The Staff believes that it is clearly more appropriate to rely on the short-term natural gas forecast published monthly by the Energy Information

Administration (EIA) as a proper forecasting tool. The EIA, part of the United States Department of Energy, is recognized as a leading independent government research body, which closely monitors the natural gas industry and maintains a significant database to perform research.

Q. What other problems exist with Mr. Beecher's proposed $140.8 million base rate inclusion of forecasted fuel and purchased power in permanent rates?

A. Setting a single point for fuel and purchased power provides the Company with a substantial opportunity to earn windfall profits from a level of fuel and purchased power that is significantly higher than what is now expected to occur. It is important to understand that the Company's $140.8 million proposal does not represent an IEC, but rather inclusion in permanent rates with no opportunity for refund to customers if actual fuel and purchased power costs are lower than this amount. For comparison purposes, the Staff believes that under its proposed floor and ceiling of an IEC, Empire's total company on-system fuel and purchase power costs will range from approximately $110.8 to $134.4 million, representing a $23.7 million total company ($19.5 Missouri Jurisdictional) IEC which is subject to refund. Mr. Beecher's permanent rate inclusion position includes $30 million more in permanent rates than the Staff's IEC base (permanent rates) proposal and even $6.4 million more than permanent and interim rates combined (Staff's proposed IEC ceiling). When compared to Empire's previous IEC floor and ceiling proposal of $105 to $125 million, Mr. Beecher now proposes to include $35 million more in permanent rates and $15 million more than Empire's previously proposed ceiling. The primary reason for this dramatic movement is Mr. Beecher's reliance on an average of volatile NYMEX futures prices that existed on a single day, October 27, 2004.

To demonstrate the impact, as well as the tremendous difference, between the Staff and Company positions, the Staff offers an example. For simplicity, assuming a one-year term on the IEC and a single true-up at the end of that term, if Empire's actual, prudently incurred fuel and purchased power costs for 2005 were $130 million, under the Staff's IEC proposal ratepayers would be entitled to a $4.4 million refund. However, under the Company's proposal, Empire would recognize a $10.8 million profit at ratepayers expense and none of this $10.8 million would be eligible for refund to Empire's ratepayers. The $140.8 million base rate position supported by Mr. Beecher in his rebuttal testimony is an unreasonable position that potentially allows the Company to receive windfall profits, at the ratepayers expense, if fuel and purchase power costs are lower than the $140.8 million level as is expected by the Staff.

Q. Is the average NYMEX gas price of $7.50, for 2005 and 2006, at October 27, 2004 representative of the hedged gas cost that Empire is actually able to achieve?

A. No, it is not. Mr. Beecher's rebuttal testimony (page 5, lines 3 through 11) demonstrates this to be the case. On October 22, 2004 Empire was able to hedge 400,000 Dth for November and December 2006 at an average cost of $6.72 / MMBtu. This is significantly less than the $7.50 average price supported by Mr. Beecher in his calculation of the $140.8 single point permanent rate inclusion for fuel and purchased power. Also, it is interesting to note that the NYMEX gas futures on October 27, 2004 supported by Mr. Beecher in his permanent rate inclusion showed November 2006 at

$6.786 / MMBtu and December 2006 at $7.184; however, just five days earlier on October 22, 2004, Mr. Beecher was able to hedge gas at an average cost of $6.72 / MMBTU. This demonstrates the daily changing nature of NYMEX gas futures prices.

Q. Does the Staff propose a change to its $3.20 / MMBtu overall natural gas price which was used to establish the floor or base amounts to be included in permanent rates as part of its IEC proposal filed in direct testimony?

A. No. The Staff examined a thirty-two month history of Empire's overall hedged natural gas costs from November 2001 through June 2004. An average of this thirty-two month history resulted in an overall natural gas price of $3.20 / MMBtu. The Staff maintains that this average natural gas price should be used to establish the floor or base amount to be included in permanent rates. The Staff believes that its proposed IEC floor forms a reasonable lower boundary for the recovery of fuel expense. This is consistent with Company witness Brad Beecher's answers in his deposition found on page 72, lines 1-10, when asked in the following exchange:

> Q. Okay. Let me ask you this: Does Empire, with respect to the IEC, does Empire want to earn profits from the establishment of an IEC or does Empire only seek an opportunity to recover its actual cost of fuel and purchased power?
> A. We seek to recover our actual prudently incurred cost of fuel and purchased power.
> Q. And so you're not seeking to make a profit?
> A. My understanding of the regulatory model that we're supposed to recover our cost on expenses.

Q. How does the preceding statement in Mr. Beecher's deposition compare to his current $140.8 million permanent rate position for fuel and purchased power?

A. The Staff believes that Mr. Beecher's $140.8 million position based on volatile NYMEX gas futures and with no opportunity for refund, contradicts the statements found in his deposition. If $140.8 million were built into permanent rates, Empire would have a significant opportunity to profit on fuel and purchased power. Mr. Beecher's deposition statement also contradicts his arguments against the Staff's IEC floor, which he asserts that the Company will not be able to achieve (Beecher Rebuttal page 8, lines 12-23 and on page 9 lines 1-11).

Q. Does the Staff propose to change its $5.62 overall natural gas price, which it used to establish the ceiling of its IEC proposal, as filed in direct testimony?

A. No. The Staff does not propose to change its position with regard to natural gas pricing, which is partly driven by the EIA's August 10, 2004 Short Term Energy Outlook Report to determine forecasted natural gas price for 2005.

Q. Has the EIA's natural gas forecast for the upcoming year 2005 changed in more recently released reports from the one issued in August 2004, that the Staff relied on for its direct filing?

A. Yes. Each month the EIA issues a natural gas forecast as part of its short-term energy outlook report. The following chart depicts the EIA's natural gas forecast for the past four months for 2005 natural gas prices:

MONTH	**$ / MCF**
August 2004	$6.60
September 2004	$6.14
October 2004	$6.18
November 2004	$6.33

Q. What explanation has EIA offered for lower gas price forecasts since August 2004?

A. The EIA reports short-term production losses in the Gulf of Mexico due to Hurricane Ivan since its August 2004 report. However, this impact appears to be more than offset by a working gas storage level that has reached its highest point since 1991. The level of storage is six percent higher than last year and nine percent higher than an average of the last five years. The EIA also points to continued high rates of drilling for natural gas in North America and states that 2005 domestic production is projected to grow by 1.6 percent. Finally, EIA states that "steady, if modest, increases in liquefied natural gas imports, restrained export growth, and carryover from the robust storage levels...are expected to contribute to moderate improvement in the supply picture through 2005."

Q. Does the Staff propose to update the unhedged portion of its current \$6.60 / MMBtu natural gas price position that was used to establish its proposed IEC ceiling to reflect the more recent natural gas price forecasts issued by EIA?

A. No. In order to be conservative in its determination of the boundaries of its IEC proposal, the Staff does not propose to update to more current EIA natural gas forecasts for 2005. If the Staff were to update its proposed IEC ceiling using the November 2004 \$6.33 / MMBtu forecasts instead of the August 2004 \$6.60 / MMBtu forecast, Empire's overall hedged IEC ceiling gas price would drop from \$5.62 to \$5.46. If the Staff had adopted this more current information the impact would have reduced its IEC ceiling proposal by approximately \$1.1 million total company (\$928,440 Missouri jurisdictional) with regard to interim rates.

Q. Please explain how the Staff calculated its overall hedged $5.62 ceiling natural gas price, which represents its current position.

A. As of August 2004, Empire had a 40% hedged position for natural gas needs for 2005 at $4.147 / MMBtu. This meant that, at that time, 60% of Empire's natural gas needs for 2005 would still have to be acquired. The Staff used the EIA's 2005 gas forecast of $6.60 / MMBtu to determine this portion of gas costs. Please see the calculation below:

PRICE USING THE EIA AUGUST 2004 FORECAST

40%	X	$4.147 =	$1.659
60%	X	$6.60 =	$3.960
Total hedged gas price =			$5.619

Q. Please explain the calculation to determine the total $5.46 / MMBtu gas price using the most recent, November 2004 EIA gas forecast for 2005.

A. Assuming Empire's August 2004 40% hedged position and EIA's November gas forecast of $6.33 / MMBtu for 2005 would produce the following calculation:

PRICE USING THE EIA NOVEMBER 2004 FORECAST

40%	X	$4.147 =	$1.659
60%	X	$6.33 =	$3.798
Total hedged gas price =			$5.457

Q. Has the Company's hedged position changed since the Staff's direct testimony filing on September 16, 2004?

A. Yes. During October 2004 the Company purchased 1,100,000 Dth for 2005 gas requirements. Also, the Company reduced its expected Dth burn for 2005. The effect of this purchase as well as the Company's decision to reduce the expected burn level for 2005 increased the Company's hedged position from 40% to 60%. The Staff has not attempted to reflect this new, hedged position in establishing the ceiling for the IEC. The effect of this change in hedged position, when taken into account with a November 2004 EIA gas forecast would further lower the Staff's ceiling gas price from \$5.62 to \$5.36. This can be seen in the following calculation:

<u>PRICE USING THE EIA NOVEMBER 2004 FORECAST AND EMPIRE'S NEW HEDGED POSITION</u>

60%	X	\$4.705	=	\$2.823
40%	X	\$6.33	=	\$2.532
Total hedged gas price			=	\$5.355

If the Staff had adopted this more current hedged information in addition to the update EIA November natural gas forecast the impact would have resulted in a reduction in revenue requirement of approximately \$2.1 million total company (\$1.8 million Missouri jurisdictional) with regard to the interim rates established by the IEC ceiling. Again, Staff believes it has been conservative in determining the boundaries of its IEC proposal.

Q. Does the Staff and Company agree to include all future capacity release income as part of a true-up for its proposed IEC?

A. Yes. The Staff proposes that all future capacity release income that Empire would earn during the term of the IEC must be included as part of the true-up of the IEC. Company witness Beecher agreed with the Staff on this issue in his deposition on page 77, lines 5-7, when he stated, "...capacity release income would be a reduction to our on-system cost, so it would be included in the IEC calculation."

Q. Does the Staff believe that the proposal, supported by OPC witness James Busch, to use a single natural gas price to determine a set level of fuel and purchased power expense is a reasonable alternative at this time?

A. No. The Staff maintains its position that given the current volatile state of natural gas prices no one can predict, with a reasonable degree of certainty, the natural gas prices that Empire will pay in the future to fuel their generating facilities. Given, Empires level of dependency on natural gas generation and purchased power, the consequences of selecting a single point estimate of fuel and purchased power and subsequently being wrong are too severe. Therefore, an IEC mechanism represents the most reasonable approach to address this situation. In the future, when gas prices are subject to less volatile conditions, then a return to the traditional annualized/normalized fuel and purchase power levels using historical data and a single point determination would be appropriate for Empire.

Q. Has the Staff updated its IEC proposal to include the new firm gas transportation contract expense as well as the transportation losses and commodity charges for natural gas which Southern Star charges pursuant to their tariffs?

A. Yes. The Staff has updated its IEC proposal to include $2.4 million of expenses related to Empire's new firm gas transportation contract with Southern Star, which became effective September 1, 2004. The Staff also has included approximately $1.1 million of transportation losses and commodity charges for natural gas.

Q. Please summarize how the changes for the new firm gas transportation contract and transportation losses impacted the Staff's IEC proposal?

A. As a result of all of these changes the Staff has increased its proposed IEC base or floor for total company on-system fixed and variable fuel and purchased power costs, to be included in permanent rates, from $107,436,748 to $110,755,906. The variable cost component of the proposed floor is $87,238,304. The Staff also increased its IEC ceiling for total company on-system fixed and variable fuel and purchased power costs from $130,888,272 to $134,413,475. The variable cost component of the proposed ceiling is $110,895,873. This creates a total company IEC band subject to refund of $23,657,569. On a Missouri Jurisdictional basis the IEC band subject to refund is $19,515,129.

Q. What IEC mechanism is the Staff proposing in this case?

A. The Staff proposes the same mechanism and 24-month period that was agreed to by all parties and approved by the Commission for Aquila in Case No. ER-2004-0034, but based on the price and operational parameters specific to this case.

DEFERRED TAXES – POSTRETIREMENT BENEFITS OTHER THAN PENSIONS (PBOP)

Q. Company witness Williams argues on pages 4 and 5 of his surrebuttal testimony that the Staff failed to include the deferred tax balance associated with PBOP in its rate base calculation. Please discuss the situation that resulted in the Company recording deferred taxes for PBOP.

A. The Company is unable to deduct for income taxes all the contributions it is making to its management Voluntary Employee Beneficiary Association (VEBA) plan.

A VEBA is a trust fund authorized by the Internal Revenue Code that enables an employer to deposit funds for PBOP.

Q. Is this situation uncommon?

A. No. I am aware that this situation exists at other Missouri utilities, yet, unlike Empire, these utilities have found a way to receive a tax deduction for all of the VEBA contributions included in rates. I am not aware of any other utility in Missouri that has proposed to increase the cost of service because it was unable to deduct all of its VEBA contributions for PBOPs.

Q. What alternatives exist for Empire to address this situation?

A. Empire could reduce the amount it funds in the management VEBA and over-fund the non-management VEBA to the extent necessary to receive a tax deduction for the full amount of the contributions included in rates. Empire may also be able to set up a single common VEBA for management and non-management contributions. Finally, Empire may also be able to fund management PBOP through its pension plan.

Q. Is it appropriate to increase the revenue requirement simply because the Company has not availed itself to one of the other options?

A. No. The Company should examine each of these alternatives to determine which is more advantageous to Empire. Increasing rates, merely because Empire is unwilling to employ one of the available alternatives that would allow a tax deduction for the full amount of the contributions included in rates, is not an option that the Commission should permit.

DEFFERED TAXES – ALTERNATIVE MINIMUM TAX (AMT)

Q. Please explain the situation that caused Empire to record deferred taxes associated with AMT.

A. During a meeting with the Staff, Company witness Williams indicated that as a result of net operating losses sustained on a consolidated corporate basis, Empire was subject to AMT. As a result, it was unable to deduct all the accelerated tax depreciation normally available to the Company.

Q. Does the Staff believe it is appropriate to increase the cost of service for this tax situation?

A. No. Empire, which has the burden of proof, has not demonstrated to the Staff that incurring AMT is appropriately included in rates for regulated operations. Empire pays taxes on a consolidated corporate basis therefore unregulated losses or other unregulated business situations may have caused Empire to be subject to AMT. If this is the case, regulated rates should not be impacted by these unregulated operations.

Further, based on discussions with Mr. Williams, Empire has not been subject to AMT in the past. Therefore, since this is an unusual situation that does not represent normal operations, as exhibited by Empire in the past, it should not be included in ongoing rates in the future.

In addition, as can be seen from the Staff's calculation of revenue requirement in this case, the Company incurred numerous expenses that have been disallowed by the Staff from the cost of service (advertising, dues and donations, etc.). These expenses, which are not appropriate for inclusion in the cost of service, contribute to the loss situation that caused Empire to be subject to AMT. It is inappropriate to increase the cost of service as a result of the Company being subject to AMT due in part to the Company incurring expenses, which were disallowed from the cost of service.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.