REBUTTAL TESTIMONY

OF

JAMES A. BUSCH

CASE NO. ER-2004-0570

EMPIRE DISTRICT ELECTRIC COMPANY

Q. Please state your name and business address.

A. My name is James A. Busch and my business address is P. O. Box 2230, Jefferson City, MO 65102.

Q. Are you the same James A. Busch that filed direct testimony in this proceeding?

A. Yes I am.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Empire District Electric Company (Empire or Company) witness Mr. Brad Beecher, Missouri Public Service Commission Staff (Staff) witness Mr. John Cassidy, and Intervenor Praxair/Explorer Pipeline (Praxair) witness Mr. Maurice Brubaker. The main focus of this discussion will be the proposed Interim Energy Charge (IEC) proposals of the other parties.

Q. What is Public Counsel's position regarding fuel and purchase power expense?

A. Public Counsel believes that fuel and purchase power expense should continue to be treated in the traditional manner, allowing for an appropriate allowance for fuel and purchase power to be included in a fuel run. This fuel run then determines an overall fuel cost, which is then used to calculate rates that the Company will charge its customers. Every electric company in the state, except Aquila, Inc., is currently operating under this traditional, regulatory framework. Public Counsel believes the inclusion of a specific level of fuel costs in rates provides the utility the proper economic incentives to manage its fuel costs in the most efficient manner.

Q. How do the IEC proposals in this proceeding differ from the traditional method for developing a fuel allowance in rates?

A. The difference is that an IEC would allow for an interim, subject to refund charge representing a range of fuel costs, instead of a single fuel cost to be used in the establishment of base rates. Thus, an interim charge would be charged to Empire's customers above a base rate to account for potential variations in fuel costs.

Q. Please explain further how an IEC would work.

A. For example, a price for the various fuel supplies (coal, natural gas, etc.) would be used to establish a base cost of fuel. This would then be used in the determination of base rates. In other words, this would be the "floor" of the IEC. Then another fuel run would be made utilizing different fuel costs. Generally, the cost of natural gas and purchased power would be the only variables that would be altered for the second fuel run. This second fuel run would then establish a new, higher total fuel cost. This would then establish the "ceiling" for the IEC. The rate that would ultimately be charged to consumers would be the base rate plus the additional IEC charge up to the ceiling that would be established for the IEC. It is this additional piece, the difference between the floor and the ceiling that would be the Interim Energy Charge. This charge would then be subject to refund after the IEC period expires.

Q. Do all parties to this proceeding support the Commission authorizing an IEC for Empire?

A. No. Public Counsel opposes an IEC.

Q. Do the three parties that have proposed an IEC (Empire, Staff, and Praxair) agree on the basic framework of an IEC in their proposals?

A. Yes, although there are some differences in the proposed parameters of the IEC proposals.

Q. What are the differences among the parties' proposed IECs?

A. There are two main differences among the proposals. The first difference is the band between the floor and the ceiling. The second difference is the length of the interim period for each proposed IEC.

Q. What are the different interim periods being proposed in this proceeding?

A. Empire is proposing an IEC with a period of at least five years. The Staff and Praxair have both proposed an IEC with a duration of two years.

Q. Historically, what is the longest interim period for which the parties have agreed upon for an IEC?

A. The first IEC agreed upon by the parties for Empire was designed to last two years. However, due to changes in the market and a subsequent agreement of the parties, that IEC was terminated after a little more than a year.

The second IEC approved in Missouri, also agreed to in a Stipulation and Agreement among all parties (this time for Aquila, Inc.), also had a two-year time frame. It began in April of 2004.

Q. Please explain the IEC bands proposed by the different parties.

A. The Staff has proposed a band that incorporates a natural gas price range of approximately $3.20 per MMBtu to $5.62 MMBtu (Cassidy Direct page 11, lines 9 and 19). Empire's band incorporates a natural gas price range of approximately $3.25 per MMBtu to $5.25 per MMBtu (Tietjen Direct page 15, line 23). Mr. Brubaker did not specifically mention a natural gas price range in his direct testimony. Instead he proposed a range of total fuel costs (Brubaker Direct page 7 and 8, lines 21 – 22 and lines 7 - 9). However, the fuel costs chosen by Mr. Brubaker approximate natural gas costs of $4.00 per MMBtu to $5.00 per MMBtu.

Q. How do these ranges compare to your recommendation for a natural gas price in your direct testimony?

A. In my direct testimony, I recommended a price of natural gas of $4.59 per MMBtu.

PUBLIC COUNSEL'S IEC POSITION

Q. What is Public Counsel's position regarding an IEC?

A. Based on discussions with counsel, it is my understanding that an IEC cannot be legally authorized by the Commission absent an agreement of all of the parties. Public Counsel has not yet been able to reach an agreement regarding an IEC with parties.

Q. Besides the unlawfulness of the IEC, does Public Counsel have any other concerns regarding the IEC?

A. Yes. As a policy matter, Public Counsel believes that the IEC does not provide the appropriate incentives for fuel procurement to the Company and lowers the business risk of the Company at the expense of ratepayers, as well as constitutes single-issue and retroactive ratemaking.

Q. Please discuss Public Counsel's belief that the IEC does not provide the appropriate incentives to the Company concerning fuel procurement.

A. One of the positive aspects of the Commission's regulatory oversight over electric utilities within Missouri is the appropriate incentive it provides those utilities to procure fuel and purchased power in an efficient manner. Based on fuel runs conducted during the course of a rate case, an amount for fuel and purchase power is built into rates for each electric utility. If the electric company is subsequently able to do a better job (that is, beat the level of fuel and purchased power included in its revenue requirement), it can keep those cost savings. Further, the company is responsible if the costs exceed that level. This is a powerful financial incentive and an incentive that occurs in real time with the actions taken by the utility.

An IEC would distort and weaken those incentives. Within a specified band, an IEC removes the incentive for an electric utility to be as diligent as it could be to drive fuel costs as low as possible. If the company pays fuel costs that are higher than the level that is built into base rates but below the ceiling, the company will simply pass those costs along to the ratepayers.

Furthermore, the company's ability to profit from the efficient management of its fuel supplies is lessened. This occurs because the establishment of the base rate or floor would include lower fuel costs than what would be built into rates under the traditional method to counterbalance the higher fuel costs that would be used in the establishment of the ceiling.

Q. Please explain your last comment in more detail.

A. In recognition of an IEC ceiling that takes into account higher fuel costs to protect the company, the fuel costs used to establish base rates under a proposed IEC can be lowered to try and "even out" the ratepayers and shareholders interests. This is in recognition of the fact that if the shareholders are to be protected from higher fuel costs, the ratepayers need to have the ability to benefit from lower fuel costs. However, the major incentive the company may have to keep fuel costs as low as possible vanishes when the company cannot keep those proceeds.

Q. Are you aware of any utility company executives in Missouri who have echoed your analysis regarding the incentives that traditional fuel cost recovery provides electric utilities?

A. Yes I am. In the 1998 Annual Report of Ameren Corporation, Chief Executive Officer Charles W. Mueller stated, "We are also focused on lowering fuel costs. In 1998 in Illinois, we chose to eliminate the fuel adjustment clauses, which called for offering credits if certain fuel costs dropped or increasing customer bills if they rose. That decision, coupled with the fact that we have operated for several years without a fuel adjustment clause in Missouri, has given us additional incentive to continue to manage our fuel costs effectively." (1998 Annual Report, Ameren Corporation, page 3)

Q. Why not create an IEC with a higher base amount to keep this incentive in place?

A. The reason this would not work is that it would completely distort the risk-reward trade-off between shareholders and ratepayers. Under current Missouri regulatory framework, this trade-off is balanced. An amount is built into rates through the course of a rate case, in which all relevant factors are considered. After rates are established, more efficient company management may lead to greater company profits. On the other hand, poor performance by the company would generally not harm the ratepayers. If an IEC would have a high floor (base rate), in conjunction with a ceiling above the base, the company would be allowed to benefit from lowered fuel costs, but the ratepayers' protection from higher fuel costs has been diminished. This is not an optimal solution.

Q. Finally, please explain Public Counsel's belief that an IEC lowers Empire's business risk at ratepayer expense.

A. If an IEC could be agreed upon, there could be a large band within which Empire could recover its fuel costs. In fact, recovery of fuel costs would almost become guaranteed. Consequently, an IEC would allow Empire to mitigate a significant portion of its business risks.

Q. Please explain.

A. One potentially large business risk for an electric utility is related to fuel procurement because the price at which an electric utility is able to obtain its fuel supply can significantly impact its profitability (net income). This is especially true if the utility has a greater reliance on fuels that are volatile such as natural gas. Thus, the greater the volatility of a particular electric utilities' fuel costs, the more volatile its profitability can be. This business risk is significantly reduced with a fuel price recovery mechanism like an IEC because the utility is allowed full cost recovery within a specified band. Consequently, as long as the utility is able to procure its fuel at a price within this specified band, it is able to stabilize its net income, which reduces its business risk, all else equal.

Q. Aren't fuel costs such as natural gas and purchased power established in a market in which Empire has no control?

A. The price that Empire pays for natural gas and purchased power is established in a market. However, it is not correct to state that Empire has no control over those prices.

Q. Please explain.

A. Empire has the ability to mitigate price volatility. Empire does this in the natural gas market by its successful implementation of its hedging program, as discussed in Mr. Beecher's direct testimony. This hedging program allows the Company to enter the natural gas market and utilize various hedging tools, such as futures contracts, to protect itself against adverse price movements. This is a luxury that Empire's ratepayers do not have. Furthermore, the Company has the ability to enter into long-term purchased power contracts that establishes the price Empire will have to pay for purchased power. This helps eliminate adverse impacts of price increases in the purchased power market.

Q. Currently, the natural gas market is extremely volatile. Doesn't this impact Empire's ability to hedge?

A. It does. However, Empire's hedging plan allows for Empire to manage its risk at its discretion. Empire is allowed to make the decision when to lock in prices for its natural gas supplies. Thus Empire does not have to purchase financial instruments at this time. Further, the price that Empire is currently paying for natural gas is far below current market prices, evidence of Empire's ability to avoid adverse price movements.

Q. Are there any other actions Empire can take to avoid price spikes in certain fuel costs?

A. Yes. In the long-run, Empire could meet its growing demand needs by reducing its reliance on natural gas powered generation facilities and purchased power. For example, it can accomplish this in various ways such as focusing on wind or coal-powered generation or purchasing power. Public Counsel is concerned that reliance on IEC-type mechanisms could influence Empire or other Missouri electric utilities to invest in more natural gas fired generation facilities, regardless of whether that decision was the best overall resource planning option. A greater reliance on non-natural gas fired generation would help keep total fuel costs as low as possible during periods of high, volatile natural gas prices.

Q. Please discuss Public Counsel's belief that the IEC constitutes single-issue ratemaking.

A. An IEC would be a specific charge to Empire's customers based solely on fuel costs. This charge would be reviewed at the end of an IEC period and the actual rate to be charged to consumers would be determined at that time. The review would not look at all of the relevant factors affecting the Company during the period of time the IEC would be in effect. It would focus solely on the single-issue of fuel costs. In fact, it would only focus on the specific issue of variations in fuel costs. Fixed costs associated with fuel would already be built in the base rate and would not be subject to the IEC or to refund. It is my understanding that the Commission is forbidden from single-issue ratemaking.

Q. Please discuss Public Counsel's belief that an IEC would constitute retroactive ratemaking.

A. As discussed above, the actual rate that the consumers would pay regarding fuel costs would not be known until sometime in the future. Empire would collect the IEC in advance of knowing the actual cost of fuel. After a review to determine Empire's actual incurred fuel costs, the Company would either keep all of the IEC revenues, refund a portion of the IEC revenues, or refund all of the IEC revenues depending upon the actual fuel costs. The actual effective rate would not be established until after the fact. It would thus be charged retroactively.

Q. Do you have an update of your natural gas price recommendation?

A. Yes. Prior to the filing of rebuttal testimony, it was brought to my attention that I had a formula error in my recommendation. Fixing the error causes my recommendation to rise from $4.59 per MMBtu to $4.68 per MMBtu.

Q. Please summarize your rebuttal testimony.

A. Public Counsel believes that the Commission cannot establish an IEC for an electric utility unless all parties reach agreement to allow such a mechanism.

Further, Public Counsel believes that an IEC can set up the wrong incentives for the utility to the detriment of ratepayers. Finally, Public Counsel's corrected natural gas price recommendation has increased to $4.68 per MMBtu.

Q. Does this conclude your rebuttal testimony?

A. Yes it does.