BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Empire District Electric Company of Joplin, Missouri, for authority to file tariffs increasing rates for electric service provided to customers in the Missouri service area of the company.	)))))	Case No. ER-2008-0093

EMPIRE'S STATEMENT OF POSITIONS AND PREHEARING BRIEF

COMES NOW The Empire District Electric Company ("Empire" or the "Company"), by and through counsel, and for its Statement of Positions and Prehearing Brief being submitted pursuant to the Order Concerning Test Year and True-Up and Adopting Procedural Schedule issued herein on November 16, 2007, respectfully states as follows to the Missouri Public Service Commission (the "Commission"):

Background and Introduction

Empire is requesting an overall increase in its Missouri retail rates of $34.7 million, approximately a 10.1 percent increase. As explained in the direct testimony of William L. Gipson, President and Chief Executive Officer for the Company, Empire provides electric service in an area of approximately 10,000 square miles in southwest Missouri and the adjacent corners of the states of Kansas, Oklahoma, and Arkansas. The Company's service area embraces 121 incorporated communities in 20 counties in the four-state area. The economy of Empire's service area is diversified, featuring small to medium manufacturing operations, medical, agricultural, entertainment, tourism, and retail interests all contributing to average or above-average customer growth over the last several years.

As of June 30, 2007, system-wide, Empire served 139,513 residential customers, 24,357 commercial customers, 360 industrial customers, 1,928 public authority customers, and four wholesale customers. In Missouri, Empire serves approximately 122,821 residential customers, 21,584 commercial customers, 286 industrial customers, 1,571 public authority customers, and three wholesale customers. In addition to electric service, Empire provides regulated water service to approximately 4,500 customers in Missouri, and, through its wholly owned subsidiary, The Empire District Gas Company, provides natural gas service to approximately 47,000 gas customers in northwest, north central, and west central, Missouri. (Gipson Direct, pp. 2-3)

The major factors driving Empire's rate increase request are: (1) the capital additions made by the Company to its electric system in 2007 (Riverton 12 & Asbury Selective Catalytic Reduction); (2) the financial impact, both capital and expense, related to a catastrophic ice storm that hit Empire's service area in January of 2007; and (3) the large capital expenditures Empire is making in order to participate in the construction and ownership of two new coal-fired generating units, Iatan II and Plum Point. (Gipson Direct, p. 4) Cost of capital, payroll, and certain other expenses have risen somewhat for Empire, but, with the addition of Riverton Unit 12, new environmental facilities at Asbury, and the major additions made to Empire's system as a result of the 2007 ice storms, Empire's fixed costs have increased significantly and are the major cost driver in this rate case. (Gipson Direct, p. 5)

Additionally, the continued volatility of both fuel and purchased energy costs, coupled with the absence of an effective energy cost adjustment mechanism in Missouri, has left Empire exposed to increased fuel cost risk. Accordingly, the Company is requesting the implementation of a fuel adjustment clause ("FAC") as part of this rate case. (Gipson Direct, p. 4) Empire has worked diligently to control the volatility associated with fuel costs through the use of a natural gas hedging program which has been in place since 2001. Further, Empire began receiving wind energy from the Elk River Wind Farm in October 2005, and Empire recently signed a contract with Horizon Wind Energy to purchase 100 percent of the output from a new wind farm, Meridian Way Wind Farm, located near Concordia, Kansas. These tools aid in mitigating price volatility, mitigate Empire's natural gas exposure and provide some price stability for Empire and its customers, but Empire remains exposed to increased fuel cost risk. (Gipson Direct, p. 5)

I. REVENUE REQUIREMENT ISSUES

A. Rate of Return Issues

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

    a. In the event the Commission grants Empire a fuel adjustment clause, what, if any, is the appropriate adjustment to the authorized return on equity?

Empire Witnesses: Vander Weide, Overcast

A return on common equity ("ROE") of 11.6 percent should be used for determining Empire's authorized rate of return ("ROR") in this proceeding. In the event the Commission authorizes a fuel adjustment clause ("FAC") for Empire, the ROE should remain at 11.6 percent and should not be adjusted as a result of the authorization of an FAC. Empire witness Dr. James H. Vander Weide was retained by Empire to prepare an independent appraisal of Empire's cost of equity and to recommend to the Commission a rate of return on equity for ratemaking purposes. Empire witness Dr. H. Edwin Overcast of Black & Veatch will present testimony regarding the additional risk Empire faces due to the lack of a fuel adjustment mechanism in Missouri and the risk associated with Empire's substantial construction program.

Empire has a significant capital program required to provide safe and reliable service to its customers. Over the next three years (2008-2010), Empire expects to spend over $200 million to add new generating capacity, almost $50 million on retrofits to existing plants, and over $150 million for transmission and distribution facilities to serve new and existing customers, for a total of almost $440 million in new capital for its regulated operations. At the end of 2006, Empire had net plant investment of just over one billion dollars. The new investment in the capital program will add over 40 percent to the existing plant investment, and, accordingly, the capital program represents a significant impact on the Company and its customers. (Overcast Direct, p. 28)

Empire's capital program must be funded by both internally generated funds and by external financing - both new equity issues and new debt issues. Internally generated cash flows result from both depreciation expense and retained earnings. Retained earnings are dependent on the actual earned return on equity resulting from the effect of costs and revenues in the period in which the new rates will be in effect ("Rate Effective Period") and the dividend payout ratio. Retained earnings also play a role in maintaining the appropriate capital structure. (Overcast Direct, p. 29) It is impossible to know exactly the required return needed to support the capital program and maintain an investment grade debt rating because of the risks associated with the construction program. The risks for Empire are significant despite the approval of the amortization provision of the Regulatory Plan. This is particularly so because in calculating the amortization amounts for rate case purposes, the formula uses the allowed return from the rate case. (Overcast Direct, pp. 29-30)

Despite the best efforts of all parties, the proforma test year expenses and revenues may not provide a reasonable opportunity for Empire to earn the allowed return in the Rate Effective Period. In order to fund the construction program and maintain an investment grade debt rating, it will be the actual results in the Rate Effective Period and beyond that result in the investment grade debt rating. Further, the Missouri regulatory model biases the actual return below the authorized return given any reasonable expectation of economic conditions and assuming the existence of a fully tracking fuel adjustment clause. In addition to the bias that exists in the use of the historic test year, there is also the asymmetric weather risk, the risk of unforeseen additional capital expenditures from storm damages and other issues. These risks are compounded by the limited financial reserve strength resulting from Empire's history of returns below the allowed return. (Overcast Direct, p. 30)

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

Empire's construction program represents substantial risks for the Company. The long list of risks is particularly unique for Empire because of its limited financial flexibility and the size of the overall undertaking. (Overcast Direct, p. 40) In terms of the estimated cost of equity for the comparable companies discussed below, Empire faces higher risk and thus requires additional risk compensation as part of the decision in this rate case proceeding. Indeed, some of the comparable companies no longer have the responsibility to build additional generation. (Overcast Direct, p. 37) The Commission, however, need not determine a specific adjustment to the cost of capital in order to recognize the construction program risks (or any of the other risks) that Empire faces that distinguish it from the comparable companies. Rather, the Commission may recognize the risk by awarding Empire its requested return of 11.6 percent. This represents a reasonable means of compensating Empire for the construction program risks. In addition, the Commission should consider a mitigation strategy designed to allow Empire deferred accounting treatment and assure probable recovery for any unusual expenses or changes in costs beyond the control of management occurring in the Rate Effective Period. Such costs include storm damage, vegetation management expense, changes in governmental policy and other items not included in test year costs subject to review and audit prior to amortization. (Overcast Direct, pp. 38-39)

In arriving at his ROE recommendation of 11.6 percent, Dr. Vander Weide applied several standard cost of equity estimation techniques, including the discounted cash flow ("DCF") model, the risk premium method, and the Capital Asset Pricing Model ("CAPM") to a large group of comparable companies. (Vander Weide Direct, p. 3) The DCF method assumes that the current market price of a firm's stock is equal to the discounted value of all expected future cash flows. The risk premium method assumes that the investor's required return on an equity investment is equal to the interest rate on a long-term bond plus an additional equity risk premium to compensate the investor for the risks of investing in equities compared to bonds. The CAPM assumes that the investor's required rate of return on equity is equal to a risk-free rate of interest plus the product of a company-specific risk factor, beta, and the expected risk premium on the market portfolio. (Vander Weide Direct, p. 16) The methodology utilized by Dr. Vander Weide is detailed in his pre-filed direct testimony.

Dr. Vander Weide utilized a large group of comparable companies because standard cost of equity methodologies require inputs of quantities that are not easily measured. Since these inputs can only be estimated, there is naturally some degree of uncertainty surrounding the estimate of the cost of equity for each company. The uncertainty in the estimate for an individual company, however, can be greatly reduced by applying cost of equity methodologies to a large sample of comparable companies. Intuitively, unusually high estimates for some individual companies are offset by unusually low estimates for other individual companies. Thus, financial economists invariably apply cost of equity methodologies to a group of comparable companies. In utility regulation, the practice of using a group of comparable companies is further supported by the United States Supreme Court standard that the utility should be allowed to earn a return on its investment that is commensurate with returns being earned on other investments of similar risk. (Vander Weide Direct, pp. 3-4, citing *Bluefield Water Works and Improvement Co. v. Public Service Comm'n.* 262 U.S. 679 (1923) and *Federal Power Commission v. Hope Natural Gas Company*, 320 US 591 (1944))

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

The 11.6 percent cost of equity for Dr. Vander Weide's proxy companies reflects the financial risk associated with his proxy companies' average capital structures, where the capital structure weights are measured in terms of market values. Since financial leverage (the use of debt financing) increases the risk of investing in the proxy companies' equity, the cost of equity would be higher for a capital structure containing more leverage. As shown in Schedule JVW-8, Dr. Vander Weide's electric company group has an average capital structure containing 34 percent debt, 1 percent preferred stock, and 65 percent common equity. He also examined capital structure data for a large group of electric companies over the last six years. The average capital structure for this large group of electric utilities contains 40 percent debt, 2 percent preferred, and 58 percent equity. (Vander Weide Direct, pp. 40-41)

Although Empire's capital structure contains an appropriate mix of debt and equity and is a reasonable capital structure for ratemaking purposes, from an investor's viewpoint, Empire's ratemaking capital structure embodies greater financial risk than is reflected in Dr. Vander Weide's cost of equity estimates from his proxy companies. (Vander Weide Direct, p. 41) Because Dr. Vander Weide's proxy companies are a conservative proxy for the risk of investing in Empire, the Company should have a weighted average cost of capital that is equal to or greater than the weighted average cost of capital for the proxy companies. Since Empire's ratemaking capital structure contains significantly more leverage than the average capital structure of Dr. Vander Weide's proxy companies, and the cost of equity increases with leverage, it is evident that such an adjustment would produce a significantly higher cost of equity for Empire. (Vander Weide Direct, p. 42) It should be noted, however, that since the Commission did not accept a financial risk adjustment in its recent AmerenUE decision, Empire requested that Dr. Vander

Weide not make a financial risk adjustment in this proceeding. (Vander Weide Direct, p. 42) Accordingly, Empire's recommendation remains at 11.6 percent.

If an FAC is authorized for Empire, an ROE adjustment should not be made, as suggested by the Staff and Mr. Gorman, a witness for Explorer Pipeline Company, General Mills, and Praxair, Inc. Given the "comparable" companies used by both Mr. Gorman and the Staff and the proposed fuel clauses that are recommended by Mr. Brubaker, a witness for Explorer Pipeline Company, General Mills, and Praxair, Inc., and the Staff, there is reason to believe that even with an FAC, Empire should be authorized a higher return, not lower. Even with the approval of the Empire FAC proposal, the appropriate ROE should be at least as high as recommended by Empire witness Dr. Vander Weide. (Overcast Rebuttal, p. 13) The rationale for a higher return may be found in an analysis of the different set of comparable companies used by Mr. Gorman and the Staff.

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

Rebuttal Schedule HEO-3 provides the status of fuel adjustment clauses for the Staff's comparable companies. Fourteen of the 16 companies used in Staff's estimate of capital cost have full tracking fuel clauses. As discussed above, the two companies without full protection on fuel costs both have substantial fuel cost recovery from a portion of their customer base. This means that investor expectations of the sample include an expectation of fuel cost recovery in terms of the required equity return. In addition, many of the Staff's comparable companies have other forms of adjustments that improve the opportunity to earn the allowed return relative to Empire. Further, Rebuttal Schedule HEO-4 shows that many of these companies have regulatory models that provide a reasonable opportunity to earn the allowed return. These comparable companies have test years that permit costs to be determined closer to the Rate Effective Period and or coincide with the Rate Effective Period. (Overcast Rebuttal, p. 15)

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

B. Rate Base Issues

1. Asbury SCR: Should Empire's Asbury SCR equipment plant addition be included in Empire's rate base in this case? If yes, should it be included through an adjustment to Empire's revenue requirement or through a true-up procedure? If the Asbury SCR equipment is not included in Empire's rate base in this case, should any future emission revenue associated with that equipment flow through the FAC?

Empire Witness: Mertens

Empire's Asbury Selective Catalytic Reduction ("SCR") equipment plant addition should be included in Empire's rate base in this case, and, as such, future emission revenue associated with that equipment should flow through the FAC.

Blake Mertens, Empire's Manager of Strategic Projects, will provide testimony regarding Empire's generating units and the new assets added to Empire's generation fleet. Specifically, he will testify regarding the in-service criteria for Riverton Unit 12 and the Asbury SCR. He will also detail proposed adjustments to Empire's test year level of operating and maintenance expenses as they relate to the Asbury SCR. These adjustments total $1,802,000 (Missouri jurisdictional).

The EPA issued its final Clean Air Interstate Rule ("CAIR") on March 10, 2005. The CAIR governs NO_x and SO_2 emissions from fossil fueled units greater than 25 megawatts and will affect 28 states, including Missouri, where Empire's Asbury, Energy Center, State Line and Iatan Plants are located, and Arkansas, where the future Plum Point Energy Station will be located. (Mertens Direct, p. 6) The CAIR is not directed to specific generation units, but instead, requires the states (including Missouri and Arkansas) to develop State Implementation Plans ("SIPs") to comply with specific NO_x and SO_2 state-wide annual budgets. Missouri and Arkansas have finalized their respective regulations and have submitted their SIPs to the EPA for approval; however, until these SIPs are approved by the EPA, Empire cannot definitively determine the allowed emissions of NO_x and SO_2 for the subject plants. To help meet CAIR NO_x requirements, Empire constructed a SCR at Asbury. This project was also contemplated as part of Empire's Experimental Regulatory Plan approved by the Commission in Case No. EO-2005-0263. (Mertens Direct, p. 6)

As part of Empire's Experimental Regulatory Plan, the parties agreed that "they will develop and agree to in-service criteria for the emissions equipment that is to be installed on...…Asbury SCR and that the equipment will meet the in-service criteria before the costs for the equipment will be included in Empire's rate base." Empire worked with the Staff to draft in-service criteria for the Asbury SCR and these criteria were presented to the other parties during Empire's Integrated Resource Plan meeting that took place on March 30, 2007. No objections were raised, and the in-service criteria for the NO_x control equipment are as follows:

> 1. All major construction work is complete.
>
> 2. All preoperational tests have been successfully completed.
>
> 3. Equipment successfully meets all operational contract guarantees. The operational contract guarantees that have been satisfied by the time of Staff's direct, rebuttal, or surrebuttal testimony filing in the current rate case will be evaluated by the Staff. Note: This applies to operational contract guarantees that are not addressed in criteria 4, 5, and 6 (as listed below).
>
> 4. The equipment shall be operational and demonstrate its ability to operate at a NO_X reduction efficiency equal to or greater than 83.7% over a continuous four (4) hour period while the generating unit is operating at or above 95% of its design load.
>
> 5. The equipment shall also demonstrate its ability to operate at a NO_X reduction efficiency equal to or greater than 79.2% over a continuous 120-hour period while the generating unit is operating at or above 80% of its design load.
>
> 6. Continuous emission monitoring systems ("CEMS") are operational and demonstrate the capability of monitoring the NO_X emissions to satisfy the parameters in items (4) and (5) above.

(Mertens Direct, pp. 7-8)

As of February 29, 2008, the Asbury SCR met the above-stated in-service criteria. Empire has provided data and information to support this fact. (Mertens Rebuttal, p. 3) Although Empire originally targeted the SCR to be in-service late in the 4th quarter of 2007, the SCR construction and "tie-in" was completed in November 2007 during Asbury's major outage. The Asbury outage was originally scheduled to start on September 22, 2007 and be completed by November 18, 2007; however, during the outage it was determined that the generator for Asbury Unit 1 required "re-winding", an event unrelated to the completion of the SCR project. Circumstances surrounding this rewind pushed the Asbury outage completion date to February 10, 2008. As a consequence, performance testing and other in-service criteria for the SCR, including a 120-hour continuous run, could not be fully completed until February 29, 2008. (Mertens Rebuttal, pp. 3-4)

As noted, the Stipulation and Agreement states that the "equipment will meet the in-service criteria before the costs for the equipment will be included in Empire's rate base." The SCR construction was completed in November 2007. Due to an event unrelated to the SCR project, the in-service criteria were met at a later date (February 29, 2008), well before the effective date of any new rates that might result from this case but after the December 31, 2007 updated test year in this case. While Empire is requesting the plant be included in rate base as part of this ongoing rate proceeding, rates reflecting costs of the Asbury SCR will not be effective until a date after which the in-service criteria were met. (Mertens Rebuttal, p. 4)

It should be noted, however, that Empire is only requesting that the Asbury project costs incurred through December 31, 2007 be included in the revenue requirement calculation in this case. As previously stated, the total estimated cost of the Asbury SCR project is $31,000,000 (excluding AFUDC). As of December 31, 2007, Empire's records show that $28,096,697 excluding AFUDC ($29,829,616 including AFUDC) had been expended on the project. Some payments to contractors and other miscellaneous expenses related to the projected were still outstanding at that time. By only including costs through end-of-year 2007, Empire is adhering to the December 31, 2007 agreed upon test-year update in this case. (Mertens Rebuttal, pp. 4-5)

Additionally, the Commission should take into account that Empire was proactive during the planning phases of the Asbury SCR project. Instead of waiting until the last minute to install the Asbury SCR (i.e. CAIR requirements do not start until January 1, 2009), Empire management decided to get ahead of the currently ongoing utility plant construction boom, a result of new coal-fired unit and air quality control system retrofits construction, and install the SCR unit during the year of 2007. Due to this proactive planning, Empire was able to install the SCR at a very low cost when compared to other currently ongoing SCR projects at other utilities coal-fired plants, especially when one considers the relatively small size of the Asbury unit. Empire does not believe it to be equitable that its customers benefit from these cost savings and Empire management's proactive planning, but not be required to pay for the investment on a timely basis. (Mertens Rebuttal, pp. 5-6)

To summarize, the Asbury SCR should be included in rate base for this proceeding for the following reasons:

1) The Asbury SCR met "the in-service criteria before the costs for the equipment will be included in Empire's rate base", a stipulation agreed to by all Parties in Empire's Experimental Regulatory Plan (Case No. EO-2005-0263).

2) Construction of the Asbury SCR was complete and the equipment useful by December 31, 2007. It was only due to other issues that arose during the Asbury maintenance outage, unrelated to the construction of the SCR, which caused the outage to be extended thus not allowing the SCR to be tested by December 31, 2007.

3) Empire is only requesting that those Asbury SCR construction costs incurred as of December 31, 2007 be included in its rate base, thus complying with the agreed upon test year update period in this case.

> 4) Empire was proactive during the planning phases of the SCR, deciding to install the Asbury SCR prior to a construction boom in the utility industry thus allowing the Asbury SCR to be installed at lower capital costs relative to what other utilities installing this type of equipment are facing today.

(Mertens Surrebuttal, pp. 3-4)

On a related note, Empire agrees with Staff witness Mantle's testimony which recognizes that emission allowance costs are variable based upon the amount of fuel burned and the cost of the allowances themselves, thus warranting inclusion in the FAC. As Empire and other utilities continue to face increased environmental regulation at generating facilities, the inclusion of emission allowance costs and revenue from sales of allowances in the FAC becomes even more vital. It is important, however, that the Asbury SCR be included as plant in-service when calculating Empire's revenue requirement in order to match the emission allowance revenue and/or costs with the investments made to mitigate any risk related to emission allowances. (Mertens Surrebuttal, p. 5)

C. Expense Issues

1. Off-System Sales Margins: What amount of off-system sales margins, if any, should be included as an offset to Empire's cost of service?

Empire Witness: Keith (Surrebuttal, pp. 4-9).

In the initial rate case cost of service, Empire has included the Missouri jurisdictional portion of a simple five-year average of its off-system sales margins as an offset to the Missouri jurisdictional cost of service. The five-year average of margins from off-system sales used in the initial filing by Empire was $3.4 million on a total Company basis and $2.8 million on a Missouri jurisdictional basis.

Empire has not contested the level of off-system sales used by the Staff as an offset to the base cost of service in this case. The Staff has used an overall level of off-system sales margins of $4.4 million on a total company basis and $3.7 million on a Missouri jurisdictional basis. In addition, the Staff has recommended that the actual off-system sales flow through the FAC in the event an FAC is authorized for Empire. The Company is not opposed to the FAC treatment for future off-system sales as long as the level built into base rates is properly reflected in the FAC base. Empire has included an example of the proper FAC treatment as part of the surrebuttal testimony in this case. The Company agrees with the overall off-system sales levels proposed by the Staff in the event they are used to offset the overall cost of service on a traditional basis; Empire also does not oppose FAC treatment for future off-system sales if the off-system sales levels built into base rates are properly used as part of the determination of the base cost of energy built into the FAC.

The OPC has recommended that off-system sales of $5.9 million on a total Company basis be used as an offset to the overall cost of service; however, OPC does not relate this level of total Company off-system sales margins to the Missouri jurisdiction. The OPC also recommends that future off-system margins be flowed through the FAC in the event an FAC is authorized for Empire. Empire is opposed to the OPC's recommended off-system sales levels if future off-system margins are **not** reflected as an FAC component, but, instead, are simply reflected as a fixed offset to the base electric rates. The OPC has elected to use a single year of this activity to establish its recommendation; however, this single year includes a single off-system contract that is scheduled to expire on September 30, 2008, one month after rates go into effect in this rate case. This expiring off-system sales contract is not scheduled to be replaced; therefore, the OPC's use of this single year likely inflates Empire's actual, future off-system sales margins by as much as 22 percent of the overall off-system sales margin.

2. Incentive Compensation: Are all costs of Empire's incentive compensation plan an expense Empire should recover from Empire's ratepayers? If not, what costs should be recovered?

Empire Witness: Harrington (Rebuttal, pp. 1-11)

Empire believes all costs associated with the Company's incentive compensation plan should be included in the cost of service that is used to set rates in this case.

In any rate case, the Commission's primary responsibility regarding issues related to a utility's wage and salary expense is to determine that the overall level of such expense is reasonable. Once the Commission has fulfilled that responsibility and has satisfied itself that the amount of wage and salary expense to be collected from customers through rates is not excessive, its job is finished, and the details of how those wage and salary amounts are administered can, and should, be left to the discretion of the utility's management.

Empire's incentive compensation program is designed to accomplish two primary objectives: 1) to allow the Company to attract and retain qualified and talented employees for key positions, and 2) to provide financial incentives that are tied to the accomplishment of annual performance objectives that promote the interests of the Company, its shareholders, and its customers. Incentive-based compensation plans are commonplace in American business today, and Empire has taken great care to assure that its plan reflects and incorporates "best practices" for such plans and that the salary levels and incentive compensation targets utilized in the plan are appropriately designed and competitively based.

Under Empire's plan, compensation of each of the Company's executives consists of three elements: base salary, an annual cash incentive, and a long-term incentive. Only the base salary element is guaranteed, however; the annual and long-term incentive elements are "at-risk" and will be earned only if the executive and the Company achieve pre-determined performance objectives. Base salary for Empire's executives is targeted at the 25th percentile of the national compensation survey utilized by the Company, and short and long-term incentives are targeted at the 43rd and 44th percentiles, respectively. Total compensation for Empire's executives is targeted at the 37th percentile of the nationwide survey. All these targets are well within the realm of reasonableness.

Empire believes the incentive compensation plan that it employs benefits all of its stakeholders – employees, shareholders, and customers – and that it would be unreasonable for the Commission to disallow certain elements of the plan simply because those elements relate to the achievement of certain incentive-based objectives. If the overall cost of Empire's compensation plan is reasonable, the labels attached to payments made under that plan should be of no concern or consequence to the Commission. The Company also believes that the Commission need not arbitrarily pick through the individual performance objectives of the executives covered by the compensation plan in an attempt to determine which of those objectives "directly" benefit ratepayers and which do not.

The overall cost of Empire's incentive compensation plan is reasonable and no adjustment to those costs is necessary or warranted in this case.

3. Bad Debt Expense: Should Staff's bad debt factor be applied to any revenue increase authorized by the Commission to determine the level of bad debt expense to be included in cost of service?

Empire Witness: Keith

Yes. Staff's proposed bad debt factor should be applied to any revenue increase authorized by the Commission in this case in order to determine the level of bad debt expense to be included in cost of service.

As will be explained by W. Scott Keith, Director of Planning and Regulatory for Empire, the Staff adjustment to uncollectible expense did not take into account the level of bad debt expense that is associated with the Staff's recommended increase in revenue. The Staff adjustment incorporates a five-year history of bad debt activity to arrive at an effective uncollectible rate of 0.543072 percent. This rate was then applied to the annualized revenue produced by the current rates to arrive at a normalized level of bad debt expenses for purposes of the overall jurisdictional revenue requirement. This part of the process used by the Staff is acceptable to Empire. What is missing from the analysis, however, is the application of the effective uncollectible rate to the recommended increase in rates. (Keith Rebuttal, pp. 8-9)

Staff's uncollectible rate should be applied in the same manner that is used to reflect the additional income taxes that are associated with the rate increase. Mr. Keith provides the following example: If $10,000,000 of additional revenue is recommended, this will need to be increased by the effect of the Staff's bad debt factor to arrive at the overall net increase required of $10,000,000. Using the Staff's effective bad debt rate of 0.543072%, this calculation would result in an overall increase of $10,054,604. The net result is a $10,000,000 increase after deducting the $54,604 in additional bad debts that will be incurred. (Keith Rebuttal, p. 9)

4. <u>Asbury SCR O&M Expenses:</u> Should Empire's projected operating and maintenance expenses associated with the Asbury SCR equipment be included in Empire's cost of service?

Empire Witness: Mertens

Yes. Empire's projected operating and maintenance expenses associated with the Asbury SCR equipment should be included in Empire's cost of service. Empire witness Blake Mertens will provide testimony regarding certain areas or plants of energy supply as they relate to operating and maintenance (O&M) expenses. Energy Supply O&M expenses include operating and maintenance expenses incurred at Empire's Asbury, Energy Center, Ozark Beach, Riverton, and State Line plants. In addition, Empire's 12-percent share of O&M expenses incurred at the Kansas City Power & Light operated Iatan plant are included in O&M expenses. O&M expenses for the 12 months ending June 30, 2007 totaled $9,952,668, which includes 60 percent of State Line Combined Cycle's ("SLCC's") O&M expenses. (This unit is jointly owned – Westar owns 40% and Empire owns 60%.) Nine adjustments were made to normalize the level of expense to allow for abnormalities that occurred during the test year and to match O&M related to assets coming into service. (Mertens Direct, pp. 9-10)

Two adjustments were made to reflect Asbury's maintenance expenses. The first was to normalize Asbury's maintenance expense to reflect normal annual outage durations. In the spring of 2007, Asbury only took a nine day scheduled outage versus its normally scheduled 23 day outage. The delay of Asbury's major outage relates to the second adjustment. The amortization of Asbury's last major outage concluded in November 2006. Asbury's major outage was originally scheduled for the spring of 2007; however, it was decided to be more economical to move the outage from the spring of 2007 to the fall of 2007 so that the SCR tie-in and the major outage work could take place at the same time and thus shorten total outage hours for the unit. (Mertens Direct, pp. 11-12)

No O&M expenses for the Asbury SCR are included in Empire's test year for this case, but, going forward, there will obviously be significant operating and maintenance expenses related to the Asbury SCR. Empire has made an adjustment of $1,292,500 to include Asbury SCR O&M expenses in this rate case. (Mertens Direct, p. 14)

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

Empire Witness: Mertens

Yes. Property taxes associated with the Asbury SCR equipment should be included in Empire's cost of service. If the Asbury SCR is not included in the revenue requirement calculation, not only will Empire not be allowed to earn a return on its investment in a timely manner, it will also not be able to pass on the expenses associated with the SCR to its customers. These expenses include annual property taxes of approximately $222,000 (Missouri jurisdictional). If Empire is required to meet Environmental Protection Agency mandated CAIR regulations, it is fair and logical that Empire's customers should pay for said adherence. (Mertens Rebuttal, p. 6)

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

Empire Witness: Mertens

Yes. Depreciation expense associated with the Asbury SCR equipment should be included in Empire's cost of service. There will be annual depreciation expenses of approximately $510,000 (Missouri jurisdictional) associated with the SCR equipment. If Empire is required to meet Environmental Protection Agency mandated CAIR regulations, it is fair and logical that Empire's customers should pay for said adherence. (Mertens Rebuttal, p. 6)

7. Commission Rules/Tracker: Should Empire's projected costs of compliance with the Commission's rules concerning vegetation management and infrastructure inspections be included in Empire's cost of service? If yes, should such costs be recovered using a "tracker mechanism" similar to that currently in place for Ameren UE? Should Empire be allowed deferral treatment of any incremental expenses it incurs above the amount reflected in its rates to comply with these rules?

Empire Witnesses: Keith, Palmer

Yes. Empire's projected costs of compliance with the Commission's rules should be included in Empire's cost of service, and Empire should be allowed deferral treatment of any incremental expenses it incurs above the amount reflected in its rates to comply with these rules.

The Commission has promulgated new vegetation management and infrastructure rules (Commission Rules 4 CSR 240-23.020 and 4 CSR 240-23.030). The final Orders of Rulemaking were published in the May 1, 2008, *Missouri Register*. The rules will become effective thirty (30) days thereafter. Empire believes that it will incur an additional $4 to $6 million per year to comply with the new vegetation management and infrastructure rules. (Keith Rebuttal, p. 11) The Commission rules provide that a utility may submit a request to the Commission regarding the deferral and tracking of the additional costs associated with the rule. (Keith Surrebuttal, p. 14) Empire has made just such a request in this case. The Staff has stated that "Empire taking immediate action to increase the scope of its tree trimming activities would be in the public interest." (Oligschlaeger Surrebuttal, pp. 23-24) If that is the goal, Empire should be provided the financial resources necessary to accomplish this.

Empire proposes that the annual expenditure target be initially set at $9.9 million on a total company basis. This equates to $8.9 million on a Missouri jurisdictional basis ($6.1 million for ongoing tree trimming and $2.8 million for vegetation and infrastructure management). (Keith Surrebuttal, p. 13)

Under Empire's proposal, if Missouri expenditures do not reach $8.9 million, then in the following year Empire would be required to spend $8.9 million plus the shortfall from the prior year, including an interest component calculated using the Company's short term interest rate. (Keith Surrebuttal, p. 13) If Missouri expenditures exceed $8.9 million, Empire proposes that it be authorized to record these costs as a regulatory asset so that they can be considered for recovery in Empire's next rate case. (Keith Surrebuttal, p. 14) No interest component would apply to this regulatory asset under Empire's proposal. (Keith Surrebuttal, p. 14)

> 8. Depreciation Rates: Should Empire's depreciation rates be subject to change during the duration of its Regulatory Plan? If yes, should Empire's proposed changes to its depreciation rates be adopted in this proceeding? Are Empire's record keeping practices regarding its plant assets and depreciation accounting adequate?

Empire Witnesses: Roff, Keith

Yes. Empire's depreciation rates should be subject to change during the duration of its Regulatory Plan, and Empire's proposed changes should be adopted in this proceeding. Further, Empire's record keeping practices regarding its plant assets and depreciation accounting are adequate.

The Staff asserts that no change should be made to existing depreciation rates because of the mistaken belief that Empire is already being compensated in the form of the regulatory amortization plan. The regulatory plan, however, is not related to the appropriate depreciation rates, but instead results in potential revenue adjustments as a function of helping Empire in maintaining certain financial ratios. The regulatory amortization will then reduce *future* plant in service when Iatan II and other environmental upgrades are placed in service. There is no link in the regulatory amortization plan to depreciation rates or to assets already in service. (Roff Rebuttal, pp. 6-7)

Donald Roff, President of Depreciation Specialty Resources, will present the results of a depreciation study that he conducted for Empire as of December 31, 2006. Application of his recommended depreciation rates to the December 31, 2006 depreciable balances results in an increase in annual depreciation expense of approximately $1.38 million. Two primary elements account for the increase in annual depreciation expense indicated by the study: (1) longer lives, which have the effect of decreasing annual depreciation expense; and (2) the effect of negative net salvage, which has the effect of increasing annual depreciation expense. (Roff Direct, pp. 1-3)

Mr. Roff conducted a thorough and complete depreciation study, consistent with the basis for Empire's existing depreciation rates. There is no reason to ignore the results of this study, which was accomplished within the periodic timeframe that has been Empire's practice. The results of this depreciation study should not be ignored simply because the regulatory amortization tool exists. Retaining the existing depreciation rates simply because of the regulatory amortization plan is inappropriate and has no basis in depreciation theory, practice or policy. (Roff Rebuttal, pp. 6-7)

The regulatory amortization calculation agreed to in Case No. EO-2005-0263 was not designed as a substitute for legitimate cost recovery. Instead, it was designed to address credit metric shortfalls during the construction of Iatan 2. Moreover, the Regulatory Amortization calculation is made after the determination of the traditional revenue requirement, and the development of ongoing depreciation rates for existing plant in service are a normal part of this process. In fact, the Commission's own rules require the filing of periodic depreciation studies. The use of regulatory amortization to recover costs that are part of the Company's traditional ongoing cost of service represents a mishandling of the funds coming from the Regulatory Plan. (Keith Surrebuttal, p. 16)

The Commission's order approving the stipulation and agreement in Case No. EO-2005-0263 states the following: "The Commission should review Empire's depreciation and amortization rates accordingly in Empire's future rate cases." As such, changes in depreciation rates and costs are not prohibited while the regulatory plan is in effect. There is no automatic amortization under the regulatory plan to compensate for an increase (or decrease) in depreciation rates, and the approval order states that the Commission should review Empire's depreciation rates in future cases. That is the intent of Empire's request for revised depreciation rates in this proceeding, and Empire's proposal should be adopted by the Commission. (Roff Surrebuttal, p. 3)

Mr. Roff recommends that Empire adopt the depreciation rates shown in Column 6 of Table 1 of Schedule DSR-3, based upon the fact that he conducted a comprehensive depreciation study, giving appropriate recognition to historical experience, recent trends, and Company expectations. His study results in a fair and reasonable level of depreciation expense which, when incorporated into a revenue stream, will provide Empire with adequate capital recovery until such time as a new depreciation study indicates the need for change. Mr. Roff also recommends that Empire implement "vintage amortization" accounting using the methodology described in his direct testimony and the rates shown in Table 1A. (Roff Direct, pp. 20-21)

Vintage amortization accounting eliminates the need for tracking thousands of small dollar items that are difficult to account for, and it provides an orderly process for retiring and amortizing these asset categories. It is believed that the following states have approved such an approach: Alabama, Georgia, Florida, Wisconsin, Hawaii, Arizona, Mississippi, Nevada, New Jersey, Oregon, Washington, Idaho, California, Utah, Wyoming, Montana, Oklahoma, Colorado, and Minnesota. (Roff Rebuttal, p. 6)

9. Other Project Costs: How should other project costs identified by OPC be accounted for in Empire's cost of service?

Empire Witness: Mertens

These charges should be capitalized as part of Empire's Iatan 2 and/or Plum Point base-load, coal-fired generation construction projects. These "other project costs" were part of

Empire's overall resource planning decision process which ultimately led to the decision to participate in the Iatan 2 and Plum Point projects. In Case No. ER-2006-0314, Kansas City Power & Light was allowed to capitalize "Certain Costs" that were required in the due diligence process related to Iatan 2 (*see* page 57 of Report and Order dated December 21, 2006). Empire requests similar treatment of these charges instead of including them as normal ongoing operating expenses. (Mertens Rebuttal, pp. 7-8)

In Public Counsel witness Robertson's direct testimony (page 3), he refers to expenses that the Company "wrote off to an expense account totaling $531,467.10 which pertain to the Sand Sage project and the Asbury feasibility/cost estimation study". These costs are related to investigation and due diligence costs for base-load, coal fired generation projects that Empire did not ultimately proceed with at this time because of participation in the Iatan 2 and Plum Point coal-fired generation projects. On page 7 of Mr. Robertson's testimony, he states "Public Counsel believes that the costs associated with the cancelled projects should not be recovered from ratepayers as proposed by the utility. These costs are not representative of normal ongoing operating expenses. . . . However, since the projects were cancelled, and no used and useful investment to rate base actually occurred, the costs should be disallowed."

Empire agrees that these costs are associated with the development of potential future investment, but the Company does not agree that these costs should not be recovered from ratepayers. These project costs were necessary and required as part of the Company's prudent and thorough investigation into possible base-load generation resource alternatives. Empire has a duty to its customers to serve them in the most economical and reliable manner. In order to meet this obligation, from time to time Empire must expend money to develop or research projects that may ultimately not move forward to completion. (Mertens Rebuttal, pp. 6-7)

On pages 4 to 5 of Public Counsel witness Robertson's surrebuttal testimony, he restates Public Counsel's position on these specific projects in the following manner: "In this instance, Public Counsel agrees with Company that the costs at issue were incurred to facilitate its overall integrated resource planning and ultimately its decision to participate in new coalfired generation construction projects. These costs should not be included as normal ongoing operating expenses, but Public Counsel would not oppose capitalization of the costs to Company's Iatan 2 project."

II. REGULATORY PLAN AMORTIZATION

1. Ice Storm Costs: Should the expense amortization of the January 2007 and December 2007 ice storm costs be reflected in the regulatory plan amortization calculation? Has Empire raised this issue out of time?

Empire Witness: Sager (Surrebuttal, pp. 1-3)

In its April 23, 2008, *Order Approving Stipulation and Agreement as to Certain Issues*, the Commission approved a non-unanimous stipulation and agreement wherein the signatory parties agreed that, for ratemaking purposes, all expenses that Empire prudently incurred to repair damage caused by severe ice storms in January and December 2007 would be amortized over a five-year period and recovered through rates. The parties further agreed that Empire will be deemed to have begun amortization of its January 2007 expenses in February 2007 and its December 2007 expenses in January 2008.

Two issues regarding the amortization of the ice storm expenses remain: 1) Should the amortization of the ice storm expenses be reflected in the Company's regulatory amortization? and 2) Has Empire timely raised this issue?

Regarding the first remaining issue, it is difficult for Empire to respond to Staff's proposal to include the amortization of the 2007 ice storm costs in the calculation of the regulatory plan amortization because, as noted below, Staff has not filed any testimony explaining why it believes its proposal is appropriate. The Stipulation and Agreement that the Commission approved in Case No. EO-2005-0263, which includes the terms of Empire's regulatory plan, has a section entitled "Amortizations to Maintain Financial Ratios," but that section has nothing to do with amortizations of normal operating expenses for ratemaking purposes, which is what the Commission has approved for the 2007 ice storms. Indeed, the amortizations contemplated by that section of the regulatory plan were intended to provide revenue to supplement Empire's revenue requirement, not replace it. In contrast, the recovery, through amortization, of the ice storm expenses is merely a direct recovery of costs that Empire incurred to repair its system and restore service to customers. As such, those costs would be considered part of the Company's revenue requirement in this case. The costs are being amortized over five years because extraordinary operating costs, like storm costs, need to be normalized for ratemaking purposes and amortization is a method routinely used for that purpose. The amortization of the storm costs never was intended or designed to produce supplemental revenue necessary to help Empire maintain its credit rating.

As for the issue of timeliness, Staff did not file <u>any</u> testimony on this issue. Moreover, the "Non-Unanimous Stipulation and Agreement as to Certain Issues," which was filed on April 4, 2008, is silent on the issue because the question of whether the ice storm amortization should be included in the regulatory plan calculation never was raised during the negotiation of that agreement. In fact, Empire first became aware of Staff's proposal during a telephone conversation with Staff the day before surrebuttal testimony was due to be filed. Because that telephone conversation did not occur until after the Company had pre-filed its rebuttal testimony in this case, Empire's first opportunity to address this issue was in its pre-filed surrebuttal testimony.

It would be fundamentally unfair, and contrary to basic principles of due process, to deny Empire the right to contest this issue when Staff has failed to put the Company on notice that an issue existed. The Commission should note that Staff's case on direct in this proceeding consists of a voluminous collection of accounting and other schedules, which are designated "Staff Report – Cost of Service," and but twelve pages of direct testimony, which merely describes, at a very high level, the various parts of Staff's report. No where in the report or in the supporting testimony – or in the rebuttal or surrebuttal testimonies that were filed subsequently – does Staff state that it intends to include the amortization of ice storm costs in the calculation of the regulatory plan amortization. Had Empire known of Staff's position prior to the filing of the Company's rebuttal testimony, the issue would have been addressed there. But Staff has never explicitly stated its position on this issue in any testimony in this case. Under such circumstances, the Commission should not punish Empire by refusing to allow the Company to contest Staff's proposal.

2. Purchased Power Agreement: Using a spreadsheet format agreed to by the Company, Staff and OPC, should the regulatory plan amortization be calculated using 2007 purchased power agreement (PPA) debt equivalent or 2008 PPA debt equivalent? Should the depreciation factor on purchased power agreements be reflected in the regulatory plan amortization calculation?

Empire Witness: Sager (Direct, pp. 1-3; Rebuttal, pp. 1-4; and Surrebuttal, pp. 1-3)

Empire believes that the 2007 purchased power agreement debt equivalent should be used in the calculation of the regulatory plan amortization in this case because that equivalent most closely aligns with the test year and true-up period utilized in this case.

The purpose of the regulatory plan amortization is to determine whether rate relief calculated under traditional methods must be supplemented in order to allow the Company's securities to continue to be rated investment grade. At least one of the parties to this case contends that Standard & Poors ("S&P"), one of the agencies who rate Empire's debt securities, includes an implied depreciation component related to purchased power agreements in its calculation of Funds From Operation (FFO). Past S&P reports specific to Empire do not support this contention, and unless conclusive proof can be submitted to the Commission that S&P has changed Empire's ratios, a depreciation factor should not be included in the regulatory plan calculation that is made in this case.

III. FUEL COST RECOVERY

1. Fuel Adjustment Clause: Should the Commission authorize Empire to use a fuel and purchased power recovery mechanism as authorized by law?

Empire's Witnesses: Gipson (Direct, pp. 5-6); Keith (Direct, pp. 21-36; Rebuttal, pp. 2-8; Surrebuttal, pp. 2-9); Overcast (Direct, pp. 1-39; Rebuttal, pp. 1-14; Surrebuttal, pp. 1-12))

Empire is asking the Commission to approve in this case rate schedules that authorize periodic adjustments to the Company's rates outside of general rate proceedings to reflect fluctuations in the actual, prudently-incurred costs of fuel and purchased power that Empire incurs above or below the level of those costs that are included in base rates. The adjustment mechanism proposed by Empire – which all parties refer to in testimony as the "fuel adjustment clause" ("FAC") – is authorized by Section 386.266, RSMo (2006 Supp.), which was enacted by the Missouri General Assembly in 2005. The purpose of that legislation was to address problems associated with fluctuating, but upwardly-trending, fuel and purchased power costs and the inability of traditional modes of utility ratemaking to adequately deal with those problems.

Since the 1979 decision of the Missouri Supreme Court in *State ex rel. Util. Consumers Council of Missouri, Inc., v. Pub. Serv. Comm'n.*, 585 S.W.2d 41, the Commission was prohibited from authorizing electric utilities in Missouri to adjust their rates between general rate cases to reflect energy cost fluctuations; however, the enactment of Section 386.266 changed all that and allowed this state to re-join the mainstream wherein federal and state regulators have found automatic cost recovery mechanisms to be a tool that is both useful and necessary in fulfilling their legal obligation to set rates that allow electric utilities, like Empire, to have a reasonable opportunity both to recover their prudently-incurred operating costs and to earn a fair rate of return.

Fuel and purchased power costs constitute the largest, single element of Empire's cost of service, totaling approximately 38 percent of test year operating costs in this case, so it is easy to understand that even small changes in a cost category this large can significantly affect funds available to provide the Company the return on investment to which it is entitled by law. Empire's recent history clearly has shown that traditional regulatory modes for recovering energy costs have failed to keep pace with the Company's ever-increasing costs of fuel and purchased power. Adoption of an FAC, like the one proposed by Empire, is the only way for the Commission to avoid repeating those failures in the future.

A. Is Empire barred by the terms of the Stipulation and Agreement in Case No. ER-2004-0570 from requesting a fuel adjustment clause while an interim energy charge is pending?

Empire believes this is a false issue that cannot lawfully be raised in this case. In its December 2006 *Report and Order* in Case No. ER-2006-0315, the Commission terminated the Interim Energy Charge ("IEC") that had been implemented pursuant to a stipulation and agreement reached in Case No. ER-2004-0570. Although the Commission's December 2006 *Report and Order* currently is on appeal, that order is lawful and reasonable and remains in full force and effect unless and until it is found to be otherwise by an appellate court. Section 386.270, RSMo; *State ex rel. Public Counsel v. Pub. Serv. Comm'n.*, 210 S.W.3d 344, 360 (Mo. App. 2006)(*rehearing and/or transfer denied*). Moreover, "[i]n all collateral actions or proceedings the orders and decisions of the commission which have become final shall be conclusive." Section 386.550, RSMo. *See, also, State ex rel. City of St. Louis v. Pub. Serv. Comm'n, 47 S.W.2d 102 (*Mo. 1932)(proceeding to fix rates is a collateral proceeding). Because, the Commission's prior order terminating Empire's IEC remains in effect and because that order clearly is collateral to the issue of whether the Company is barred from requesting an FAC, this issue should not be considered by the Commission in this case.

B. If the Commission authorizes Empire to use a fuel adjustment clause (FAC), how should it be structured?

Empire's Witnesses: Keith (Direct, pp. 21-36; Rebuttal, pp. 2-8; Surrebuttal, pp. 2-9); Overcast (Direct, pp. 1-39; Rebuttal, pp. 1-14; Surrebuttal, pp. 1-12).

In Case No. ER-2007-0004, which was decided in May 2007, the Commission approved an FAC for Aquila, Inc. This was the first – and to date only – FAC approved by the Commission since the enactment of Section 386.266, RSMo (2006 Supp.). Empire has closely modeled its proposed FAC on the clause the Commission previously approved for Aquila. The main features of Empire's proposed FAC are as follows:

- Future changes in FAC-related charges will be based on 95 percent of the difference between the cost of fuel and purchased power that is built into base rates and the cost of fuel and purchased power that the Company actually incurs during each accumulation period;

- Fuel and purchased power cost changes (both increases and decreases) will be based upon Empire's actual, Missouri jurisdictional historical costs recorded in FERC accounts 501, 547, and 555; the costs/benefits associated with the Company's hedging programs; and any emission allowance costs (SO_2) that are recovered by Empire and recorded in FERC account 509;

- Costs recovered through the FAC will exclude capacity charges associated with purchased power contracts;

- Only two changes to FAC-related rates, to reflect net over/under recoveries of energy costs, will be made each year: one in June and one in December;

- Over/under recoveries of Missouri jurisdictional energy costs will be recorded on the Company's books in appropriate FERC accounts using an asset/liability account to track over/under recoveries on the balance sheet and also in an offsetting expense account to reflect over/under recoveries on the income statement. This process will provide an audit trail that will be useful during the periodic prudence reviews required under the Commission's rules; and

- Prudence reviews, to ensure that only prudently-incurred costs are included in Empire's FAC-related rates, will be held at least once every 18 months.

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

Empire's witnesses: Keith (Direct, pp. 21-36; Rebuttal, pp. 2-8; Surrebuttal, pp. 2-9); Overcast (Direct, pp. 1-39; Rebuttal, pp. 1-14; Surrebuttal, pp. 1-12)

Empire proposes that 95 percent of any future increases in fuel and purchased power costs above the level included in base rates be recovered from customers. Correspondingly, if future energy costs are less than is included in base rates, 95 percent of the Company's savings will be returned to customers.

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

Empire's witnesses: Keith (Direct, pp. 21-36; Rebuttal, pp. 2-8; Surrebuttal, pp. 2-9); Overcast (Direct, pp. 1-39; Rebuttal, pp. 1-14; Surrebuttal, pp. 1-12)

Empire proposes to recover through the FAC all Missouri-jurisdictional changes (both increases and decreases) from the cost levels included in base rates for the following FERC accounts: 501, 509, 547, and 555. These costs include, but are not limited to, various unit train, fuel handling, natural gas transportation costs, and emission allowances.

The Company does not propose to include to flow through its proposed FAC any costs or revenues associated with off-system energy sales.

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

Empire's witnesses: Keith (Direct, pp. 21-36); Mertens (Surrebuttal, pp. 5-6)

Empire, in cooperation with Staff, has developed detailed heat-rate testing procedures for each of its generating units that the Company believes comply with the requirements of 4 CSR 240-3.161(2)(P). Empire has been working diligently with Staff to develop mutually acceptable procedures. Significant progress has been made over the past several months to reach consensus; however, at the time of surrebuttal filings in this case procedures for Riverton Units 7 and 8 had not been developed to the satisfaction of both parties, mainly due to the special considerations that had to be accounted for due to the age of the units. The Company will continue to work with Staff to develop mutually satisfactory procedures and will submit those procedures for approval by the Commission when the procedures for all the units are complete.

d. What rate design should be applied to FAC charges?

1. Should the base cost of fuel be determined by season?
2. How should the actual $/kWh cost of fuel and purchased power energy be determined?
3. How should the Cost Adjustment Factor be determined?

Empire witnesses: Keith (Direct, pp. 21-36; Rebuttal, pp. 2-8; Surrebuttal, pp. 2-9)

Empire does not believe that the base cost of fuel should be determined by season. Although the cost of fuel can vary season to season, historically that variance has been extremely small; on average, fuel costs in summer are approximately $3 per Mwh greater than in winter. This difference – which amounts to approximately 2.7% of an average summer electric bill – is insignificant and does not warrant a requirement that base fuel costs be calculated seasonally for purposes of an FAC.

The Company's proposed methods for determining the actual cost per Kwh for fuel and purchased power and then converting those costs to a Cost Adjustment Factor are spelled out in the proposed tariff sheets (Schedule WSK-3) that accompany the pre-filed direct testimony of W. Scott Keith. As proposed by Empire, The actual cost of fuel, purchased power, and allowances (FERC accounts 501, 547, 555, and 509) for the Missouri retail jurisdiction will be accumulated over a six-month period. The actual recovery of fuel, purchased power and emission costs in base rates will be determined by multiplying the amount of fuel costs included in base rates ($0.03075/Kwh) by actual Missouri jurisdictional sales during each six-month accumulation period. The difference between energy cost and energy cost recovery during each accumulation period will then be multiplied by 95 percent to arrive at the amount of over/under recovery of energy costs. Any over/under recovery will then be divided by the Missouri jurisdictional sales during the accumulation to arrive at the average cost of under/over recovery per Kwh. The expansion factors (e.g., 1.01 and .98) are then applied to arrive at the average cost per Kwh that will be applied to a secondary customer bill or to the bill of a customer that is served at primary and higher voltage. In subsequent accumulation periods the calculation will also take into account a "true-up" of any under/over recovery from prior accumulation periods.

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

Empire believes a requirement for a periodic review of the prudence of fuel and purchased power costs is the only incentive mechanism that needs to be included in any FAC approved by the Commission in this case. Such periodic reviews are required by both Section 286.266.4(4), RSMo (2006 Supp.) and the Commission's FAC rules, and the FAC proposed by the Company in this case includes a requirement for prudence reviews no less frequently than once every eighteen months. These periodic reviews will ensure that only prudently-incurred costs are passed on to customers. Any costs that are determined not to have been prudently-incurred will be subject to refund with interest.

Several parties to this case have proposed what they allege are incentive mechanisms. In reality, however, these mechanisms merely cap the amount of prudently-incurred energy costs that Empire can recover from its customers, leaving the balance of such costs to be paid for by the Company's shareholders. As such, these are not incentive mechanisms but are, instead, nothing more than loss-mitigation mechanisms that, in times of increasing energy costs ensure that Empire will be required to provide electric service to its customers at levels that are below cost. Empire believes such a result is contrary to what the General Assembly had in mind when it empowered the Commission approve FACs.

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

Empire's witnesses: Keith (Direct, pp. 21-36; Rebuttal, pp. 2-8; Surrebuttal pp. 2-9); Overcast (Direct, pp. 1-39; Rebuttal, pp. 1-14; Surrebuttal, pp. 1-12)

The Company did not propose that any costs or revenues associated with off-system energy sales be included in any FAC that is authorized by the Commission in this case. The Company, however, is not opposed to including these off-system costs and revenues in the FAC if these components are included when the FAC is determined.

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

Empire's witnesses: Keith (Direct, pp. 21-36; Rebuttal, pp. 2-8; Surrebuttal, pp. 2-9); Overcast (Direct, pp. 1-39; Rebuttal, pp. 1-14; Surrebuttal, pp. 1-12); Mertens (Direct, pp. 6-9; Surrebuttal, pp. 5-6)

Empire proposes to flow through the FAC amounts recorded in FERC account 509. Emission allowance revenue may be generated and sold from the Asbury SCR unit; however, the revenue associated with this unit should not flow through the FAC until the costs associated with the Asbury SCR are included in rates. Allowing these costs in rates will allow Empire to recover from its customers both a return of and a return on the investment associated with the Asbury SCR. Excluding those costs from this case and, instead, deferring their recovery to a future time violates the "matching principle," which requires that investment, revenue, and expense be matched as closely as possible for ratemaking purposes. In addition, it would produce a result that is fundamentally unfair by allowing ratepayers to benefit from assets without paying the costs of those assets. If the Commission does not include the costs of the Asbury SCR in the cost of service used to set rates in this case, the revenue for emission allowances associated with that unit should not flow through the FAC.

2. <u>Fuel and Purchased Power Expense:</u> Should Empire's recovery of fuel and purchased power expense be based upon its current adjusted expense levels, or on the rate allowance for this item ordered by the Commission in Case No. ER-2004-0570?

Empire Witness: Keith

Empire believes this is a false issue that cannot lawfully be raised in this case.

The fuel and purchased power costs that the Commission uses to set rates in this case should be based on Empire's current, adjusted levels of those costs and <u>not</u> on cost allowances ordered by the Commission in Case No. ER-2004-0570. The cost allowances in that case were based on a Stipulation and Agreement restricted Empire's recovery of certain fuel and purchased power costs; however, in the Company's last general rate case, Case No. ER-2006-0315, the Commission terminated those restrictions. At pages 43-44 of its December 2007 *Report and Order* in Case No. ER-2006-0315, the Commission found that the fuel and purchased power costs allowed in Case No. ER-2004-0570 "[do] not allow sufficient recovery of Empire's prudently incurred fuel and purchased power costs . . .." The Commission explained the rationale for its finding as follows:

> This Commission has the duty to ensure that rates are just and reasonable in a manner that will allow a utility to adequately recover its costs . . . This Commission cannot abrogate its duty to both the utility and its customers simply because some of the parties have previously reached a Stipulation and Agreement that addresses the issue of fuel costs to the serious detriment of the utility. Give our statutory mandate, the Commission must ignore the Stipulation and Agreement as it pertains to fuel cost recovery, and set rates that are just and reasonable and that may better ensure Empire's solvency and its ability to provide safe and adequate service to its customers.

Id. at p. 43.

IV. NON-REVENUE REQUIREMENT

1. Pensions/OPEBs Special Events: Should Empire's prior stipulations concerning its pension and OPEB expenses be modified to reflect Empire's proposed language regarding the possible occurrence of certain "special events" in the future?

Empire Witnesses: Delano, Vogl

Yes. Empire's prior stipulations concerning its pension and OPEB expenses should be modified to reflect Empire's proposed language regarding the possible occurrence of certain "special events" in the future.

Empire currently utilizes a tracking mechanism for both Financial Accounting Standard (FAS) 87 costs (pension expense) and FAS 106 costs (other post retirement benefits (OPEB)) costs. (Delano Direct, p. 2) These tracking mechanisms resulted from Commission orders in Case Nos. ER-2004-0570 and ER-2006-0315. Empire is requesting a modification to the current methodology to ensure that any one-time charges or credits recognized in accordance with FAS 88 and FAS 106 are properly reflected in rates. (Delano Direct, pp. 4-5) The Company is also requesting modifications to provide additional funding flexibility to enable the Company to avoid benefit restrictions due to certain provisions of the Pension Protection Act of 2006. (Delano Direct, p. 5)

The language proposed by Empire is found in Schedule CKV-1, attached to the pre-filed rebuttal testimony of C. Kenneth Vogl. Staff agrees with the language proposed by Empire and points out that similar language has been approved by the Commission for AmerenUE and Laclede as the result of stipulations (Eaves Surrebuttal, p. 5) Staff further suggests one addition to Empire's language in order to provide notice of any special events that would trigger the new provisions. (Eaves Surrebuttal, p. 5) Empire finds this Staff addition to be acceptable.

2. Energy Efficiency Programs: Should the Missouri Department of Natural Resources' recommendations concerning Empire's interaction and involvement with the Customer Program Collaborative be adopted?

Empire Witness: McCormack

Empire has received Commission authorization to implement six demand side programs – four for residential customers and two for commercial and industrial customers. Two additional programs requiring more than one utility for successful implementation are in the development process. (McCormack Rebuttal, p. 3) Empire continues to work with its customer programs collaborative (CPC) to discuss and seek approval of demand side management programs. All members of the CPC, to include the Missouri Department of Natural Resources (MDNR) may propose additional demand side management programs to the CPC for consideration (McCormack Rebuttal, p. 5)

Empire has recently filed a Unanimous Stipulation and Agreement in its integrated resource planning (IRP) case (Case No. EO-2008-0069). This stipulation is designed to address those "deficiencies" that have been identified by the parties to that case. Empire is unaware of any remaining disputes in the IRP case. Empire finds to be acceptable the MDNR's recommendation that Empire meet with the CPC at least quarterly, as well as MDNR's recommendation that Empire provide interim e-mailed updates to the CPC members. Empire does not take a position as to the remainder of the MDNR recommendations.

3. <u>Low Income Assistance Program:</u> Should Empire's Experimental Low-Income Program (ELIP) be continued with changes? If so, what should those changes be? What should be done with unspent ELIP funds? Should interest be paid to customers on the unspent funds? If yes, how should the interest be calculated?

Empire Witness: McCormack

Yes. Empire's ELIP program should be continued, but only with modification. Several changes were made as a result of the Commission's Order in Case No. ER-2006-0315. However, customer participation has continued to be much lower than the Commission's authorized funding level of $300,000, and funds, both customer and shareholder, continue to go unused. (McCormack Direct, p. 8) Accordingly, Empire proposes that additional changes to the program be ordered in this case. Empire recommends the following:

1. Refund one-half of the balance of unused ELIP funds (customer portion) as of the effective date of the rates in this case as a one time credit to customer bills during one billing cycle (one month);

2. Use the remaining balance of unused ELIP funds (shareholder portion) as of the effective date of the rates in this rate case as follows:

a. The shareholder funds will be used to support the actual ELIP expenditures until the new rates are implemented in the Iatan 2 rate case;

b. The remaining balance of the shareholder ELIP funds, whether it is a plus or minus, at the time of the Iatan 2 rate order will be used as an offset to the customer programs collaborative (CPC) approved regulatory asset balance and taken into account in the DSM amortization level coming out of the Iatan 2 rate case;

c. An evaluation of the ELIP will be completed prior to the filing of the Iatan 2 rate case with the cost of the evaluation paid using the ELIP shareholder funds;

3. In Case No. ER-2008-0093, ELIP costs will be set at zero in the Missouri jurisdictional cost of service, and shareholder funding of the ELIP will be set at zero; and,

> 4. The ELIP tariff will be modified in Case No. ER-2008-0093 to reflect changes in customer and shareholder funding levels, and specify that the ELIP will terminate as of the effective date of the new tariffs coming out of the Iatan 2 rate case, unless otherwise authorized by the Commission.

(McCormack Rebuttal, pp. 5-6)

Empire believes that interest should be paid on the unused customer supplied funds at the rate specified in the Credit Action Fees Schedule CA tariff (one percentage point over the *Wall Street Journal* published prime rate on the last business day of the prior year). Empire proposes to calculate simple interest beginning January 1, 2007, as the tariffs in effect prior to January 1, 2007, excluded interest. (McCormack Surrebuttal, p. 2)

4. <u>Distribution Facilities Demand Charge</u>: How should the facilities demand charge be calculated during the initial period of its implementation?

Empire Witness: Overcast

Staff has proposed a rate design change related to the implementation of a facilities charge, and this proposal is not opposed by the Company. Through the testimony of H. Edwin Overcast, the Company will explain that it supports the use of a facilities charge as part of its rates applicable to demand billed customers as proposed by the Staff *so long as* the implementation of the proposal does not cause a revenue shortfall during the Rate Effective Period.

5. Should the employee purchase plan be terminated?

Empire Witness: McCormack

Yes. As will be presented through the testimony of Sherrill McCormack, a Planning Analyst with Empire, the Company is planning to discontinue the Employee Purchase Plan upon approval of the revised tariffs in this rate case. The cost of this program is not reflected in the rates charged to Empire's Missouri customers, and fewer than 20 employees have used this program annually since January 2005. The funding requested by Empire's employees has been less than $35,000 annually during the same time period. (McCormack Direct, p. 11)

6. Should the changes to wording of the GP tariff be allowed to reference the rider XC verbiage?

Empire Witness: Long

Yes. Changes to the wording of the GP tariff should be allowed to reference the rider XC verbiage. In addition to tariff changes stemming from the proposed rate increase and authorization of an FAC, Empire is proposing four other tariff changes: (1) a change in the General Power Service Schedule GP referencing the excess facilities charge, (2) a change to Chapter III, Section D of the Rules and Regulations, (3) the addition of a late payment fee for the Special Transmission Service Contract: Praxair Schedule SC-P, and (4) a change in the late payment fees for Schedules Large Power LP, General Power GP and Total Electric Building TEB.

The General Power Service Schedule GP tariff, unlike the other tariffs, does not reference the application of the Rider XC. To be consistent among pricing plans, Empire, through its witness Jayna Long, is proposing the following verbiage be added as a new Conditions of Service: "Where the customer's use of welding, or other equipment characterized by fluctuating or severe demands, or the need for multiple or oversized transformers, necessitates the installation of additional or increased facilities (including distribution transformers, service conductors or secondaries) solely to serve such customer, the applicable provisions of Rider XC will apply in amendment to the provisions of this schedule." (Long Direct, pp. 10-11)

7. Should a change in the rules and regulations be amended to remove liability associated with loss of phase on Empire's transmission and distribution facilities that is related to factors beyond the Company's control?

Empire Witness: Long

Yes. A change in the rules and regulations should be made to remove liability associated with "loss of phase" on Empire's transmission and distribution facilities related to factors beyond Empire's control.

With regard to Chapter III – Service Specifications, Empire is requesting the addition of a 3rd item to Section D. Power Supply: "For any poly-phase services, the Customer is responsible for protecting motors and other equipment from damage in case of a single phasing condition on the Company's distribution and/or transmission systems. This removes Empire from any liability associated with "loss of phase" on the Company's distribution and/or transmission systems caused by weather, accidents, or other factors beyond the Company's control." (Long Direct, p. 11) As noted, this would relieve Empire of liability associated with factors wholly outside of its control.

8. Should a late payment fee be added to tariff SC-P?

Empire Witness: Long

Yes. A late payment fee should be added to tariff SC-P. Through its witness Jayna Long, Empire's proposes to add a late payment fee to the Special Transmission Service Contract: Praxair, Schedule SC-P. Unlike the Company's other rate schedules, this tariff currently does not include a late payment fee. Empire is requesting that the following paragraph be added to the tariff to provide consistency among rate schedules: "PAYMENT: The above rate applies only if the bill is paid on or before fifteen (15) days after the date thereof. If not so paid, the above rate plus 5% then applies. (Long Direct, pp. 11-12)

9. Should the method used to calculate late fees for LP, GP & TEB be changed?

Empire Witness: Long

Yes. The method used to calculate late fees for the LP, GP, and TEB schedules should be changed. Empire witness Jayna Long will provide testimony regarding changes in the late payment fee for the following three schedules: Large Power LP, General Power GP, and Total Electric Power TEB. Empire requests that the late payment fees for these rates be structured and charged the same percent (5 %) as the Commercial CB and Small Heating SH schedules. (Long Direct, p. 12)

Respectfully submitted,

Brydon, Swearengen & England P.C.

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Certificate of Service

I hereby certify that the foregoing has been sent by United States mail, hand-delivered, or transmitted by facsimile or electronic mail to all counsel of record on the 6th day of May, 2008.

/s/ Diana C. Carter