Exhibit No.:
Issue: *Off-System Sales, Fuel, Unwinding of Forward Natural Gas Contracts*
Witness: *Janis E. Fischer*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Surrebuttal Testimony*
Case No.: *ER-2006-0315*
Date Testimony Prepared: *August18, 2006*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

JANIS E. FISCHER

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2006-0315

Jefferson City, Missouri
August 2006

**** <u>Denotes Highly Confidential Information</u> ****

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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-2006-0315

AFFIDAVIT OF JANIS E. FISCHER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Janis E. Fischer, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 20 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Janis E. Fischer

Janis E. Fischer

Subscribed and sworn to before me this 17th day of August, 2006.

Toni Charlton

TONI M. CHARLTON NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

TONI M. CHARLTON
Notary Public - State of Missouri
My Commission Expires December 28, 2008
Cole County
Commission #04474301

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JANIS E. FISCHER

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2006-0315

Q. Please state your name and business address.

A. Janis E. Fischer, Governor Office Building, P. O. Box 360, Jefferson City, Missouri 65102.

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

A. I am a Utility Policy Analyst with the Missouri Public Service Commission (Commission or PSC). In this position I advise the Commission on the impact on Missouri of filings at the Federal Energy Regulatory Commission (FERC). I will also participate in cases involving natural gas pipelines before the FERC on behalf of the Commission. Prior to July 26, 2006 I was a Regulatory Auditor with the Commission.

Q. Are you the same Janis E. Fischer who has previously filed direct and rebuttal testimony in Case No. ER-2006-0315?

A. Yes.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of this surrebuttal testimony is to respond to the rebuttal testimony of The Empire District Electric Company (Empire or Company) witness Todd W. Tarter with regard to fuel costs. I will also respond to the rebuttal testimony of Company witness W. Scott Keith with regard to Empire's position on the treatment of the gain on the unwinding of natural gas hedge positions and off-system sales.

EXECUTIVE SUMMARY

Q. Please summarize your surrebuttal testimony.

A. My surrebuttal testimony provides the Staff's comments in response to rebuttal testimony filed in this case. In more specific terms, this testimony addresses:

- Comments of Empire witness Keith which imply that the Staff's use of the update period in this case to establish a normalized level off-system sales margins is inconsistent with the Staff's historical normalization methods and that the Staff picks and chooses its normalized off-system sales margin based upon the highest margin level. The Staff disagrees with both of these claims and provides documentation to refute these accusations.
- Comments of Empire witness Tarter in opposition of the Staff's methodology used to calculate a normalized natural gas price. The Staff provides arguments to support its position of applying an eighty percent hedged and twenty percent spot price level in calculating a normalized weighted natural gas price.
- Comments of Empire witness Keith in opposition of the Staff's amortization of the gain realized from the unwinding of forward natural gas contracts. The Staff provides support for its position to amortize the approximate $5.2 million gain over five years and refutes Empire's position.

OFF-SYSTEM SALES POSITIONS

Q. What are the parties' positions on treatment of off-system sales in this proceeding?

A. The Staff's position is that Empire's off-system sales level incorporating the update period in this case (the twelve months ending March 31, 2006) is representative of an appropriate level of off-system sales on an ongoing basis. Empire is recommending a five-year average of off-system sales to normalize off-system sales margin, after certain American Electric Power (AEP) transactions are eliminated from the average. OPC's proposed adjustment is based on a five-year normalization of off-system sales margins, without adjustment for the AEP transactions. OPC's position is that a five-year average off-system sales margin is most appropriate with the AEP transactions included in the off-system sales.

Q. How did Empire witness Keith characterize the Staff's position on this issue in his rebuttal testimony?

A. He accuses the Staff of being inconsistent in its treatment of off-system sales, in comparison with positions allegedly taken by the Staff in previous Empire rate cases. Beginning on page 9, line 15 through page 10, lines 1-4 of his rebuttal testimony, Mr. Keith states the following:

> The Staff has taken a position in this rate case that is inconsistent with the past rate treatment given this issue. Jumping back and forth between the use of a five-year average and using the current year depending on which yields a higher revenue amount is unfair and is only designed to artificially lower rates for the customer, not produce a fair or consistent result.

Q. Do you agree with Mr. Keith's statements?

A. No, Mr. Keith is incorrect in how he characterizes the Staff's positions on the issue of off-system sales in past Empire cases. Review of the Staff's position in past rate proceedings demonstrates that the Staff has not always used a five-year average for purposes of recommending an appropriate level of off-system sales to reflect in rates.

The Staff's analysis of off-system sales typically includes a review of monthly data related to off-system sales revenues, costs and margin over a period of years, usually at least five years. The intention of this analysis is to determine the most appropriate off-system sales margin level to include in calculating the cost of service. The most appropriate off-system sales margin level is the level that will be most representative of an off-systems margin occurring at the time the rates determined from the current rate case go into effect. The Staff uses similar multiple year analyses to normalize many utility costs. Over the last ten years and four preceding Empire rate cases, the Staff determined that the use of a five-year average of off-system sales margins was appropriate only in the most recent Empire case, Case No. ER-2004-0570.

Q. How did the Staff witness John P. Cassidy explain the Staff's off-system sales adjustment in Case No. ER-2004-0570?

A. Staff witness Cassidy included two questions and answers related to off-system sales in his direct testimony. One answer described the nature of off-system sales and the other provided an explanation of why it is appropriate to include off-system sales in the revenue requirement determination. Mr. Cassidy went on to explain that an adjustment to normalize off-system sales was consistent with the adjustments made by the Company and the Staff in previous rate cases. He did not characterize use of a five-year average to normalize off-system sales as being the Staff's standard position on this issue. Staff witness Cassidy's second question and answer stated:

> Q. Why is it appropriate to include off-system sales in the current revenue requirement determination for the Company?
>
> A. The same generating facilities, equipment and personnel that are necessary to provide service to Missouri retail electric customers are also used to make off-system sales. It is appropriate to include the off-system sales in this case because Empire

> customers are already paying for all costs associated with these facilities in the production of electricity to meet their load. To the extent that other sales can be made using these facilities, the customers should benefit from these sales. Off-system sales represent an efficient utilization of the electric system that has been put in placed to meet the electricity needs of Empire's customers. Staff adjustment S-3.1 adjusts off-system sales revenue to a normalized level. This adjustment is consistent with the adjustment made by the Company and the Staff in previous rate cases.

Q. What type of adjustments did the Staff make to normalize off-system sales in the other three Empire rate cases that occurred over the last ten years?

A. A review of the Staff's off-system sales adjustments in prior Empire rate cases shows that off-system sales results for a twelve month period incorporating the update or true-up period in those cases was used as the appropriate normalized level of off-system sales. The test year level of off-system sales in each of those rate cases was adjusted by the Staff to incorporate the update or true-up period level of off-system sales. An update and/or true-up period is used in the rate case process to include economic changes affecting both revenues and expenses past the test year period in the determination of rates. In Case No. ER-2001-299, the Staff used the off-system sales amount for the twelve months ending June 30, 2001, the end of the true-up period for the case, in calculating revenue requirement. In Case No. ER-2002-424, the Staff used a twelve-month period incorporating the update period for the level of off-system sales in calculating the revenue requirement. In Case No. ER-97-81, the Staff made an adjustment to off-system sales to include in its revenue requirement the true-up period (twelve months ending July 31, 2001) level of off-system sales.

Q. Does the Staff perform a similar analysis of off-system sales in other utility company rate cases?

A. Yes. The Staff has also performed a multi-year analysis of off-system sales in many electric utility rate cases in Missouri. In some cases, this analysis has led the Staff to advocate off-system sales amounts based on actual results in a recent twelve-month period. In some cases, the analysis will lead the Staff to determine that the use of a multi-year average (usually five years) of off-system sales is more appropriate, though this approach is selected less frequently.

Q. Does the Staff, as Mr. Keith implies, choose a five-year average versus test year off-systems sales margin in a rate case based on which option yields a higher revenue amount in that particular case?

A. No. There are many reasons that lead to the Staff's choice of a test year and update period for a normalized level of off-system sales margin. The multiple year analysis takes into account off-system sales revenues, costs and margin along with fuel and purchased power prices. In the last Empire rate proceeding, Case No. ER-2004-0570 the Staff's decision to use a five-year average of off-system sales actually resulted in a negative adjustment to test year's off-system sales revenues. It is interesting to note that the AEP transactions included within the multi-year period analyzed in that case were included by both Empire and the Staff in calculating the five-year average off-system sales levels recommended for inclusion in revenue requirement.

Q. What factors led to the Staff's determination that use of the test year and update period levels in this rate case was the most appropriate basis for setting off-system sales margin?

A. Natural gas prices have increased along with purchased power prices during this period, affecting the overall cost of off-system sales. In addition, coal conservation efforts have reduced coal plant generation and/or have increased the electric generation cost per Kwh. Reduced coal generation in the interchange marketplace has led to greater value being placed on Empire's gas-fired units, and increased Empire's overall off-system sales margins. Refer to my rebuttal testimony in this case for further discussion on this point.

Off-system sales can be generally influenced by the same factors that influence a utility's overall level of fuel and purchased power costs. With the changes in the fuel and purchased power markets in the last five years, and in particular the pronounced increase in gas and purchased power costs, no party in this case is suggesting that use of multi-year averages is appropriate for determining the level of fuel expense in this proceeding. The Staff believes that this situation also suggests that use of a five-year average to develop the off-system sales allowance in rates would be ill-advised.

The other factor that the Staff considered in determining its approach to off-system sales in this proceeding was the impact of the AEP transactions in 2001 through 2003. These AEP transactions appear to skew Empire's off-system sales margins above a normalized level when included and below a normalized level when excluded in a five-year analysis. When considering all factors currently influencing off-system sales and the impact of the AEP transactions on the most current five years of data concerning off-system sales, use of Empire's actual off-system sales margin for the twelve months ended March 2006 appeared to be the most appropriate amount to include in Empire's revenue requirement.

Q. Will the Staff make a correction to its off-system sales margin adjustment presented in its direct testimony?

A. Yes. As indicated by Mr. Keith at page 10 of his rebuttal testimony, the Staff has determined it made an error in calculating the total off-system sales margin in the amount of $45,353. The impact of this correction will be included in the Staff's revenue requirement run.

FUEL

Q. What portions of Empire witness Tarter's rebuttal testimony are you responding to?

A. The Staff is responding to pages 3, line 10 to page 7, line 15 of Mr. Tarter's rebuttal testimony.

Q. What is the first point in Mr. Tarter's testimony you would like to address?

A. At page 5, lines 15-19 of his rebuttal testimony, Mr. Tarter indicates that the use by the Staff of actual spot natural gas prices in determining its weighted average gas price without normalizing for weather creates a "bias of the actual weather in that period."

Q. What is the Staff's response to Mr. Tarter's assertion?

A. Any time historical price information is used to develop natural gas prices for use in the ratemaking process, weather conditions during the historical periods examined will have an influence on the actual prices paid for natural gas. However, while it is true that weather does impact the cost of natural gas, there are a number of other factors that also affect the price of natural gas. The Staff is not aware of any way to definitively quantify the affect weather (cooling degree days and heating degree days) has on natural gas prices apart from all of the other factors that influence natural gas prices, such as the price of oil, storage levels, or weather phenomena not captured through the weather normalization process such as droughts and hurricanes. The weather normalization methodology used by the Staff in determining normalized revenue levels for Empire relies upon quantitative data collected to measure heating and cooling degree days at locations where Empire's customers reside. This type of weather normalization does not directly reflect the impact of rainfall amounts, hurricanes, floods and other weather related phenomena on Empire's customer usage, nor does the Staff attempt to measure impact of the heating and cooling degree days experienced throughout the Southern Star pipeline system (Empire's gas supplier). All of these other weather related phenomena impact the price of natural gas.

Q. Since historical gas price information can reflect the impact of weather conditions and other variables over time, would it be better to use forecasted gas price data in the ratemaking process to minimize the impact of weather?

A. No. As discussed in the rebuttal testimony of Staff witness Kwang Choe in this proceeding, the Staff does not believe that Empire's proposed use of NYMEX futures values for natural gas price purposes is appropriate. Dr. Choe's analysis demonstrates that NYMEX futures have not been an accurate predictor of actual natural gas prices over time. In fact, even NYMEX futures prices are affected by weather conditions and tend at times to reflect a weather bias. A weather bias could occur when current weather conditions such as droughts, heat waves or hurricanes, for example, temporarily increase the NYMEX futures prices because of a real or perceived supply shortage.

Given the Company's inability to forecast accurately natural gas prices in the future, recent historical gas price levels should be used in this proceeding for pricing of spot natural gas. The Staff believes its recommended spot gas price is reasonable for purposes of setting rates in this proceeding.

Q. What other statement in Mr. Tarter's rebuttal testimony related to weather normalization will you comment on?

A. Mr. Tarter, on page 6, lines 4-8 of his rebuttal testimony, states that the Staff's "exclusion" of January 2006 natural gas spot purchases from its weighted average natural gas spot price does not account for typically high January natural gas prices. He implies that the Staff's recommended price for spot natural gas purchases is too low, for this reason.

Q. What is the Staff's response to these statements?

A. The Staff's methodology in determining a weighted average price for natural gas spot purchases included all actual spot purchases that Empire entered into during the twelve months ending March 31, 2006. It is true that the Company did not make any spot purchases of natural gas in January 2006 as it normally might. However, this twelve-month period also incorporates natural gas spot purchase prices affected by Hurricanes Katrina and Rita in the late summer and fall of 2005. The effect of these hurricanes on natural gas spot purchase prices was to increase prices above a typical level for the months of September through at least January 2006.

By using historical information to set natural gas prices, the Staff has used pricing information that may be both higher and lower at times than hypothetical "weather normalized" gas prices. However, Mr. Tarter has chosen to focus only on that pricing data applicable to a brief period of time that he believes has led to a lower overall gas price than he believes to be reasonable. He has not demonstrated that Staff's overall natural gas price recommendation in this case is unreasonable on a going forward basis.

Q. What other sections of Mr. Tarter's rebuttal testimony are you responding to?

A. Mr. Tarter states on page 6, lines 12-21 that the Staff has made an incorrect assumption by imputing a natural gas hedged level of eighty percent in its calculation of natural gas costs and that this results in an artificially lower average cost of natural gas in the Staff's production cost model.

Q. Does the Staff agree with Mr. Tarter's comments?

A. No. Both the Company and the Staff have developed their natural gas pricing recommendations in this and recent cases by determining a representative cost for "hedged" gas and a representative price for "spot" gas. The question raised by Mr. Tarter is what is the appropriate weighting to give each of these components in determining an overall recommended gas price level. The Staff's position is that such weighting should be based upon Empire's actual historical relative usage of hedged vs. spot gas.

Q. What percentage of its gas usage did Empire assume to be hedged for purposes of this case?

A. As explained in Mr. Tarter's rebuttal testimony, Empire's proposed level of hedged natural gas costs in this case is based upon its actual hedges in place as of July 10, 2006 pertaining to Empire's projected 2007 gas usage. As of July 10, 2006, only 61% of Empire's projected gas usage for 2007 was hedged. Empire has assumed that the remaining 39% of its gas usage in 2007 should be valued at its recommended price for spot natural gas purchases, established using NYMEX futures prices.

Q. What is Empire's current policy on the percentage of hedged gas it intends to purchase?

A. As reflected in Tarter Direct Schedule 8, Empire's policy is to hedge a minimum of 60% of its natural gas purchases during a twelve-month period, up to a maximum of 80% hedging. By Empire's own admission, the Company has hedged its natural gas purchases at levels of **____** and above on a month-by-month basis in recent years. This is documented in the monthly Gas Position Summary Reports that were provided by Empire in response to Staff Data Request No. 199.

Empire stated the following in response to Staff Data Request No. 270, which asked what Empire's goal was for the percentage of gas usage to be hedged in calendar year 2006 and 2007:

> **____**

> [Emphasis added]

When gas prices are rising, Empire considers whether to increase its current hedge level from the minimum **____** level up to the **____** level. As the Company's current practice is to utilize up to the maximum level of hedged gas, the Staff has reflected that practice in its gas price recommendation in this case.

Q. For what period of time is the Staff basing its hedged price of natural gas in this proceeding?

A. The Staff is basing its hedged price recommendation on actual hedges in place at March 31, 2006, covering usage for the period April 2006 through December 2007.

Q. As of March 31, 2006, what percentage of Empire's projected natural gas usage for April 2006 to December 2007 was actually hedged?

A. Approximately **____**. Because there are 21 months between March 2006 and December 2007, the endpoint for the period examined by the Staff, Empire has the capability of making additional purchases of hedged gas to cover its gas requirements during this time period. Based upon its current practices and policies, the Staff expects that Empire will do so, at least up to 80% of its current gas purchases.

Q. What impact does the use of the eighty percent hedge level proposed by the Staff have on the weighted price of natural gas being proposed by the Staff and Empire?

A. The Staff has calculated gas costs based upon weighted actual Empire gas hedge prices for the twenty-one months ending December 2007 and spot prices for the twelve months ending March 31, 2006, applying the eighty percent ratio of hedged to spot prices. This analysis has been attached as Highly Confidential Schedule 2 to my surrebuttal testimony. The analysis indicates that the Staff and Empire are **_ ___**/MMBtu apart and that the impact of the eighty percent hedge level versus Empire's hedge level is approximately **_____**/MMBtu (two-thirds of the gas price difference between the Staff and Empire).

Q. Is it reasonable to expect that Empire will be able to purchase its additional hedged quantities of gas for the period April 2006 to December 2007 at prices less on average than spot purchase prices?

A. Yes, overall, Empire has been able to hedge natural gas at prices that beat the spot purchase price. This is one of the fundamental reasons for hedging. The Staff's calculation of a weighted cost of gas, which included eighty percent hedged and twenty percent spot purchases was based on this premise. It is certainly a more reasonable assumption than the Company's position that such additional hedged gas should be assumed to be purchased at the average spot price recommended by Empire in this case. This position is particularly unreasonable since the spot price of gas has been historically, and is currently, significantly higher than the hedged price of gas Empire has been able to obtain.

GAIN ON THE UNWINDING OF NATURAL GAS HEDGE POSITIONS

Q. What are the parties' positions in this case concerning a gain achieved by Empire in the test year from an "unwinding" of forward natural gas contracts?

A. The Staff's position is that the gain achieved by the unwinding of forward natural gas contracts during the test year should be amortized over five years and one-fifth of the amount netted against fuel costs in the current rate cases revenue requirement. Empire's position is that the gain should not be used to offset fuel costs in the current rate case. The position of Praxair/Explorer Pipeline is that the gain achieved by the unwinding of forward natural gas contracts during the test year should be used in total as an offset against fuel costs in the current rate case. The term "unwinding" refers to a transaction that has the effect of undoing or canceling an earlier transaction.

Q. What portions of Empire's witness, Keith's rebuttal testimony related to the unwinding of natural gas hedge positions is the Staff responding to?

A. The Staff is responding to pages 2-8 of Mr. Keith's rebuttal testimony.

Q. What is the first comment of Mr. Keith on this issue you will respond to?

A. I will address Mr. Keith's assertion, at page 4, lines 5-6 of his rebuttal testimony, that "this transaction was highly unusual and non-recurring."

Q. From an accounting perspective, what is the significance of an "unusual" and "non-recurring" event or transaction?

A. From an accounting perspective, an item is considered "extraordinary" when it is of both an unusual nature and infrequent in its occurrence. An extraordinary item requires special distinction in its presentation on the company's income statement. Extraordinary items should be segregated from the results of ordinary operations and be shown net of taxes in a separate section of the income statement.

Q. Has Empire presented the unwinding of natural gas hedge positions as an extraordinary item on its income statement?

A. No. The Staff has reviewed both of Empire's income statements in its September 30, 2005 Form 10-Q and its December 31, 2005 Form 10-K and has found that the unwinding of natural gas hedge positions is not identified as an extraordinary item on either document.

Q. Would the use of the terms "unusual" and "non-recurring" necessarily be interpreted by Mr. Keith from the accounting perspective you discuss above?

A. Not necessarily, but the distinction should be made that PriceWater Coopers, the external auditing firm that provides the audited financial statements for Empire and also reviewed the unwinding transactions, chose not to present the unwinding transactions as an extraordinary item on the Empire income statements in its audited financial statements for the period including the transaction. Rather, the unwinding transaction was included appropriately with the accumulated gains and losses from hedges realized during the calendar year 2005.

Q. Does the Staff consider the unwinding of physical hedged gas to be an unusual event?

A. No. Empire has procedures in place for the periodic examination of forward natural gas contracts and the determination of when it may be appropriate to unwind such contracts. Empire's Risk Management Oversight Committee meets regularly to assess aggregate risks and to review Empire's market positions, exposures and strategy. **____ ____**

This indicates to the Staff that while the magnitude of the August 2005 unwinding may be larger than normal, the nature of this transaction was not considered to be unusual or unforeseen by Empire. In fact, the Risk Management Oversight Committee minutes in November 2005 **____** This supports the fact that unwinding of forward contracts was still being contemplated by Empire after the August 2005 unwinding transaction.

Q. Is there some accounting treatment that Empire is trying to avoid by not having additional unwinding of forward natural gas contracts?

A. Yes. Empire currently is able to designate forward natural gas contracts as normal purchases. Unwinding of forward natural gas contracts would require that physical gas supply contracts be accounted for on a mark to market basis to conform with Generally Accepted Accounting Principles (GAAP) and United States Securities and Exchange Commission (SEC) reporting requirements. Accounting under the mark to market basis would require recording the price or value of all gas hedges on a quarterly basis, by calculating profits and losses from the hedge contract dates to the financial statements ending date. In Empire's opinion this requirement would introduce volatility to Empire's financial statements as the market value of natural gas changes. Whether reported on Empire's financial statements or not, the volatility associated with the forward natural gas contracts still exists.

Q. At what quantity and price per MMBtu did Empire entered into the contracts for July and August 2009-2011?

A. Empire entered into physical contracts with British Petroleum Corporation (BP) for delivery of **_______** MMBtu each month at a price of **______**/Dth.

Q. What were the NYMEX futures prices for July and August 2009-2011 at the time of the unwinding, August 15, 2005?

A. Empire's response to Staff Data Request No. 199, March 31, 2006 Hedge Report indicated that NYMEX futures prices for the period July and August 2009-2011 when weighted, averaged **______**/MMBtu after the Southern Star basis differential was applied . This resulted in an approximate $5.2 million gain for which the Staff recommends amortization over five-years.

Q. What was the impact of the unwinding activity on August 15, 2005 on the quantity of gas Empire held forward natural gas contracts for?

A. Empire was able to unwind 744,000 MMBtu for each month (July and August 2009-2011) for a total of 4,464,000 MMBtu. Empire then entered into additional contracts for 100,000 MMBtu for each month from January 2006 through December 2013. The result of the unwinding and additional contracts was to increase Empire's MMBtu quantity of forward natural gas contracts by 4,392,000 MMBtu.

Q. What was the weighted cost of these additional forward natural gas contracts?

A. The NYMEX futures prices contained in Empire's response to Staff Data Request No. 199, March 31, 2006 Hedge Report for the periods January 2006 through December 2013 when weighted, averaged **______**/MMBtu after the Southern Star basis differential was applied.

Q. Since Empire purchases natural gas to be used in the generation of electricity and its customers are required to pay for costs associated with Empire's generation of electricity, is there any reason that gains and losses from the sale of natural gas purchased for electric generation should not be flowed back to customers to offset other generation costs?

A. No. In fact, Empire has included other gains and losses associated with the expiration of natural gas contracts (when actual physical delivery occurs) routinely in its generation costs. See Highly Confidential Schedule 1 attached to this testimony for an example of the documentation to support this conclusion.

Q. In the event the Commission accepts the Company's characterization of the unwinding transaction as being "unusual" and "non-recurring," does that mean that such unwinding gain should not be reflected in any way in the ratemaking process?

A. No, it does not. There is past precedent for inclusion of costs associated with unusual and non-recurring events in Empire's rates.

Q. Has Empire ever requested recovery from the Commission of costs associated with unusual and nonrecurring events?

A. Yes, Empire has. Empire sought and received Commission approval in Case No. EO-94-149 for recovery of flood damage costs at the Company's Iatan and Riverton facilities associated with the 1993 flood of the Missouri River and its tributaries. The Staff recommended approval of the AAO in Case No. EO-94-149 on the grounds that the 1993 flood was an extraordinary event and that Empire's flood related expenditures of approximately $1 million were material and that the deferral was appropriate. The Commission Order effective March 1994 in Case No. EO-94-149 granted the AAO. These costs were amortized over five years, and included in Empire's rates.

Q. Were Empire's flood damage expenses in 1993 "unusual" and "non-recurring?"

A. Yes, though this did not prevent Empire from seeking deferral and later rate recovery of these costs. Apparently, Empire's position is that costs (flood related cost recovery) it deems to be unusual and non-recurring in nature should be assigned in part to ratepayers, while gains (unwinding of forward natural gas contracts) it deems unusual and non-recurring should accrue to shareholders only. This position is inconsistent and unfair.

Q. What other reason does Mr. Keith argue that this test year gain should not be reflected in Empire's rates in this proceeding?

A. Mr. Keith argues that under Empire's existing Interim Energy Charge (IEC) tariff, the unwinding gain will offset fuel/purchased power cost for which recovery from customers is "capped" at a certain level. Mr. Keith states that it is unlikely that Empire will recover the total amount of its fuel/purchased power expenses incurred since the IEC was enacted in March 2005, even after the unwinding gain is taken into account.

Q. Is Mr. Keith correct in his argument?

A. No. Mr. Keith's rebuttal testimony ignores the fact that Empire has requested in Case No. ER-2006-0315 that the existing IEC be terminated and that a set point fuel price be established for determination of the revenue requirement to which customer rates in Missouri will be set in this proceeding. If Empire's request to terminate its IEC is adopted by the Commission, this means that Empire's incurred fuel/purchased power costs in the test year and update period for this case will be the starting point for establishment of an ongoing level of fuel/purchased power costs to be placed in Empire's rates. Yet, while Empire is advocating that the increases in its fuel and purchased power costs that it incurred during the test year (while its current IEC is in effect) be used to set new and increased rate levels, it at the same time opposes any recognition of the unwinding gain that offset a portion of these increased fuel costs in the test year (while the IEC is in effect). This is, again, both unfair and inconsistent to ratepayers.

Q. Please summarize then, the factors that the Staff considered in determining that a five-year amortization of Empire's $5.2 million unwinding of forward gas contracts gain was appropriate

A. In summary, Empire's current hedging program for its natural gas costs is directly related to provision of regulated electric service to its customers. Gains and losses are recognized by Empire routinely during hedging transactions. Because the $5.2 million gain associated with the unwinding of this forward natural gas contract in the test year was larger than normal, the Staff is recommending a "smoothing out" of the gain over five years for rate purposes.

Q. Does that conclude your surrebuttal testimony?

A. Yes, it does.

Schedules 1 and 2 have been Deemed Highly Confidential in their Entirety.