

EXHIBIT

Exhibit No.: _____

Issue(s):

Natural Gas Price/IEC

Witness/Type of Exhibit:

Busch/Rebuttal

Sponsoring Party:

Public Counsel

Case No.:

ER-2004-0570

REBUTTAL TESTIMONY

FILED

DEC 28 2004

OF

Missouri Public
Service Commission

JAMES A. BUSCH

Submitted on Behalf of the Office of the Public Counsel

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2004-0570

November 4, 2004

Exhibit No. 86
Case No(s) ER-2004-0570
Date 12-06-04 Rptr 45

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

In the Matter of the tariff filing of The Empire)
District Electric Company to implement a)
general rate increase for retail electric service)
provided to customers in its Missouri service area.)

Case No. ER-2004-0570

AFFIDAVIT OF JAMES A. BUSCH

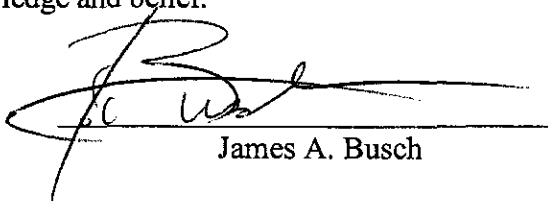
STATE OF MISSOURI)

COUNTY OF COLE)

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James A. Busch, of lawful age and being first duly sworn, deposes and states:

1. My name is James A. Busch. I am the Public Utility Economist for the Office of the Public Counsel.
2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony consisting of pages 1 through 11.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.


James A. Busch

Subscribed and sworn to me this 4th day of November 2004.)

KATHLEEN HARRISON
Notary Public - State of Missouri
County of Cole
My Commission Expires Jan. 31, 2006


Kathleen Harrison, Notary Public

My commission expires January 31, 2006.

1 charge its customers. Every electric company in the state, except Aquila, Inc., is
2 currently operating under this traditional, regulatory framework. Public Counsel
3 believes the inclusion of a specific level of fuel costs in rates provides the utility
4 the proper economic incentives to manage its fuel costs in the most efficient
5 manner.

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

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

13 Q. Please explain further how an IEC would work.

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

1 would be the Interim Energy Charge. This charge would then be subject to refund
2 after the IEC period expires.

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

5 A. No. Public Counsel opposes an IEC.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

6 Q. Please explain your last comment in more detail.

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

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

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

1 incentive to continue to manage our fuel costs effectively.” (1998 Annual Report,
2 Ameren Corporation, page 3)

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

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

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

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

20 Q. Please explain.

21 A. One potentially large business risk for an electric utility is related to fuel
22 procurement because the price at which an electric utility is able to obtain its fuel
23 supply can significantly impact its profitability (net income). This is especially

1 true if the utility has a greater reliance on fuels that are volatile such as natural
2 gas. Thus, the greater the volatility of a particular electric utilities' fuel costs, the
3 more volatile its profitability can be. This business risk is significantly reduced
4 with a fuel price recovery mechanism like an IEC because the utility is allowed
5 full cost recovery within a specified band. Consequently, as long as the utility is
6 able to procure its fuel at a price within this specified band, it is able to stabilize
7 its net income, which reduces its business risk, all else equal.

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

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

13 Q. Please explain.

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

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

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

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

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

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

22 A. An IEC would be a specific charge to Empire's customers based solely on fuel
23 costs. This charge would be reviewed at the end of an IEC period and the actual

1 rate to be charged to consumers would be determined at that time. The review
2 would not look at all of the relevant factors affecting the Company during the
3 period of time the IEC would be in effect. It would focus solely on the single-
4 issue of fuel costs. In fact, it would only focus on the specific issue of variations
5 in fuel costs. Fixed costs associated with fuel would already be built in the base
6 rate and would not be subject to the IEC or to refund. It is my understanding that
7 the Commission is forbidden from single-issue ratemaking.

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

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

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

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

21 Q. Please summarize your rebuttal testimony.

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

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

4 Q. Does this conclude your rebuttal testimony?

5 A. Yes it does.