FILED[3]
SEP 2 9 2006
Missouri Public Service Commission

Exhibit No.:
Issue: Hedge Unwinding, Off-system sales. Prepayments, Banking Fees, Outside Services, Edison Electric Membership Dues and Rate Case Expense
Witness: W. Scott Keith
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Empire District
Case No. ER-2006-0315

Before the Public Service Commission

of the State of Missouri

Rebuttal Testimony

of

W. Scott Keith

July 2006

*** Denotes Highly Confidential***

Empire Exhibit No. 21 NP
Case No(s). ER-2006-0315
Date 9-05-06 Rptr AF

NP

TABLE OF CONTENTS
OF
W. SCOTT KEITH
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION

REBUTTAL TESTIMONY
OF
W. SCOTT KEITH
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2006-0315

INTRODUCTION

Q. STATE YOUR NAME AND ADDRESS PLEASE.

A. My name is W. Scott Keith and my business address is 602 Joplin Street, Joplin, Missouri.

POSITION

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am presently employed by The Empire District Electric Co. ("Empire" or "the Company") as the Director of Planning and Regulatory. I have held this position since August 1, 2005. Prior to joining Empire I was Director of Electric Regulatory Matters in Kansas and Colorado for Aquila, Inc. from 1995 to July 2005.

Q. ARE YOU THE SAME W. SCOTT KEITH THAT EARLIER PREPARED AND FILED DIRECT TESTIMONY IN THIS RATE CASE BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION") ON BEHALF OF EMPIRE?

A. Yes.

PURPOSE

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony will discuss issues that have been raised by witnesses for the other parties in this rate case. Specifically, I will address the following:

- Gain on the unwinding of an Empire natural gas hedge position
- Off-system sales
- Prepayments
- Banking fees
- Outside services
- Edison Electric Institute Membership fees
- Rate case expense

GAIN ON THE UNWINDING OF NATURAL GAS HEDGE POSITION

Q. HAVE YOU REVIEWED THE DIRECT TESTIMONY FILED ON BEHALF OF THE OTHER PARTIES CONCERNING THE RECOMMENDED RATE CASE TREATMENT OF THE GAIN ON THE UNWINDING OF A FUTURE HEDGE POSITION DURING THE TEST YEAR?

A. Yes. I reviewed the direct testimony of Janis E. Fischer of the Commission Staff ("Staff") and the direct testimony of Maurice Brubaker representing industrial interveners Praxair, Inc. and Explorer Pipeline Company ("Industrials") on this topic.

Q. PLEASE DESCRIBE THE TRANSACTION THAT HAS BECOME AN ISSUE WITH THE STAFF AND INDUSTRIALS IN THIS RATE CASE.

A. This transaction involved the unwinding of a portion of a long-term natural gas purchase that Empire had with BP. Part of this purchase had locked in the price of natural gas deliveries scheduled to take place in the summer of 2009, 2010 and 2011. These positions in 2009 through 2011 were sold back to BP and a gain of slightly over $5 million was recognized on Empire records as lower fuel costs in August of 2005.

Q. WHY DID EMPIRE UNWIND THIS TRANSACTION IN THE SUMMER OF 2005?

A. Empire entered into this unwinding transaction with BP in an effort to offset the dramatic price increases in natural gas that were taking place and expected to take place during the summer, fall and winter of 2005. In addition to the gain associated with the transaction, this transaction reduced Empire's credit exposure with BP, which was nearing *________*, and enabled Empire to use this decrease in credit exposure to increase its near-term natural gas hedge positions versus the long-term hedging positions.

Q. WHAT RATEMAKING TREATMENT DO THE STAFF AND INDUSTRIALS RECOMMEND CONCERNING THE GAIN ASSOCIATED WITH THE UNWINDING OF THIS PARTICULAR HEDGE POSITION?

A. Each witness recommended that some or all of the gain of approximately $5 million be used to reduce future rates. Specifically, Ms. Fischer recommended, beginning at page 20, line 14 of her direct testimony, that the gain be amortized over a five-year period. This would equal a reduction in ongoing Empire fuel costs of approximately $1 million a year. Mr. Brubaker has recommended, beginning at page 11, line 2 of his direct testimony, that the entire gain be reflected as a reduction in test year fuel costs and used to reduce Empire's future electric rates. This is equal to an annual reduction in ongoing fuel costs of approximately $5 million per year.

Q. DO YOU AGREE WITH EITHER OF THESE RECOMMENDATIONS?

NP

A. No. Both of these recommendations are inappropriate and should be rejected by the Commission.

Q. WHAT ARE SOME OF THE PROBLEMS ASSOCIATED WITH THE TWO RECOMMENDATIONS?

A. Both proposals completely ignore the fact that this transaction was highly unusual and non-recurring and that the gain from the transaction was used to recover a portion of fuel and energy costs that can never be recovered from Empire's Missouri retail customers. In addition, this transaction occurred during the term of the current Interim Energy Charge ("IEC"), which makes it subject to potential refund in the upcoming audit of IEC revenues and fuel and energy costs. Both proposals attempt to capture a single, non-reoccurring event from August 2005 and use it to reduce Empire's electric rates beginning in 2007 despite the fact that Empire's Missouri retail customer base has been shielded from the escalating cost of energy by the fixed or capped nature of the existing Empire rates in Missouri.

Q. HOW WERE THE PROCEEDS FROM THIS TRANSACTION ACCOUNTED FOR ON EMPIRE'S RECORDS?

A. The gain from this transaction was used to lower Empire's overall fuel costs in August of 2005. At this point in the life of the IEC, Empire's cost of fuel and energy were well over the IEC cap of $24.11 per megawatt-hour ("Mwh") established in the last rate case. Empire witness Todd Tarter describes what has happened to Empire's average energy costs since the existing IEC was implemented in March of 2005, beginning at page 5, line 5 of his direct testimony in this case.

Q. WHAT WAS THE LEVEL OF ENERGY COST UNDER-RECOVERY AT

NP

DECEMBER 31, 2005 FOR EMPIRE'S MISSOURI ELECTRIC OPERATIONS?

A. By the end of calendar year 2005, Empire had been unable to recover \$13.5 million of Missouri retail fuel and energy costs. This under-recovery balance includes the impact of the \$5 million hedging gain that is an issue raised by Staff and the Industrials in this rate case. If the gain from this hedging transaction is set aside, the fuel and energy under-recovery in Empire's Missouri retail operations would have been in excess of \$18 million for calendar year 2005. This under-recovery of Missouri energy costs has all been borne by Empire and its shareholders, not the Missouri retail customers due to the energy cost cap in the IEC and the fixed nature of the Missouri base electric rates, and it is appropriate that the Company retain the proceeds from this transaction to recover a portion of the Missouri energy costs that it has not recovered from its Missouri retail customers.

Q. **DOES THE EMPIRE RATE CASE INCLUDE ANY OF THE FUEL AND ENERGY COSTS THAT EMPIRE WAS UNABLE TO RECOVER FROM ITS MISSOURI RETAIL CUSTOMERS IN 2005?**

A. No. Empire's rate filing is based on future fuel and energy costs, not on past under-recoveries of energy costs or past gains and losses from its natural gas hedging activities, including the one-time significant hedging gain that is an issue in this rate case.

Q. **HAS THE IEC CAP OF \$24.11 PER MWH ESTABLISHED IN THE LAST RATE CASE WORKED TO THE BENEFIT OF THE MISSOURI RETAIL CUSTOMER SINCE THE CURRENT RATES WENT INTO EFFECT IN**

NP

MARCH OF 2005?

A. Yes. The IEC cap has shielded Missouri retail customers from the rapid and unforeseen escalation of fuel and energy prices that have taken place since March of 2005. As of June 30, 2006, Empire's fuel and energy costs have exceeded the IEC cap by $18.9 million. This figure includes the impact of Empire's natural gas hedging policy, including the $5 million gain that is an issue in this rate case. Absent the $5 million gain, Empire's energy costs for its Missouri retail operation would have exceeded the IEC cap by almost $24 million.

Q. IS THE UNWINDING OF LONG-TERM HEDGING POSITIONS ROUTINELY PERFORMED AS PART OF EMPIRE'S NORMAL RISK MANAGEMENT POLICY?

A. No. This type of unwinding transaction is unique and has not been used since August 2005. In addition, Empire's external auditor, Pricewaterhouse Coopers, has advised Empire that additional transactions of this type could jeopardize Empire's current accounting treatment of derivatives. This information was conveyed to the parties in this case in response to Staff data request 300.

Q. WILL THERE BE AN AUDIT OF THE ENERGY COSTS AND IEC REVENUE INCURRED DURING THE PERIOD IN WHICH THE IEC IS IN EFFECT?

A. Yes. According to the terms of the IEC tariff an audit of the IEC will take place to determine if any IEC revenue collected by Empire should be refunded to the Missouri retail customers.

NP

Q. WILL THE HEDGING BENEFITS AND LOSSES DURING THE PERIOD IN WHICH THE IEC WAS IN EFFECT ALSO BE SUBJECT TO AUDIT?

A. Yes. All of the IEC revenue and energy costs, including the impact of hedging, will be subject to audit to determine if the transactions entered into by Empire were prudent

Q. BEGINNING AT PAGE 11, LINE 11, OF HIS DIRECT TESTIMONY, MR. BRUBAKER INDICATES THAT EMPIRE'S HEDGING PROGRAM WAS DEVELOPED AND IMPLEMENTED FOR THE BENEFIT OF RETAIL CUSTOMERS. DO YOU AGREE?

A. No. Empire implemented this policy to mitigate the volatility associated with natural gas prices. Over the long-term, Empire's customers will see the impact of this policy in the price they pay for electricity. Over the short-term, the benefits/costs associated with this policy in Empire's Missouri retail operation are borne to a large degree by the shareholders between rate cases, not Missouri retail customers. For example, last year's unexpected increase in fuel and energy costs in its Missouri retail operations has been borne for the most part by the Company due to the IEC cap. The Empire customers in other states paying electric rates that include an energy cost recovery mechanism that changes periodically will see the impact of Empire's hedging policy sooner than the retail electric customers in Missouri due to the fixed nature of Missouri electric rates. All of Empire's other rate jurisdictions have electric rates that include periodic energy cost adjustments.

Q. HAS EMPIRE REFLECTED THE IMPACT OF ITS NATURAL GAS

HEDGING POLICY IN ITS RATE CASE FILING?

A. Yes. Empire has reflected the costs/benefits associated with its natural gas hedging policy in its projection of future Missouri retail energy costs in this rate case. This, in effect, transfers the benefits/costs associated with this policy at a single point in time to Missouri retail customers. If Empire is ultimately authorized to implement a periodic energy cost adjustment in Missouri then the costs/benefits associated with its natural gas hedging program, including any unwinding of future natural gas positions, would transfer to the customers in Missouri in between rate cases.

OFF-SYSTEM SALES

Q. WHAT HAVE THE OTHER PARTIES TO THIS RATE CASE PROPOSED REGARDING OFF-SYSTEM SALES?

A. Essentially, Staff has recommended that the ongoing Missouri retail revenue requirement reflect the level of off-system sales for the 12 months ending March 31, 2006. This position was discussed by Staff witness Janis Fischer beginning at page 28, line 1 of her direct testimony. The Office of the Public Counsel ("OPC") has recommended that a five-year average of off-system sales for calendar years 2001 through 2005 be used in the determination of the ongoing Missouri retail revenue requirement. This was discussed by OPC witness Ralph C. Smith beginning at page 14, line 13 of his direct testimony.

Q. PLEASE COMPARE THE OFF-SYSTEM SALES RATE TREATMENT RECOMMENDED BY EMPIRE WITH THOSE BEING RECOMMENDED BY STAFF AND THE OPC.

A. The table below compares the total-Company Off-system sales gross profit that Empire, Staff, and OPC each recommend in the rate case. Each of these gross profit levels would be allocated to the Missouri retail cost of service using an allocation factor of 82.11 percent.

Description	**Empire-Original**	**Empire-Update**	**Staff**	**OPC**
2001	* *	* *		* *
2002	* *	* *		* *
2003	* *	* *		* *
2004	* *	* *		* *
2005	* *	* *		* *
TME 3-31-06		$3,009,011	$3,051,821	
Average	$1,478,214	$1,552,197	$3,051,821	$2,751,905

Q. DO YOU AGREE WITH EITHER THE STAFF OR OPC RECOMMENDATIONS CONCERNING OFF-SYSTEM SALES?

A. No.

Q. WHY DO YOU DISAGREE WITH THE POSTION TAKEN BY THE STAFF?

A. First, it is my understanding that in past Empire rate cases the level of off-system sales used to determine the ongoing Missouri retail revenue requirement has consistently been determined by using a five-year average. This is essentially the process Empire used to develop the level of off-system sales included in its February 1, 2005 filing and the update of that calculation through December 31, 2005 displayed above. 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. As indicated by the table, off-system sales revenue can fluctuate substantially from year-to-year and is driven by market forces beyond the control of Empire, such as weather and plant outages. A multiple-year average of off-system sales profit levels is more appropriate to use in a rate case than the single year snapshot recommended by the Staff, which can be influenced by factors beyond the Company's control. In addition, the Staff adjustment appears to have overstated the level of gross profit actually earned by Empire for the twelve months ended March 31, 2006 by $42,819.

Q. PLEASE DESCRIBE THE STAFF PROPOSAL IN GREATER DETAIL FOR THE COMMISSION.

A. Based upon the workpapers I reviewed, the Staff used the following analysis to determine the level of total company off-system sales.

Description	**Off-system Revenue**	**Off-system Cost**	**Off-system Gross Profit**
As Recorded:			
TME 12-31-05	$14,156,035	$10,653,866	$3,502,169
TME 3-31-06	$12,410,012	$9,401,001	$3,009,011
Decrease			$493,157
Staff Adj:			
TME 12-31-05	$14,156,035	$9,195,259	$4,960,776
TME 3-31-06	$12,410,012	$7,899,585	$4,510,427
Decrease			$450,348

NP

Difference			$42,809

As indicated, the Staff adjustment to test year, December 31, 2005, off-system sales levels excluded the correct level of off-system sales costs and as a result understated the adjustment necessary to reduce the level of off-system sales gross profit to the level that occurred during the twelve months ended March 31, 2006.

Q. HAVE YOU REVIEWED THE TESTIMONY FILED BY MR. SMITH ON BEHALF OF OPC RELATED TO OFF-SYSTEM SALES?

A. Yes.

Q. WHAT HAS THE OPC USED AS A BASIS FOR ITS RECOMMENDATION FOR OFF-SYSTEM SALES?

A. The OPC has recommended that a five-year average of Empire's historical off-system sales be used in this rate case. This calculation is discussed at page 16 of Mr. Smith's direct testimony.

Q. DO YOU AGREE WITH THE OPC'S RECOMMENDATION ON OFF-SYSTEM SALES?

A. No. The OPC has not adjusted Empire's historical off-system sales levels to remove an unusual transaction that took place with AEP.

Q. WHEN DID THE AEP TRANSACTION TAKE PLACE AND HOW MUCH ENERGY DID EMPIRE PURCHASE FROM AEP DURING THE TERM OF THE TRANSACTION?

A. The transaction was a short-term energy purchase that took place from June 1, 2002 through June 30, 2003. This purchase was broken into three distinct periods; 100

megawatts of must take energy was purchased from June 1, 2002 through December 31, 2002 at a specified contract price; Continuation of the 100 megawatt purchase from January 1, 2003 through March 31, 2003 at a different specified contract price; and finally, a purchase of 50 megawatts of energy from AEP beginning April 1, 2003 through June 30, 2003 at a specified contract price.

Q. HOW DID EMPIRE USE THE ENERGY PROVIDED BY THIS CONTRACT?

A. Empire could not count on the AEP capacity when it came to reserve requirements; in essence, the transaction became a source of lower cost energy. This energy was used on-system to the extent it could be used effectively and resold off-system when it could not be used on-system. During the term of this transaction, 1,221,452 megawatt-hours (Mwh) were purchased from AEP under this contract, 698,955 Mwh or over 57 percent of the energy purchased was sold off-system and 522,497 Mwh of the energy purchased was consumed on-system.

Q. DO YOU AGREE WITH MR. SMITH'S CHARACTERIZATION OF THIS TRANSACTION?

A. No. Beginning at page 15, line 6, Mr. Smith has mischaracterized the transaction as an off-system sale to AEP. This is incorrect. The AEP transaction represented a short-term purchase of energy from AEP by Empire, not a sale of capacity or energy to AEP from Empire. The energy Empire purchased from AEP could not be used to meet any of Empire's reserve requirements. The AEP contract included low cost energy that could be used on the Empire system or sold off-system. As a result of gaining access to this low cost energy, Empire was able to significantly increase the level of its off-system sales activity and the level of off-system sales gross profit it was able to earn on the energy resold in the wholesale marketplace during the term of the transaction.

Q. IN HIS RECOMMENDATION CONCERNING THE APPROPRIATE LEVEL OF OFF-SYSTEM SALES FOR EMPIRE, DID MR. SMITH INCLUDE THE GROSS PROFIT EARNED ON THE SALE OF EXCESS AEP ENERGY OFF-SYSTEM?

A. Yes, and this will lead to an overstatement of the five-year off-system sales average gross profit for rate case purposes since it fails to match all of the costs associated with the transaction with the revenue, and represents the resale of a supply resource to which Empire no longer has access.

Q. DID THE HISTORIC OFF-SYSTEM SALES GROSS PROFIT USED BY MR. SMITH REFLECT ANY DEDUCTION FOR THE FIXED CHARGES INVOLVED WITH THE AEP CONTRACT?

A. No. The off-system sales gross profit calculation only reflected the cost associated with the AEP energy, which as I mentioned earlier, was low in comparison to some of the other supply resources Empire had available.

Q. HOW MUCH GROSS PROFIT WAS RECORDED FROM THE SALE OF THE EXCESS AEP ENERGY TO OFF-SYSTEM SALES CUSTOMERS DURING 2002 AND 2003?

A. The off-system sales gross profit associated with the sale of this excess AEP energy

NP

amounted to *____* million in 2002 and *____* million in 2003.

Q. WHAT PERCENTAGE OF THE GROSS PROFIT FROM OFF-SYSTEM SALES DOES THE SALE OF EXCESS AEP ENERGY REPRESENT IN 2002 AND 2003?

A. The sales of excess AEP energy represented *65* percent of the total off-system sales gross profit in 2002 and *87* percent of the off-system sales gross profit in 2003.

Q. IF THE GROSS PROFIT ON THE SALES OF EXCESS AEP ENERGY HAD REFLECTED A PORTION OF THE FIXED CHARGES ASSOCIATED WITH THE PURCHASE, WHAT WOULD THE GROSS PROFIT BE ON THESE TRANSACTIONS?

A. As I mentioned earlier, the excess energy sold off-system represented over 57 percent of the total energy purchased from AEP under the contract. In total, Empire paid AEP *___* million in fixed charges during the contract term. If a ratable portion of the fixed charges are allocated to the AEP-related off-system sales based upon the proportion of the AEP energy used, then the gross profit from the AEP excess energy sales would be reduced by approximately *____* million. The table below displays this calculation.

Description	Amount
Fixed Charges	*____________*
Percentage of Energy Sold Off-system	57.22%
Allocated Fixed Costs-Off-system	*____________*

In total, the gross profit earned on the sale of excess AEP energy during 2002 and

NP

2003 was *___* million. If a ratable portion of the fixed charges are allocated to these transactions, the actual realized gross profit associated with the sale of excess AEP energy is only *___* million, not the *___* million included in the calculation Mr. Smith is presenting on behalf of the OPC at page 15 of his direct testimony.

Q. HAVE THE FIXED CHARGES ASSOCIATED WITH THIS AEP CONTRACT EVER BEEN INCLUDED IN EMPIRE'S MISSOURI RETAIL COST OF SERVICE?

A. No. It is my understanding that the AEP fixed charges have never been included in the Missouri retail cost of service in any manner. This is not surprising given the short-term nature of the transaction.

Q. IS THIS SITUATION DIFFERENT FROM THAT ASSOCIATED WITH ASSET-BACKED OFF-SYSTEM SALES?

A. Yes. Generally, the assets used to make off-system sales have been included in the retail cost of service and it is only fair that the costs associated with carrying those assets reflect the benefits of the asset-related off-system sales. In this particular transaction, unlike an asset-backed transaction, the Missouri customers have never been charged with any of the AEP fixed costs.

Q. HAS THE ENERGY PURCHASED FROM AEP BEEN REPLACED WITH SIMILAR PURCHASED POWER ARRANGEMENT SINCE IT EXPIRED IN JUNE OF 2003?

A. No. Empire has not entered into any similar purchased power contracts since the AEP contract expired.

Q. PLEASE DESCRIBE HOW THE AEP-RELATED OFF-SYSTEM SALES TRANSACTIONS WERE HANDLED IN THE EMPIRE RATE CASE FILING.

A. The excess AEP energy sales and related gross profit on energy were eliminated from the five-year average of off-system sales. The following table displays how this was done in the initial rate case filing and updated through the end of calendar year 2005.

Year	Off-system Gross Profit	Less: AEP	Balance Per Filing 9-30-2005	Off-system Gross Profit	Less: AEP	Balance Per Update 12-31-2005
2001	* *		* *	* *		* *
2002	* *	* *	* *	* *	* *	* *
2003	* *	* *	* *	* *	* *	* *
2004	* *		* *	* *		* *
2005	* *		* *	* *		* *
Average			$1,478,214			$1,552,197

As indicated, Empire's updated off-system sales recommendation using a five-year average and eliminating the sales associated with the expired AEP energy purchase is $1,552,197 on a total Company basis. In terms of Missouri jurisdictional operations, this is equivalent to $1,276,061 in off-system sales gross profit.

Q HOW DOES EMPIRE'S UPDATED RECOMMENDATION COMPARE TO THAT OF THE STAFF AND OPC?

A. It is substantially lower than the Staff's recommendation to use a single year to establish a going level of off-system sales gross profit and the OPC's recommendation to use a five-year average of off-system sales gross profit, including the AEP transaction. The following table compares each of the positions

NP

and quantifies the impact in terms of the Company's Missouri jurisdictional revenue requirement.

Description	Empire As Updated	Staff	OPC
Off-system-Total	$1,552,197	$3,051,821	$2,751,905
Off-system-MO	$1,276,061	$2,508,902	$2,262,341
Difference-Compared to EDE		($1,232,841)	($986,280)

As indicated, the Staff's proposal results in a $1.2 million reduction of the Empire Missouri jurisdictional revenue requirement and the OPC's proposal results in almost a $1 million reduction in the Missouri retail cost of service.

PREPAYMENTS

Q. HAVE YOU REVIEWED THE TESTIMONY OF THE STAFF'S WITNESS PAULA MAPEKA AS IT RELATES TO PREPAYMENTS?

A. Yes. Ms. Mapeka discusses these prepayment balances at pages 3 and 4 of her direct testimony.

Q. DO YOU AGREE WITH THE PREPAYMENT LEVELS BEING RECOMMENDED BY STAFF IN THIS RATE CASE?

A. No. The prepayment levels being recommended by Staff have excluded two prepayment accounts and balances that are currently used to properly account for prepayments associated with the purchase of natural gas and wind energy.

Q. HAS THE STAFF AGREED TO INCREASE THE LEVELS OF PREPAYMENTS TO INCLUDE THE INVESTMENT IN THESE TWO ACCOUNTS?

A. Yes.

NP

BANKING FEES

Q. HAVE YOU REVIEWED THE DIRECT TESTIMONY OF STAFF WITNESS KOFI BOATENG ON THE PROPOSED STAFF ADJUSTMENT TO BANKING FEES?

A. Yes.

Q. DO YOU AGREE WITH THE STAFF ADJUSTMENT TO BANKING FEES?

A. No. I believe the proposed Staff adjustment, which is discussed briefly at pages 37 and 38 of Mr. Boateng's direct testimony, is inappropriate.

Q. WHY?

A. I disagree with the proposed Staff adjustment for two reasons. First, the Staff's adjustment uses a five-year average of banking fees, which does not properly annualize the costs associated with Empire's recently expanded line-of-credit. Secondly, the Staff has improperly used Empire's overnight interest earnings to reduce Empire's retail cost of service. This latter piece of the proposed Staff adjustment is unwarranted and simply uses shareholder funds and the interest earnings on those funds that are properly recorded in interest income to reduce retail rates.

Q. WHY DO YOU BELIEVE THE EARNINGS ON THE SHORT-TERM INVESTMENT OF CASH SHOULD BE EXCLUDED FROM THE RETAIL COST OF SERVICE IN MISSOURI?

A. In very simple terms, the rates in Missouri are based upon a cost of service that includes an allowance for cash working capital. This cash working capital calculation does not include an allowance for excess cash investment. In addition, in order for the Staff's position to have any merit, all of the cash generated by the Company's electric rates would, by necessity, have to be directly tied to an excess cash requirement in the Missouri cost of service. This is simply not correct. The cash generated from the business is the property of Empire, not its customers.

Q. DO THE RATES PAID BY EMPIRE'S CUSTOMERS PRODUCE EXCESS CASH PERIODICALLY?

A. Yes. For example, the rates can produce cash from items such as depreciation, the periodic payment of dividends, periodic interest and return on equity. In addition, if the rates are seasonal in nature, extra cash could be generated seasonally. To the extent these funds are invested on a short-term basis they produce interest income. A significant portion of these cash earnings are directly related to the authorized rate of return built into the rates, and as such are directly related to the bondholders and shareholders, not the customers. In addition, as I mentioned earlier, the Missouri retail cost of service includes an allowance for cash working capital that excludes any excess cash balances. This Staff adjustment should be rejected.

OUTSIDE SERVICES

Q. HAVE YOU REVIEWED THE STAFF'S TESTIMONY ON OUTSIDE SERVICES AND THE RELATED ADJUSTMENT PROPOSED BY THE STAFF?

A. Yes. I reviewed the direct testimony of Kofi Boateng in this area and the

NP

workpapers he supplied on the adjustment. Mr. Boateng discusses this adjustment at page 28 of his direct testimony.

Q. DO YOU AGREE WITH THE PROPOSED STAFF ADJUSTMENT TO OUTSIDE SERVICES?

A. No. The adjustment as proposed by the Staff simply uses a five-year average to arrive at what is termed a normalized level of expenditures. In addition to using a simple five-year average the Staff excludes past charges incurred for two items, which the Staff defines as nonrecurring. The use of this type of analysis- a five-year average- to establish an ongoing level of outside service costs is not appropriate for Empire at this time.

Q. WHY?

A. The five-year average proposed by the Staff fails to reflect the fact that Empire has incurred significant costs, including outside services, in the development of an Integrated Resource Plan ("IRP") that will be filed with the Commission on July 31, 2006. This 2006 IRP filing was agreed to as part of the regulatory plan agreement reached last year. In addition to the 2006 IRP filing, Empire is required to file another IRP with the Commission in the fall of 2007. The Staff's average calculation simply does not take the additional IRP expenditures into account and understates the ongoing level of outside service expense the Company can reasonably be expected to incur when the rates coming from this rate case are expected to be in place.

Q. HOW MUCH DOES THE COMPANY EXPECT TO SPEND TO FILE THE 2006 IRP?

NP

A. As of June 28, 2006 the Company had incurred $100,293 in IRP-related costs. This is expected to increase after the filing is made with the Commission and meetings are held with the Staff, OPC, and the Industrials to discuss the results. At the present time, the Company estimates that it will incur at least an additional $75,000 in costs for the 2006 IRP. In addition, Empire is scheduled to file a formal IRP in the fall of 2007. This filing will comply with the Commission's formal IRP rules and undoubtedly cost more than the abbreviated IRP filing made this summer. The Commission should reject the use of a five-year average to establish an ongoing level of outside service costs proposed by the Staff, and instead use the test year level of outside expenses, adjusted upward by the estimated costs of the 2006 IRP filing of $175,000, to establish the ongoing level of outside service expenses for Empire in this rate case.

<u>**EDISON ELECTRIC INSTITUTE**</u>

Q. HAVE YOU REVIEWED THE STAFF ADJUSTMENT RELATED TO EDISON ELECTRIC INSTITUTE FEES?

A. Yes. I have reviewed the direct testimony of Mr. Kofi Boateng concerning the Edison Electric Institute ("EEI") starting at page 26, line 11.

Q. DO YOU AGREE WITH THE STAFF ADJUSTMENT TO ELIMINATE 100 PERCENT OF THE EEI MEMBERSHIP FEES PAID BY EMPIRE?

A. No. The Staff adjustment appears to rely solely on a Kansas City Power & Light rate case from the early 1980's as support for its adjustment. There is nothing in the direct testimony that indicates that the Staff found Empire's membership fees to be imprudent or ineffective. The Staff simply recommended elimination based upon a past rate case that is over twenty years old.

Q. IS THE COMPANY'S MEMBERSHIP IN EEI BENEFICIAL FOR EMPIRE AND ITS CUSTOMERS?

A. Yes, I believe the Company, and ultimately its customers, enjoy benefits as a result of the Company's membership. As a result of the Staff's proposed adjustment to eliminate 100 percent of the Company's EEI membership dues, I sent an email to various department heads in the Company and asked them to indicate how they use the Company's EEI membership. In most of the responses I received, especially those from the environmental, safety, and financial departments, there are indications that the EEI membership provides access to industry resources that are very cost effective and are vital to the Company's successful operation of its electric utility system. In addition, absent its EEI membership, the responses indicated that the Company would incur significant additional costs to replace the services offered to the Company through its membership in EEI.

Q. DOES EEI CHARGE ITS MEMBERS FOR LEGISLATIVE LOBBYING COSTS?

A. Yes, and those costs are accounted for below-the-line and not included in the Company's regulated cost of service. Approximately 25 percent of the EEI dues paid during the test year ended 12-31-2005 were charged below-the-line. In total the EEI membership dues charged to electric operations equaled $84,854, out of total membership dues of $112,472

RATE CASE EXPENSE

Q. HAVE YOU REVIEWED THE STAFF'S TESTIMONY ON RATE CASE EXPENSE AND THE PROPOSED STAFF ADJUSTMENT TO THAT EXPENSE?

A. Yes. Staff witness Paula Mapeka discusses this aspect of the Staff's revenue requirement beginning at page 8, line 19 of her direct testimony.

Q. DO YOU AGREE WITH THE STAFF'S RATE CASE EXPENSE RECOMMENDATION?

A. No, but in this case Empire is willing to waive its disagreements with the Staff in this area if a reasonable estimate of the actual rate case expenses incurred by Empire to take this case through the Commission hearing process is included in the Company's retail cost of service.

Q. WHAT LEVEL OF RATE CASE EXPENSE HAS THE STAFF INCLUDED IN ITS MISSOURI RETAIL REVENUE REQUIREMENT?

A. The Staff only included the actual rate case expenses that Empire had recorded on its general ledger as of May 31, 2006. In total this amounted to $63,349. In addition, the Staff amortized this amount over two years. In effect, the Staff's cost of service includes rate case expense of $31,674.

Q. DOES EMPIRE ANTICIPATE SPENDING MORE THAN $63,349 ON THE MISSOURI RETAIL RATE CASE?

A. Yes. The cost used by the Staff for rate case expense is incomplete. For example, the actual rate case cost at May 31, 2006 excludes the costs Empire has incurred during the settlement conference of the week ending June 14. In addition, Empire has retained several outside consultants to analyze the positions the Staff has taken with respect to incentive compensation, return on equity, pensions, and amortization. Finally, the rate case cost at May 31, 2006 does not include the additional legal expenses Empire will incur as a result of going through the hearing process at the Commission. At this point, Empire estimates that its additional rate case expense could exceed $250,000. Under the methodology used by the Staff in this area, this level of additional rate case expense would increase the Staff adjustment by $125,000.

Q. HOW DO YOU RECOMMEND THAT THE COMMISSION TAKE INTO CONSIDERATION THE ACTUAL RATE CASE EXPENSES INCURRED BY EMPIRE IN THIS RATE CASE?

A. If a reasonable estimate of rate case expenses cannot be included in Empire's cost of service, I would recommend that the Commission consider an update of actual and estimated rate case costs closer to the hearing date. For example, Empire could file an update of its actual rate case costs as of August 31 as well as a new estimate of the costs necessary to complete the hearing process. Finally, if true-up exhibits and testimony are required as part of the process, Empire could file an exhibit that included an update of rate case costs.

Q. DO YOU AGREE WITH THE RATE CASE EXPENSE AMORTIZATION PERIOD OF TWO-YEARS RECOMMENDED BY THE STAFF?

A. Yes.

TWO STAFF REVENUE REQUIREMENTS

Q. HAVE YOU REVIEWED THE TESTIMONY OF MARK OLIGSCHLAEGER OF THE STAFF CONCERNING THE TWO SEPARATE REVENUE REQUIREMENT CASES OR RUNS?

A. Yes.

Q. HOW HAS EMPIRE CHOSEN TO ADDRESS THE TWO SEPARATE REVENUE REQUIREMENTS PRESENTED BY STAFF?

A. Because of its proposal to terminate the existing IEC, Empire has tailored its responses to the accounting issues in this rate case to respond to the Staff revenue requirement that assumes that the Commission will terminate the existing IEC.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

NP

AFFIDAVIT OF W. SCOTT KEITH

STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the 27th day of July, 2006, before me appeared W. Scott Keith, to me personally known, who, being by me first duly sworn, states that he is the Director of Planning and Regulatory of The Empire District Electric Company and acknowledges that he has read the above and foregoing document and believes that the statements therein are true and correct to the best of his information, knowledge and belief.

W. Scott Keith

W. Scott Keith

Subscribed and sworn to before me this 27th day of July, 2006.

Patricia A Settle

Pat Settle, Notary Public

My commission expires: ____________.

Patricia A. Settle
Notary Public - Notary Seal
State of Missouri
County of Jasper
Expires February 09, 2008