STATE OF MISSOURI

PUBLIC SERVICE COMMISSION

TRANSCRIPT OF PROCEEDINGS

Hearing

December 15, 2004
Jefferson City, Missouri
Volume 14

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

KEVIN A. THOMPSON, Presiding,
DEPUTY CHIEF REGULATORY LAW JUDGE.

STEVE GAW, Chairman,
CONNIE MURRAY,
ROBERT M. CLAYTON,
JEFF DAVIS,
LINWARD "LIN" APPLING,
COMMISSIONERS.

REPORTED BY:

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PROCEEDINGS

JUDGE THOMPSON: Let's go ahead and go on the record. I believe we are ready for recross based on questions from the bench for Mr. Murray; is that correct?

MR. KRUEGER: It is, your Honor, but there is one preliminary matter I'd like to mention regarding --

JUDGE THOMPSON: Yes, Mr. Krueger.

MR. KRUEGER: -- taking additional testimony. And that is that last night after the hearing concluded, the Staff, at Commissioner Davis' request, provided him with a copy of the Staff's internal procedures. And after we did so, it occurred to me that that might be recorded as an ex parte contact where it's not an exhibit in the case and in fact hasn't even been shown to the other parties. In fact, I haven't seen it either. It's just something that I think that at least the other parties ought to be aware of, and I've asked John Keeble (ph. sp.) to obtain copies of it so they can take a look at it if they wanted to.

JUDGE THOMPSON: Very good. I appreciate that.

MR. COFFMAN: Your Honor, I would like to make a motion that the exact copy that was provided to the Commissioner be made an exhibit, if we can reserve a line for that.

JUDGE THOMPSON: All right.

MR. COFFMAN: I assume that Mr. Krueger is going to provide the copy -- the exact copy that was provided to Commissioner Davis last night.

MR. KRUEGER: Yes, what we're providing is the copy of the procedures off of the -- as they're printed up. It's not one that includes Mr. Murray's notes or anything like that. This is the printed procedures.

JUDGE THOMPSON: The one that the Commissioner received, does that have handwritten annotations?

MR. KRUEGER: It does not.

JUDGE THOMPSON: It does not. Okay. So the one you would be able to make available would be identical?

MR. KRUEGER: It will.

JUDGE THOMPSON: Very good. Okay. We'll reserve No. 125 for that manual. Anything else? Very well.

I see Mr. Conrad is not with us today, so Mr. Coffman.

MR. COFFMAN: Okay. Thank you.

CROSS-EXAMINATION

QUESTIONS BY MR. COFFMAN:

Q. Good morning, Mr. Murray.

A. Good morning.

Q. I think I just have one line of questions, and I believe this was from earlier -- earlier in the day yesterday, you were asked some questions, I believe by Judge

Thompson, regarding the business profile number that has been given to Empire District Electric by Standard & Poors.

A. Yes.

Q. Do you recall that?

A. Yes.

Q. Are you familiar with the guidelines by which Standard & Poors arrives at a business risk profile for a utility company?

A. Yes, those were updated in June of 2004, I believe.

Q. Okay. Have you seen this document?

A. The write-up on their revised guidelines and profiles, yes.

Q. Is it your understanding that Standard & Poors develops a business risk profile from one to ten based upon all of the business risks that a utility may have?

A. Yes.

Q. Would it be your expectation or your understanding that Standard & Poors granted Empire a business risk profile of six based on all business risks, including all risks involved with fuel and purchase power costs and volatility of such costs?

A. Yes, they were all encompassing of everything except for financial risk, basically.

Q. So in your mind, would it be fair to consider that the business risk profile of six be, in some way, adjusted based on any fuel and purchase power risk?

A. It's -- it assesses all the risk, which is fuel and purchase power, exposure, and the regulatory climate, and their economic climate, and their demand as far as the region they're operating in. It encompasses all those issues.

Q. So in granting Empire a six, all that was taken into account?

A. Yes, as far as I know.

Q. Okay.

MR. COFFMAN: Thank you very much.

JUDGE THOMPSON: Mr. Swearengen.

MR. SWEARENGEN: Yes. Thank you.

CROSS-EXAMINATION

QUESTIONS BY MR. SWEARENGEN:

Q. Good morning, Mr. Murray.

A. Good morning.

Q. How are you doing?

A. Pretty good.

Q. I have just a few questions, and essentially I heard some of the responses that you gave yesterday to questions from Commissioner Davis and Commissioner Gaw with respect to the DCF model and your use of it in this case. And I don't think you changed your testimony from responses that you had given to me earlier in the day yesterday, but I just wanted to make sure of that and just kind of go back over a couple of those points with you, if that would be okay.

I think you said that the DCF model, the discounted cash flow model, is commonly used to estimate the cost of equity. Is that true?

A. Yes.

Q. And I think you say that in your view, cost of equity and the required rate of return is the same.

A. Cost of equity and required return on equity, yes.

Q. Are the same?

A. Yes.

Q. Okay. And someone asked you about various forms of the DCF model, and I think you said basically the model is the same, there are different forms of it that can be applied. Was that your testimony?

A. Yes.

Q. And -- and what, for the record again, what form of the DCF model have you used in this case?

A. Mine is the constant growth annual form of the DCF model.

Q. And what form of that model or other forms have the other witnesses used, just for purposes of illustration, do you recall?

A. Dr. Murry used the same form that I used, which is the annual constant growth form and Dr. Vander Weide used the quarterly DCF with constant growth. And then Travis Allen -- OPC witness Travis Allen used the same semi-annual form of the DCF.

Q. Thank you. Now once again, with respect to the form of the model that you used, what was the word you used to describe it?

A. The constant growth annual form of the DCF.

Q. Okay. And you applied that form of the model on a company specific basis to Empire. Would that by a fair statement?

A. That's correct.

Q. That's not -- the company specific approach is not a different form of the model, it's just the way you apply the form you utilize. Is that a fair statement?

A. Yes, it's just applying it to a specific company. The form that I use for comparable companies are the same that I applied in Empire.

Q. And yesterday, when you were on the witness stand yesterday morning, I asked you if that was -- the company specific DCF approach was the primary tool that you used for determining a return or a cost of capital for Empire, and you said yes. And I take it that would still be your testimony.

A. That's correct.

Q. And when you do a company specific DCF analysis, as you did for Empire in this case, you look at only facts pertaining to Empire and then plug them into the formula, is that true?

A. Yes.

Q. And then the result is your cost of capital recommendation. Is that a fair statement? That's what I asked you yesterday morning, and I thought you said yes.

A. Yes.

Q. Okay. And then do you recall yesterday morning when I asked you about the fundamental assumption of the DCF formula or the model, and that is that the company whose cost of equity is being estimated operates in a steady state equilibrium. Do you recall that question?

A. Yes.

Q. And then do you recall that I took you through a series of assumptions with respect to the DCF model as to whether or not they should apply to Empire in this case, for example, the dividend payout ratio and rate of return on equity are expected to remain relatively constant.

A. Yes.

Q. Do you remember that series of questions?

A. Yes, I do.

Q. And at the conclusion of all of that, I asked you, I said given this, would you agree that Empire violates the fundamental assumptions of the DCF model, and your answer was yes. Do you recall that?

A. Yes.

Q. And that's still your answer?

A. Yes, it is.

Q. Okay. And then I asked you given that fact or those facts, did that not suggest extreme care in applying the DCF to Empire in this case, and I think you said yes.

A. That's correct.

Q. And that's still your testimony?

A. Yes, it is.

Q. Now, in exercising that extreme care in applying the DCF model to Empire in this case, that would involve an exercise of judgment on your part; is that right?

A. Yes, specifically with the growth factor, you're correct.

Q. And would it be fair to say that your judgment with respect to that issue would be based on your education, training, and experience?

A. Yes, and on analysis of the company, that's correct.

Q. All right. Let me ask you this: I can't recall who asked the question yesterday, but you referred to an AG Edwards report as the basis for your response. Do you recall that?

A. I don't know that I indicated it was a basis for my response. I indicated that that was one of the growth rates that's embodied in the projected growth rates from IBIS of three percent.

Q. Did you have any particular AG Edward report in mind when you -- when you made that statement?

A. No, I didn't. Like I said, I had analyzed IBIS' estimates of growth and I later found out from -- by contacting IBIS that the -- the two projected growth rates that IBIS had in its publication were from AG Edwards and from Lyman Brothers, and they indicated -- or I found from data request response information from Empire that one of those -- that the AG Edwards report was the three percent growth.

Q. Do you customarily use AG Edwards reports in formulating your opinions and recommendations to the Commission in connection with rate of return?

A. It's hard to tell if IBIS -- when I look at IBIS, unless you do further follow-up, you don't know exactly what brokers are following the company. They don't specify that unless you call them and find out, so they're -- it's quite possible that with many other companies, that AG Edwards may be one of the brokers that's providing estimates to IBIS.

Q. In this particular case, have you utilized the AG Edwards reports in any respect with -- in formulating your opinion and recommendation to the Commission?

A. Yes.

Q. And which reports were those, do you recall?

A. It wasn't a specific report. Like I said, there was a three percent growth rate in the IBIS projections, and that was based on an AG Edwards report. I believe AG Edwards is pretty well consistent on a projection of three percent growth. I don't believe I've seen any reports that differ on that long-term projected growth, at least not that are in my possession.

MR. SWEARENGEN: May I approach the witness, please?

JUDGE THOMPSON: You may.

MR. SWEARENGEN: Thank you.

BY MR. SWEARENGEN:

Q. Mr. Murray, I'm going to hand you a document entitled AG Edwards Empire District Electric Company equity research recent development report dated October 29, 2004. Have you ever reviewed this document previously?

A. I believe that's a more recent report. I have not seen the October 29th. I don't believe that was provided in a DR response. I don't recall specifically that date.

Q. If I would turn your attention to the second page of that report and ask you to read into the record, if you would, please, the paragraph that is third from the bottom. Would you do that?

A. Yes. On September 20th, the Staff of the Missouri Public Service Commission recommended a 12 million parenth 4.9 percent parenth increase in base rate revenues based on an extremely low 8.79 percent return on common equity with a roughly 50 percent equity capital structure. We find the Staff's recommendation troubling given that the recent industry average ROE authorizations have been in the 10 to 12 percent range, given that the Missouri Public Service Commission authorized a 10.5 percent ROE to neighboring Missouri Gas Energy in September of 2004. Despite the Staff's recommendation of 9.2 percent, we believe the company will receive a more constructive order from the MPSC.

I'd like to note that I didn't recommend a 9.2 rate in the MGE case, so that's not correct.

Q. And what did you recommend in the MGE case?

A. It was 8.5 to 9.5.

Q. Okay. And then one last question, if you could read into the record from page 3 of this report, the fourth paragraph from the bottom, please. Thank you.

A. The significance of the rate case is

highlighted by a September 28th rating act from Standard & Poors to the Staff recommendation. S&P placed a in response to the Staff recommendation. S&P placed the triple B slash A dash two corporate credit rating of Empire District Electric on credit watch with negative implications. The credit watch listing reflects prospects of erosion of EDE's financial condition if recent testimony by Staff is endorsed by MPSC. As of June 30th, total debt to total capitalization was 3.3 percent.

Q. Thank you.

MR. SWEARENGEN: That's all I have. Thank you.

JUDGE THOMPSON: Thank you. Redirect.

MR. KRUEGER: Thank you, your Honor.

REDIRECT EXAMINATION

QUESTIONS BY MR. KRUEGER:

Q. Good morning.

A. Good morning, Mr. Krueger.

Q. Did you see that AG Edwards report that Mr. Swearengen showed you before today?

A. No, I did not.

Q. Did you rely on it in preparing your testimony in this case?

A. Not that report, no.

Q. To what extent did you rely on AG Edwards, if at all, in preparing your testimony?

A. It had to do with the growth projections for earnings per share.

Q. And did you say that was three percent?

A. Three percent, that's correct.

Q. Okay. Do you have any knowledge if that's changed?

A. That report also indicated that they were projecting a three percent earnings per share growth rate.

Q. Thank you. Commissioner Gaw asked you yesterday about the result of your application of the CAPM case in Empire's 2002 rate case. Do you recall that?

A. Yes, I do.

Q. Were you able to find the answer to that question?

A. Yes, I was. In the 2002 rate case for Empire specific capital asset pricing model, the long-term based on the market risk premium from 1926 through 2001, on Schedule 16 attached to my direct testimony in that case, the CAPM -- the CAPM result was 8.67 percent. For a short-term period of 1992 to 2001, the CAPM result was 7.41 percent.

Q. Thank you. Commissioner Davis asked you some questions about the use of standardized testimony or a template as part of your pre-filed testimony yesterday. Do you remember those questions yesterday?

A. Yes, I do.
Q. Are you familiar with the practices that other ROE witnesses, other than those that are on the Staff, follow with regard to the use of standardized testimony?
A. Yes, I am.
Q. Do you know anything about whether Dr. Murry utilizes standardized testimony in preparation of the testimony that he files in a case?
A. He does.
Q. And how do you know that?
A. He's filed testimony in cases in the state of Missouri since I've been here. He's filed testimony in the last two Empire cases. He actually filed testimony in Empire's rate cases back to somewhere around the mid-90's, and you know, obviously I notice similarities in explanations of theory and the basis of regulation and what have you. And obviously those things do not change and it would -- you know, it really, I don't think, would make much sense to continuously change that testimony because the explanation is the same, and he had actually admitted so in his deposition that he had standardized portions of testimony.
Q. Okay. Thank you. Do you know anything about whether Dr. Vander Weide uses standardized testimony in the testimony that he files in rate cases?
A. The reason why I know he uses standardized

portions of testimony is because of his admission of so in his deposition. This is the first case that I've had the -- you know, had the pleasure of working in a case with Dr. Vander Weide, and so this is my first exposure to his testimony, but I do know from his deposition that that's the case.

Q. Do you have any reason to believe that the practice of incorporating standardized testimony into the testimony that's filed in a case is unusual or out of the ordinary?

A. No, it's not unusual.

Q. Would you give just a brief overview of the steps that you follow -- that you followed in preparing your direct testimony in this case? And I'm talking about the sequence of activities that you went through in preparing the testimony.

A. Obviously the most important thing in -- in starting off with any rate cases is evaluating the -- and analyzing the financial data of your subject company and the comparable companies that, you know, that's what's really going to reflect what change in the capital economic environment.

The explanation of the theory and the legal issues of -- of, you know, of rate of return regulation, that shouldn't change much unless my attorney tells me that there's something that has changed within the core cases. Maybe we'll clean that language up a little bit from time to time if there's some questions, you know, confusion from either Commissioners or other parties, we might try to, you know, improve the explanation. But the main part of, you know, any part of direct testimony is to really get to the specifics of the company and the specifics of the current capital and economic environment and trying to, you know, estimate a fair and reasonable rate of return.

Q. So is gathering data the first thing that you do?

A. Yes, actually preparing schedules is the first and foremost thing we're going to do to start analyzing what -- what we see as far as the cost of capital for any specific company.

Q. And then you subsequently prepare your testimony after the schedules are prepared?

A. Once we do the analysis, then we can explain why we did certain things within that analysis.

Q. In this case, did you do all that work yourself or were there some portions that others did for you?

A. Actually, Mr. John Keeble, who is filling in in our department in the absence of my manager, Ron Bible, because he was mobilized, he's helping out with the workload and we're giving him some experience, so he helped out with the schedules in this case, and I worked with him on that and -- but after, you know, after the schedules are prepared, I analyze and evaluate the data that goes into those schedules and determine, you know, what -- what's a reasonable recommendation.

Q. The work that Mr. Keeble did, was that done under your direct supervision?

A. Yes, it was.

Q. Do you, from time to time, make changes in the standardized testimony that you include in your direct testimony?

A. Yes, there's always room for improving some explanations.

Q. Now, when you make those changes, are they your own ideas or has someone told you to include the changes in the standardized testimony?

A. It could be a little bit of both. If I have a suggestion from somebody that's reviewing it to say that this might read a little bit better, this might communicate your point a little clearer, then I might change that. But I also, you know, change the testimony based on my own initiative in order to, like I said, you know, keep in mind some of the confusion that maybe some of the Commissioners might have about the testimony, so then I'll make those changes, too.

Q. And in your testimony yesterday, you described some of the changes that you did make in the standardized portions of testimony.
A. Yes, I did.
Q. Does your rebuttal testimony or surrebuttal testimony include any standardized portions?
A. Sometimes it does. For the most part, that, you know, if there's new issues in a case, you're starting from scratch and you're really going through and analyzing all sorts of new issues. Obviously, you know, sometimes there -- the issues are the same in certain people's direct testimony from case to case, such as doctor -- since Dr. Murry has filed testimony in Missouri, obviously, as we indicated, his approach is fairly similar from case to case, and so he does have that standardized part of his analysis.
And so the criticisms I've had in previous cases still apply to this case, and so there's really no reason to -- to reestablish that criticism. I'll look back to my previous rebuttal testimony on some of his analysis and use that, and then if there's new issues in a case, then I'll start from scratch on those -- those issues.
Q. Okay. Thank you. You told Mr. Swearengen that you did not look at a loud ROE's before doing your analysis.
A. Yes, I did.

Q. Why not?

A. Because what we're trying to do here is really, you know, determine what's going on in the current capital and economic environments, and those allowed ROE's may, even for, you know, the 2004 Public Utilities Ford Knightly, that could be from a case that was occurring in 2003 and was just determined in 2004. And the public utility bond yields starting in the spring of 2003 have dropped considerably, so I believe, you know, some of that information, you know, may not -- the information they were considering at that time considering the fact, like in Missouri, we have 11-month rate case process, things can change, you know, fairly significantly from one year to the next in a capital and economic environment. So I think it's important to -- to really look at the specifics of what's going on in our, like I said, in the capital markets and the economy right now.

Q. Did you do anything to make yourself aware of what other states are allowing on the ROE issue in your preparation for this hearing?

A. In the preparation for the hearing, I wouldn't -- I wouldn't necessarily say the preparation for the hearing. I looked at it -- we're starting to look at it, you know, because we know that it is a concern of the Commission because it was specifically cited in the MGE order, so obviously if, you know, if this is something that they're cognizant of, then we should be looking at it, too, to try to get an idea of what's going on within those -- within some of those other states.

Obviously, every state is a little different as far as how they're, you know, their regulatory environment is because of restructuring of the electricity markets; some states have deregulated, some haven't. So you have to do that with caution, but because of the fact that -- that this is something that the Commission is looking into and relying on, I did want to find out what, you know, what some of these staffs in other jurisdictions were recommending.

And also just to -- to find out the reliability of some of the survey results from Public Utilities Ford Knightly because, as I found, the 2003 and 2004 survey, they're five or six cases that were actually settled but they weren't indicated as such in that survey, so I think until there is a very thorough and complete and accurate survey done, it always needs to be used with caution.

Q. I don't need you to repeat the things that you mentioned to Commissioner Davis in answer to his questions yesterday, but were there any other specific inquiries that you made other than those that you mentioned to him either in regard to ROE's allowed in other states or recommendations by staffs in other states?

A. I think we talked a lot about Arkansas yesterday, and also talked about Colorado and the fact the staff recommended 9.25 to 9.75 in that case, and they settled on 10.25.

Kansas, I talked to Adam Gatewood, he -- obviously because of the fact that we share some, you know, some of the same utilities that operate in our states, talked to him and they just recently were involved in an Aquila case, and he had recommended a 9.5 percent return in that case. And so it was -- it was interesting to discuss some of those issues with him because I find that some of these other witnesses are facing some of the same heat that I am as far as, you know, this is what we're seeing.

We're seeing these projected growth -- even the projected growth rates are lower and these dividend yields are at a certain level, and so I -- unless you start trying to fish for something higher, you know, the results that weren't -- that we're receiving are lower, and I think a lot of that -- the test of reasonableness of that is to look at the fact that the price to earnings ratios for utilities is higher than they are -- than they've been on a historical basis, and I've seen some literature that indicates that is the case.

Q. Why did you decide to use the DCF method in making your cost of capital estimate in this case?

A. I believe it is the most, you know, the most reliable, most company specific -- when I say company specific, I'm talking about for all companies. When you apply the DCF, it's getting at the very specifics of the company. It's looking at the dividends of that company, it's looking at the stock price of that company, and a stock price reflects all investors' expectations about what they think the risks are with that company. And then you can look very specifically at what a reasonable growth is to expect for that company.

Where the capital asset pricing model and the risk premium model, you're looking at some outside variables, such as a total market risk premium, you're looking at, you know, the interest rates. And that's subject to a judgment as to which interest rate to use. And so there are, you know, that involves factors that aren't specific to the company, so -- and I think when you're trying to determine an opportunity cost for the company in order to be able to track capital, it's very important to look specifically at what's going on within that company.

Q. To your knowledge, has the Commission ever indicated that it's not appropriate to use a company specific DCF analysis?

A. To my knowledge, that's not been the case, and

I believe they adopted -- in the 2001 case, they adopted OPC witness' lower recommendation of 10 percent, which was primarily based on an Empire specific DCF analysis.

Q. Okay.

MR. KRUEGER: That's all the questions I have, your Honor.

JUDGE THOMPSON: Thank you very much. Mr. Murray, you may step down. Thank you for your testimony in the case. You are excused. Mr. Allen.

JUDGE THOMPSON: I'll remind you, Mr. Allen, you're still under oath. Take your seat. I believe we are ready for questions from the bench for you. Commissioner Appling.

COMMISSIONER APPLING: No questions this morning.

JUDGE THOMPSON: I have some questions for you, Mr. Allen.

THE WITNESS: Okay.

QUESTIONS BY JUDGE THOMPSON:

Q. With respect to the level of business risk associated with Empire, in your opinion, does its high reliance on natural gas as a fuel and the volatility of natural gas, does that increase the business risk or have no effect?

A. Certainly if you hold everything else equal, that would result in an increasing factor in the business risk, but business risk is just one indicator of the overall risk of a company. And the overall risk of a company is what investors look at when making investment decisions. You wouldn't just -- you wouldn't just look at the bark of a tree, you'd step back and look at the whole tree when trying to make an investment decision.

Q. Okay. Define business risk for me.

A. Business risk is the variability -- or it can be defined as the variability in a company's net income due to the operations of its business. For example, change in sales, change in the overall economic environment, change in cost.

Q. Okay. And what's overall risk?

A. Overall risk is an all-encompassing risk, including not just the business risk of the company but also the financial risk of the company.

Q. So as a layperson attempting to understand these concepts, from the point of view of an investor, the risk of a company is the risk that your investment will be lost. Is it not?

A. Yeah, you can look at it like that, yes.

Q. Well, I mean, is that not a usual way to look at it?

A. That's a laymen's term way, yes.

Q. Okay. So how does the sophisticated investor look at it?

A. I think what the sophisticated investor will look at is they'll try to get an understanding of the business aspect of the company, the risks that are involved in the actual business of the company, and also the financing risk, the fixed charges on the company's cash flow. But ultimately, yes, you're concerned about the loss of your investment.

Q. Okay. Because you're trying to pick a place to park your money, right?

A. Yes.

Q. And you want to park your money someplace, it depends, I suppose, there's a spectrum, right?

A. Yeah, you want to park your money based on your overall risk tolerance. You're going to pick what level of risk you are willing to tolerate and then based on that, you're going to pick companies that give you the best return relationship for that risk.

Q. Okay. For example, I might want a stock that's likely to grow. We've heard testimony about growth stock and income stock in this case, haven't we?

A. Yes.

Q. And like I believe there was testimony by someone that Microsoft, for example, was a growth stock. It doesn't -- not likely to pay a dividend, but instead it's going to hopefully increase in value. Is that an accurate recounting of the testimony?

A. I believe that's accurate. Actually, Microsoft does pay a dividend now, though.

Q. Okay. But then there's other stocks that do pay dividend and aren't expected to necessarily grow in value.

A. Well, I wouldn't say that they're not expected to grow at all, but the growth is not as high or, you know, expect them to grow as quickly as what you would normally consider your growth stocks.

Q. Okay. And isn't it true that the higher the risk, the more likely a substantial return? In other words, isn't it true that very risky stocks are the ones that are -- may on the rare occasion result in the largest amount of income or growth?

A. Well, it's a risk return tradeoff, yes, so the higher the risk, the higher the expected return of investors, obviously.

Q. Okay. So, from the point of view of an investor, if you knew that Empire was faced with an unusually high reliance on natural gas as a fuel and that natural gas prices are very volatile, wouldn't that make that -- Empire a less desirable place to park your money?

A. Well, it depends on, again, you're singling out one aspect. An investor is not going to just look at one specific aspect. They're going to try to look at -- measure all factors of the risk of the company. Now, if that -- certainly that will have an impact on the overall risk of the company, though, yes, you're correct there.

Q. Well, let's pretend you're an investor looking at Empire. What else would you look at?

A. I would try to get a gauge of the overall level of risk of the company using the measures that I've used in this case, looking at the beta of the company, looking at the bond rating of the company, looking at the ValueLine safety and timeliness ratings of the company.

Q. And what exactly is the beta?

A. The beta measures the volatility of the company's stock against the overall markets.

Q. In other words, how likely it is to move?

A. Yeah, for example, if you have a beta of 1 -- 1.0, then what you're saying is that the -- on average, the company's stock is going to track with the market, so if the market goes up ten percent, you would expect the company's stock to go up ten percent and vice versa.

Companies with betas greater than 1 are generally going to increase by a larger amount than the market, so if the market goes up, say, -- say on the extreme, company has a beta of 2, so it's twice as volatile as the market, so if the market goes up ten percent, you would expect your stock, on average, to go up 20 percent and vice versa. If the market went down ten percent, you would expect your stock to go down 20 percent, on average.

Q. And you also talked about bond rating.

A. Yes.

Q. What's bond rating?

A. Well, the bond rating is a measure of -- what rating agencies try to do is look at the potential that a company will default on its long-term debt, so -- so what they'll try to do is get a measure of business risk and financial risk and try to give them a rating to determine, you know, the likelihood that there's going to be a default or that their -- their assets -- I'm sorry, their net incomes, their cash flow is not going to be enough to pay or service the debt.

Q. What is Empire's bond rating, if you know?

A. Empire's bond rating is a triple B.

Q. Is that good?

A. It's investment grade.

Q. And what does that term mean?

A. You know, it means that -- investment grade is a measure of -- I guess it's kind of hard to say exactly a definition, but investment grade is -- is a -- is a needed designation for, for example, a lot of mutual funds and things to be able to invest. So those companies that are investment grade have more -- more return and yield for risk, a better yield risk relationship.

Q. Would it be fair to say that investment grade means that the risk of default is low enough that it would not be irresponsible for a fiduciary to invest in trusted funds in that firm?

a. Yeah, I think I didn't do a very good job of explaining it there, but yeah, I believe the government agencies have regulation on, for example, pension funds, what they can invest in as far as bond ratings go, and a lot of them are -- you have to be -- at least be investment grade for them to be able to invest in these companies.

Q. So sort of a gross measure of safety; is that correct?

A. Yes, you can characterize it as that.

Q. Okay. Well, how far is that rating from the top of the rating scale?

A. I actually have a handout if you'd like to see it, but in general, what you've got --

Q. Just tell me would be fine.

A. Okay. For example, Standard & Poors, you have triple A, then you've got the double A categories, then you've got the triple B categories.

Q. So it's the third?
A. Yes, third tier.
Q. All right. And how far is it from the bottom?
A. I don't know off the top of my head. It's -- I think the ratings go all the way down to D.
Q. Okay. So let's say it went down one step, would it still be investment grade, if you know?
A. One step, yes, it's triple B, so it could go down triple B minus and still be investment grade.
Q. What's the cutoff?
A. Triple B minus.
Q. So you could go down one step and be investment grade, but if it goes down two steps, it would not be?
A. That's correct, based on Standard & Poors, yes.
Q. Okay. Now, I heard testimony yesterday from Mr. -- excuse me, Dr. Vander Weide that Empire is not earning its cost of capital. Did you hear that testimony?
A. Yes, I did.
Q. Do you agree with that statement or disagree?
A. Well, based on my calculation of what their cost of capital is, which is 8.96 to 9.41 percent, and based on their recent ROE's, then I would agree with that statement that they have not been earning their cost of capital.

Q. Okay. Now, there's also been testimony that Empire has paid a particular amount as a dividend over the past several years. Have you heard that testimony?

A. Yes, I have.

Q. So as an investor, if the risk at Empire goes up, wouldn't it, in fact, make it all the more less attractive as an investment because there's no reason for me to expect a higher dividend in exchange for this higher risk that I would undertake?

A. Well, if the risk went up -- overall risk went up, then you would expect that investors would require a higher rate of return from the company.

Q. But there's no evidence that the company is going to change its dividend, is there?

A. From what I've heard in this case, I can't say -- I can't testify to that they are going to change it.

Q. I guess what I'm driving at, let me drive right there, is that based on what I've heard here, I'm suspicious that these models are perhaps not capable of accurately reflecting Empire's situation. What's your response to that?

A. I don't agree with that. I think that these models are actually accurately gauging the current low cost capital environment that Empire is in right now, and that's the reason why you're seeing these low ROE numbers from myself particularly, and I believe staff witness Murray, is that's -- we're trying to reflect what the current environment and what investors are currently expecting.

Q. Let me right that down. Low cost capital environment. What do you mean by that phrase, low cost capital environment?

A. What I mean is that the expectations of investors has -- as far as the return requirements, has decreased in recent years, and I think a lot of it is attributable to the low cost of the interest rates. You know, interest rates have been at a historically low level in recent years.

Q. So you're saying that investors just don't expect much for their money now?

A. What I'm saying is that I think there's a corelation between the -- the level of interest rates and the overall level required return of investors. And as of right now, as the interest rates have dropped, I think the overall required return of investors has dropped in general, as a general statement.

Q. Okay. Does that phrase also suggest that money is more readily available to Empire than it might otherwise be?

A. I don't understand your question.

Q. In other words, are they going to pay less for what they borrow?

A. Yes, you can make that current market rates, and yeah, based on -- on the decrease in interest rates in general, you can make that assumption, yes.

Q. Are you able to explain why the numbers you came up with are higher than the numbers that Staff witness Murray came up with?

A. I'm assuming you're talking about my ROE recommendation.

Q. That's exactly what I'm talking about.

A. I think the main reason -- I think David Murray testified to this yesterday -- was that our growth rates were pretty much similar with our DCF analysis, but the difference was in the price -- the time frame that we chose to calculate the price component of the DCF model.
Mr. Murray used a six-month period, whereas I used a six-week average period of prices. And consequently, my dividend yield was higher than his. I --

Q. So it's a different of inputs?

A. Yes.

Q. Different input.

A. Yes.

Q. Well, how is the Commission supposed to select among the various numbers that have been offered by four different expert witnesses all using similar but not quite identical models except in the case, I guess, of Dr. Vander Weide, where the model was somewhat less similar?

In other words, you used a different input, you got a different number. Well, if the Commission selects your number as opposed to his number, that's going to make a significant difference for this company, is it not?

A. Yeah, I believe so. I think the rate base is $600 million, so yes, it would make a difference.

Q. So what can you tell me about your selection of input that would persuade the Commission to select your results over those offered by the other witnesses?

A. Well, I believe as far as stock price is concerned, it's my belief that what you're trying to do is funnel current investor expectations, and I believe that the use of a six-week average is a better approximation of investor expectations than what Mr. Murray used, the six-month average. I believe that's too long of a period to accurately gauge the current expectations of investors.

And what you're trying -- what I try to do with the six-week average is get a general -- an understanding of where the stock price has been currently, so what you're trying to do when you average is you're trying to eliminate the day-to-day fluctuations. You try to get a general picture of what the stock price has been in recent weeks so as to gauge investor expectation -- current investor expectation.

I believe the growth rate that we used or that I used, the three percent growth rate is accurate, and I believe that it's pretty consistent with witness David Murray's growth rate. I believe his was range was 2.25 to 3.25 percent. And, you know, the dividend is not as much of a contingent issue because you know what the dividend is.

Q. Okay.

A. But, I'm sorry, but back to your question, you know, I think the Commission has, you know, has the job of weighing the evidence in the case and seeing what they believe is -- or seeing or reading the testimony and determining what they believe is -- is the best case and the best result.

Q. Well, I appreciate that. I know that that is, in fact, the Commission's duty. Would you agree with me that what you are doing is an art rather than a science?

A. I would agree with you that it is as much of an art as it is a science, yes.

Q. In other words, there is specialized knowledge on the part of the practitioner, for example, in your selection of a different input, than that that Mr. Murray used, isn't that right?

A. That's correct.

Q. You made an expert decision that the inputs you were using would yield a more accurate or more representative result, correct?

A. Correct.

Q. Okay. Are you familiar with the testimony of Dr. Murry and Dr. Vander Weide in this case?

A. Yes, I am.

Q. Now, those two gentlemen have been doing this for quite a bit longer than either you or Mr. Murray, isn't that right?

A. That's correct.

Q. In fact, both of those gentlemen are professors at esteemed institutions, isn't that correct?

A. That's correct.

Q. So shouldn't the Commission give more deference to their results than yours?

A. No.

Q. And why is that?

A. Because I believe that my result is the actual required rate of return of investors of Empire as of right now. If I didn't believe that, I wouldn't recommend it.

Q. Well, I don't doubt your sincerity, but I'm trying to understand what errors or flaws did you see in what they did?

A. Primarily with Dr. Murry, and I believe Staff witness David Murray has talked about this, and I fully concur with him, that the growth rate that he used based on ValueLine was a six percent growth rate was essentially, I think, extremely optimistic.

And when you look at how ValueLine calculates their growth rates in the base period, the base period that he used was, I believe, 2000 to 2002. They had the anomalous .59 earnings per share that year, and I think that obviously had a result of skewing that growth rate up to the six percent. If you look at how ValueLine does their calculations, what the analysts will do is not necessarily make a projection on growth, but what they'll do is they'll say earnings per share in 2004, for a hypothetical example, is going to be $2.50.

What they will do is say, okay, what I do expect in the future, say 2005, 2006? They'll say, well, I think maybe $2.50, $2.60, right, so what they'll do then is back out what implied growth rate that is, and whenever you back implied growth rate out, if you have an anomalous year, that's going to result in obviously a growth rate that is skewed upwards.

And you know, my review of the various consensus growth rates, S&P growth rate, and the IBIS growth rate, I believe it's fully -- fully supports my three percent growth rate range.

Q. Okay. Tell me what you mean by the term

anomalous year.
A. Well, what you're trying to do -- the anomalous year, I believe Mr. Gipson, Bill Gipson, testified that the earnings per share in 2001, the $0.59 is -- was, you know, not representative of a normal year's earnings for Empire.
Q. But it is historically accurate?
A. It's historically accurate, but if you look at the earnings per share of Empire for the last ten or so years, you would see a big discrepancy between that one year, and I believe he had talked about --
Q. Was it anomalous in that it was unusually low or unusually high?
A. Unusually low.
Q. And do you -- can you give me an opinion on why that anomaly occurred?
A. Well, I believe Mr. Gipson testified as to the cost that they incurred due to the proposed merger that failed with UtiliCorp. I believe that was his testimony.
Q. What's the likelihood of another anomalous year in the future?
A. You know, it's possible, I believe, that currently for 2004, expectations are that earnings per share for Empire are going to be around a dollar, I think that's what Dr. Murry testified to, so -- but obviously that's not

nearly as low as the $.59 in 2001.

But when you're looking at ValueLine and you understand how they calculate their growth rates, I think it's important for an analyst, and I think this is what investors would do would be to -- to try to normalize earnings in the beginning base period and then calculate what they expect the growth rate to be. And you know, I think when you do that, obviously you get around a three percent growth rate, which is pretty consistent with what the consensus growth rate estimates are right now.

Q. You know, everything you say just gives me so many more questions to ask.

A. Well, it's not, yeah, it's an interesting field.

Q. But we do want to get done today.

A. It's not three plus three equals six, and I understand that. It's something difficult to wrap your head around. I understand that.

Q. Let me ask you this: These tools and methods of analysis that you have employed, are they typically used by investors in selecting an investment?

A. Yes, I believe they are.

Q. Is that the purpose they were formulated, if you know?

A. Yeah, well, the DCF model was originally --

not to bore you with the history of it, but it was originally produced or designed or invented by an individual named John Williams, who the idea of it was to come up with the intrinsic price of a security, what investors -- what stock price was representative of the value of that company, and since then, Dr. Myron Gordon has manipulated that formula to the form that we use today to determine the required rate of return.

Q. So there's an underlying assumption, here, is there not, that in determining the cost of equity for Empire for rate-making purposes that this is essentially the same as determining the value of that security for investment purposes?

A. It's the same formula that has been ma manipulated to solve for the required rate of return, and how you do that is by using the current stock price, yes.

Q. But are those two tasks really the same? In other words, is the Commission's task in setting a rate really significantly similar to the decision an investor makes in choosing where to invest money?

A. Yeah, I believe it is, because, you know, the Commission's task is to determine what -- what rate of return investors are requiring, and that's certainly what investors --

Q. No, the Commission's task is to set a just and reasonable rate. That is somewhat different, I think.

A. Which I -- my interpretation of a just and reasonable rate is that it's the required rate of return of investors.

Q. Really. And do you have any authority for that? In other words, is there a court case or a treatise where that equivalency is stated?

A. Well, I believe that, you know, the Hope and Bluefield cases talk about equal risk, equal return, and, you know, I believe that it is the required rate of return of investors, so equal risk, equal required rate of return of investors.

I believe Dr. Vander Weide testified that it was universally accepted as the required rate of return of investors. I don't believe any -- any witness -- any of the four witnesses in this case believe otherwise, that it's not the cost of capital or the required rate of return.

Q. Okay. Now you were talking about earnings per share. What does earnings per share mean?

A. Earnings per share is simply net income divided by the number of shares outstanding, so it's the profit divided by the number of shares outstanding.

Q. So is Empire earning a profit?

A. Yeah, it's earning a profit.

Q. But it's not earning its cost of capital. Can you explain the difference between those two things?

A. The -- the -- the earnings per share, as I said, was net income divided by number of shares outstanding, then the ROE of a company is simply the net income divided by the total equity, so that -- there would be a discrepancy there.

Q. Okay. As a financial analyst, would you consider the fact that Empire's not earning its cost of capital to suggest that it is financially unhealthy or unsound?

A. Well, obviously, as an investor, you would want the company to earn its required rate of return, but, you know, my understanding of -- of the way that regulation is performed here in Missouri is that the Public Service Commission provides enough revenue so that, in its mind, the Commission's mind, that if the utility company is operating prudently and efficiently, that it would have the opportunity to earn its required rate of return or its authorized rate of return. That's my understanding of the way it works.

Q. But what significance to a financial analyst does the fact that Empire's not earning its cost of capital have with respect to the health or soundness of this company? Does it indicate that the company is unhealthy or unsound?

A. Well, you know, I mean --

Q. I think that's a yes or no.

A. Yeah, I think the comparison though, is that does it indicate that it's healthy or unsound, I mean, because it's not earning its cost of capital would obviously be -- when comparing it to a company that did, obviously you would say that the company that was earning its cost of capital was, in general, in a healthier position than a company that wasn't.

Q. And Dr. Vander Weide, I believe, testified that this was not a condition that could long continue. Would you agree or disagree with that testimony?

A. I would agree with that. In a long-term, it's not as sustainable.

Q. And how is the Commission to fix that problem? What is the fix for that problem?

A. You know, I think that a -- the Commission is -- should determine what the prudent costs of this company are, prudent costs of this company are, and what the investors required rated of return is and give that --

Q. I'm not considered with investors' expected rate of return. I'm asking what is the fix for this company's situation of not earning its cost of capital. What do we do?

A. I'm trying to explain that to you.

Q. Okay. Please do that.

A. I think this company, that the Commission should determine what the prudent costs of this company are going to be in the future and to determine what the required rate of return for this company is and give this company the -- the revenues and rates that will allow it to -- or allow it the opportunity to -- to recover its cost in the future and allow it the opportunity to earn the authorized rate of return.

In our, other than that, you know, that's what the -- that's -- I'm not sure that just because the company does not earn its allowed ROE, that it is, you know, that we consider that the -- it's not a guarantee is what I'm trying to get to.

Q. Okay. Very good. Well, is it your opinion that Empire has been inefficiently managed?

A. You know, I haven't analyzed the actual costs that they have incurred with regard to what the Commission has determined to be prudent cost, so I can't testify to that.

Q. But are you familiar generally with the case that the Public Counsel's putting on in this proceeding?

A. In general, yes.

Q. And is Public Counsel putting on -- making an allegation or putting on evidence that Empire has been imprudently managed?

A. I don't believe so, but I'm not sure if that's

--

Q. Okay. If you were the CEO of an unregulated company that was not earning its cost of capital, would you raise prices?

A. Well, raising prices in an unregulated company will not necessarily guarantee that this company is now going to earn its cost of capital, because in an unregulated company, you don't have a captive customer base. So if you raise your prices, you might lose a lot of sales. Compared to, for example, if you're K-Mart competing against Wal-Mart, and K-Mart raises the price on Dial soap to $6 for a bar of soap, that doesn't guarantee that now K-Mart is going to earn its cost of capital, because the public is going to go to Wal-Mart and buy a bar of Dial soap for, I don't know, $.70, whatever the cost. So just rasing the prices is not going to guarantee that the company is going to earn their cost of capital.

Q. Thank you.

JUDGE THOMPSON: Commissioner, do you have any questions?

COMMISSIONER APPLING: Not at this time.

JUDGE THOMPSON: Thank you, sir. I believe we're ready for recross based on questions from the bench. Mr. Krueger.

MR. KRUEGER: Thank you, your Honor. I think

I have just one question.

CROSS-EXAMINATION

QUESTIONS BY MR. KRUEGER:

Q. Does risk pertain only to the total loss of an investment or the risk that the investment may simply perform differently than you expect?

A. It performs to the risk that it might not perform the way that you'd expect it.

Q. That the return would be greater or less than --

A. Yes.

Q. -- than expected?

A. Yes.

Q. Okay.

MR. KRUEGER: Thank you.

JUDGE THOMPSON: Mr. Conrad, I see you back there.

MR. CONRAD: No questions, Judge, thank you.

JUDGE THOMPSON: Thank you, sir. Mr. Swearengen.

MR. SWEARENGEN: Yes, your Honor.

CROSS-EXAMINATION

QUESTIONS BY MR. SWEARENGEN:

Q. Just a couple of questions, Mr. Allen, to follow-up on what Judge Thompson was asking you about. And you used the example of Wal-Mart and K-Mart. Would you agree with me that neither Wal-Mart or K-Mart have any public utility obligation to provide service?

A. I would agree with that.

Q. And so whether or not either of those companies would continue in business really wouldn't make any difference from that standpoint?

A. Well, I mean, it would make a difference to them, but yeah, it wouldn't be a public-need product, so yes.

Q. On the other hand, in the case of Empire, would you agree that it's not in the public interest that that company go out of business?

A. Yes, I'd agree.

Q. And why is that?

A. Because it is a basic necessary for the public, the product.

Q. Judge Thompson asked you some questions at the outset about risk. Do you recall those questions?

A. Yes.

Q. And I think you said you'd read the testimony of Dr. Vander Weide in this case.

A. Yes.

Q. Do you recall that in his direct testimony, Dr. Vander Weide attempted to set out the primary factors that affect Empire's business and financial risks?

A. Could you give me a page number on that?
Q. I sure can. Page 14 of his direct testimony.
A. Yeah, he went through a variety of risk measures for Empire from page 14 to 16.
Q. And those include high operating leverage, demand uncertainty, peak demand, high degree of financial leverage, technology risk, would you agree?
A. And regulatory uncertainty, yes.
Q. Regulatory uncertainty. Would you -- would you mind reading into the record what he says about regulatory uncertainty, please?
A. Sure. Regulatory uncertainty. The business and financial risk of electric energy companies such as Empire ultimately depend on their ability to charge rates that cover their costs. As long as regulators allow the companies to charge rates that reflect its cost of providing service, including its cost of capital, risk is minimal. However, if regulatory authorities set rates that fail to reflect the companies cost of providing service, regulatory risk can be substantial.
In Missouri, electric companies face these substantial risks that they will not -- that they will be unable to recover increases in fuel and purchase power cost. This risk arises because Missouri, unlike most states, does not have a fuel adjustment clause mechanism. In addition,

Missouri does not allow Missouri utilities to include CWIP in rate base and depreciation rates are significantly lower for electric utilities in Missouri than in other jurisdictions.

Q. Thank you. And when the letters CWIP appear in his testimony, what do you understand that to mean?

A. Construction work in process.

Q. Now, do you agree with Dr. Vander Weide's testimony on page 16 concerning regulatory uncertainty?

A. I can agree that with regards to -- I understand that Missouri does not -- has legislation against fuel adjustment clauses and construction -- I believe construction work in process, but I'm not sure if that's a legal issue or not. But to the fact that those are not allowed to be recovered or to the fact that -- here's what I can agree to: The fact that one state has fuel adjustment clause and one doesn't, then all else equal, the state that has the fuel adjustment clause would imply less risk for the company. And to the fact that a company that has construction work in process that is allowed in rates prior to the completion of the project, the state that allows it into the rates prior to would obviously -- those would have less risk than the state that didn't, all else equal.

And for depreciation rates, I really don't know a lot about the depreciation rates.

Q. Let me see if I can get at it this way then.

Let's see if you can answer the question this way. The first sentence beginning on line one, the business and financial risks of electric energy companies, do you agree or disagree with that sentence?

A. I would agree with that.

Q. How about the second sentence, do you agree with that?

A. I would agree with that.

Q. How about the third sentence?

A. Yes, I'd agree.

Q. How about the next sentence? In Missouri, electric companies face the substantial risk that they will be unable to recover increases in purchase and power costs. And perhaps you need to read that sentence in conjunction with the following sentence. Do you agree with those two sentences?

A. I'm not sure that I can agree with those two sentences.

Q. And why is that?

A. Well, because my understanding of rate-making in Missouri is that the Commission will set a rate for fuel and purchase power costs that they believe is adequate and will allow the companies to recover their costs or the opportunity to recover their costs. That's my understanding of the way the process works.

Q. And if it turns out that that decision, for whatever reason, for example, in the case of natural gas is a fuel is subject to prices, subject to wide swings and variations, isn't there risk that if there is no automatic recovery mechanism or fuel adjustment charge or some other mechanism, that the company may not recover its actual costs?

A. There's the upside risk and the downside risk as well, so there's a risk that they might not, there's also the risk that they recover more.

Q. And that's a risk that the company has that they might recover more?

A. Well, that's not a risk for the company, that's a risk for the ratepayers.

Q. Let me ask you this question: To the extent that there is no mechanism to permit recovery on an ongoing basis of those actual costs, would you agree that that is a risk that the company faces?

A. I believe I answered that question as to -- to the Commission allows the opportunity to recover those costs and that if the cost -- the price that the Commission sets say it's $6 or $4 for gas, and the gas is $6, then that is a risk for the company. But if the price is $4 and -- or the price that the Commission sets for gas is $4 and the actual price of gas is $3, then that's a risk for ratepayers.

Q. Okay. Thank you. And then the next sentence that concerns construction work in progress in rate base, do you agree or disagree with that?

A. I believe that's correct.

Q. And the rest of that sentence which says depreciation rates are significantly lower for electric utilities in Missouri than in other jurisdictions, do you agree or disagree with that or do you know?

A. I don't know.

Q. Okay. Now, would you agree that another aspect of regulatory uncertainty could perhaps be the -- and I will use the word misapplication of the DCF formula in setting unauthorized return for a company? Could that be a risk that the Commission might make a mistake in doing that?

A. I believe that the Commission could make -- could make that mistake, sure.

Q. Do you have Dr. Vander Weide's surrebuttal testimony with you?

A. Yes.

Q. If you would take that out and turn to page 6, please.

A. Okay.

Q. There on line 4, the question is what is the fundamental assumption of the DCF model. Do you see that?

A. Yes.

Q. Would you read into the record, please, his answer?

A. As discussed above, the fundamental assumptions of the DCF model is that the company whose cost of equity is being estimated operates in a steady state equilibrium where its dividend payout ratio and rate of return on equity are expected to remain relatively constant. And in its earnings, I'm sorry, and its earnings, dividends, book value, and stock price are all expected to grow at the same rate and perpetuity.

Q. Do you agree with that statement as to the fundamental assumption of the DCF model?

A. That's one of the assumptions of the DCF model.

Q. That's one of the assumptions.

A. Yes, I agree.

Q. And the next question, in what way does Empire violate these assumptions, would you read that answer into the record, please?

A. Empire violates these assumptions in at least three ways. First, Empire is currently earning a rate -- a return on equity that is less than either its allowed rate of return on equity or its cost of equity capital. This situation is unsustainable in the long run. If Empire continues to earn less than its cost of equity, stockholders will pressure management to liquidate the firm.

Second, Empire's dividends currently exceed its earnings and the situation is also unsustainable in the long run. Because the problem lies primarily in Empire's low earnings, Empire's earnings must grow at a greater rate than its dividends until its dividend payout ratio reaches a more normal level.

Third, Empire is in the dangerous situation where its bond rating agencies have placed the company on a negative watch for a bond downgrade. This situation is unsustainable in the long-run as well.

Q. And do you agree with Dr. Vander Weide's testimony on that point, the point being how Empire violates the DCF assumptions?

A. I'm not sure if I believe that the third point that he makes is necessarily a violation of the DCF assumptions; but the first two, sure.

Q. The first two?

A. Yes.

Q. Sure are. Okay. Thank you.

MR. SWEARENGEN: That's all I have. Thank you.

JUDGE THOMPSON: Thank you. Redirect, Mr. Coffman.

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REDIRECT EXAMINATION

QUESTIONS BY MR. COFFMAN:

Q. Mr. Allen, you were asked questions regarding fuel -- fuel volatility. And I assume that you have reviewed the fuel-related testimony in this rate case.

A. I've reviewed the direct testimony of Office of the Public Counsel witness James Busch, and I believe I reviewed the direct testimony of Brad Beecher.

Q. Do you have an opinion about whether the current state of natural gas prices is -- exhibits a situation that is more volatile than, say, two years ago?

A. No.

Q. Okay. Do you have any understanding or knowledge about whether or not the degree to which Empire is reliant on natural gas, that is the percentage of energy is produced from natural gas, is any greater than it was a few years ago?

A. I can't testify to a few years ago, but my understanding is that they -- they rely were predominantly on natural gas, and I believe it's to a significant degree greater than 50 percent of their production or their burn of natural gas, I believe.

Q. It is true, is it not, that you have read a variety of analysts' opinions and commentary on fuel volatility and risk as it relates to this electric company?

A. Yes.

Q. And is it your opinion that from the consensus of these analysts that that fuel volatility has somehow increased in just the last two or three years any greater than it has been, say, in the year 2001?

MR. SWEARENGEN: Objection, leading.

JUDGE THOMPSON: Sustained.

BY MR. COFFMAN:

Q. Do you have any opinion, Mr. Allen, about whether the volatility today with regard to fuel and purchase power cost has changed from recent periods, periods before this year?

A. Well, my understanding is that, you know, it's -- natural gas is obviously a volatile commodity, but as far as whether or not it's more volatile today than it was before, I can't testify to that. That's not an area I reviewed.

Q. Well, to the degree that the risk profile of this company has changed, would you expect that to be reflected in what analysts are projecting the growth rate to be for Empire?

A. You're talking about the business risk profile --

Q. Specifically --

A. -- or The overall risk profile?

Q. The overall risk.

A. Can you ask the question again?

Q. Yes. Would you expect any recent change in the risk of Empire to be incorporated in what analysts are projecting to be a proper growth rate for Empire Electric Company?

A. Yes, any -- any -- the overall risk of the company is going to be incorporated.

Q. And you were asked several questions about the three percent growth rate that you arrived at and how you received that. Would you clarify or give a sense to the Commission of how -- how many sources of information or analysts you reviewed to arrive at that three percent growth rate?

A. Yeah, I did a -- in my direct testimony, I did a projected BR plus SB calculation, and that came out to be around one and a half percent. Then I also looked at the S&P 500 -- or I'm sorry, the S&P consensus growth rate, which I believe at the time of my testimony for Empire was around two percent.

I also looked at the Thompson growth rate, which around the time of my testimony, I believe, was two and a half percent. And I looked at the ValueLine growth rate, which was shown at the time of my testimony, six percent rated growth, but when I dove in deeper into that six percent growth rate, I, as discussed earlier, when I took anomalous 2001 earnings per share data into consideration and adjusted the growth rate to that, it fell at right at around three percent.

So I cast my net, I tried to look at as many growth rates as I could in making my determination that the growth rate for Empire should be around three percent.

Q. Could you give an approximation of how many analysts went into that survey?

A. Well, as far as the Standard & Poors consensus growth rate, I believe there was four analysts that contributed to that two percent growth rate. And as far as the Thompson's financial growth rate, I believe there was also four analysts that contributed to that consensus growth rate. ValueLine is simply the opinion of the analyst, the one analyst that covers that stock. And for Empire, his name is Paul Deboss, (ph. sp.) and -- yeah, I think that's a good approximation.

Q. And if you consider that ValueLine recommendation of Mr. DeBoss of a six percent, how would you characterize that six percent as it related to all the other analysts that you reviewed?

A. I would consider it as an outlier.

Q. And is it true that when you run the ValueLine calculation, taking out the one year relating to 2001, the calculation would have arrived at close to three percent or less than that?

MR. SWEARENGEN: Objection, leading.

JUDGE THOMPSON: Sustained.

MR. COFFMAN: I believe that's already in the record.

BY MR. COFFMAN:

Q. You were asked about the earnings that were reflected in 2001, and that the $.59, and the question about the testimony as to the failed merger -- or the proposed merger between Empire and UtiliCorp that did not take place. Do you understand who was to be the primary beneficiary of that proposed merger? That is either the shareholder or the ratepayer?

A. I believe that it was -- the primary beneficiary was the shareholders.

Q. Or would have been?

A. It would have been the shareholders, yes.

Q. There has been a considerable amount of discussion and perhaps confusion about what is referred to when where he say the required rate of return. Can you explain to me what you understand the phrase required rate of return to be referring to?

A. Well, my understanding of the required rate of return is the return that investors are actually expecting to earn on a security. And not necessarily what is authorized by this Commission, but what they actually expect to earn. And, you know, financial theory would tell you that if this Commission authorizes 11 percent, and for example, we do a DCF analysis on Empire of, as we have done, and we -- we come up with around -- that the required rate of return is between, in my analysis, 8.96 to 9.41 percent, based on a DCF analysis of Empire, which I believe the company is indicating that the DCF model is -- is not reliable to use for -- for Empire because it violates some of the assumptions.

But, you know, really the assumptions is -- is -- to quote the Nobel prize winning accomplice Norman Friedman, the assumptions, the important thing to understand about the assumptions of a model is not whether or not they are -- they are realistic in the real world, because in general, they never are. The important thing is how good the results are, how well the model actually represents current investor expectations.

And I believe that this model has -- has done this, and I believe that that is -- that the current expectations of investors is around, you know, nine to nine and a half percent, so whenever you -- whenever you analyze this and you come up with a required rate of return between nine and nine and a half percent, that's what investors are expecting, so if this Commission authorizes something higher than that, it does not necessarily mean that that's what investors are going to earn, because what's going to occur is adjustors are going to adjust the stock price so that what they actually earn is what they require, not what is authorized.

Q. You were asked questions by the Judge regarding Empire not actually earning its cost of capital, and whether or not the Commission should do something to quote-unquote fix that problem. Is it your understanding that it is the Commission's responsibility to guarantee that a utility earns its cost of capital?

A. No, it's not. It's not a guarantee. This Commission should authorize rates of return that if the company is operating efficiently and prudently, then it has the opportunity to earn its rate of return -- earn up to its authorized rate of return. So it's like a fishing license. You know, say, nine percent, if they are run prudently and efficiently, they should have the opportunity to earn a return on equity of up to nine percent.

Q. Would it be fair to say that it's actually the utility's skill and opportunities that it must face that determine whether or not it -- it attains an authorized rate of return?

MR. SWEARENGEN: Objection, leading.

JUDGE THOMPSON: Sustained.

BY MR. COFFMAN:

Q. Is it true that the rate of return is -- the rate of return that you are recommending is but one component of the overall rate-making or revenue requirement formula?

MR. SWEARENGEN: Objection, leading.

JUDGE THOMPSON: Sustained.

BY MR. COFFMAN:

Q. Could you clarify for me your role in recommending a rate of return and that is what -- how it relates to the overall goal of setting a revenue requirement?

A. Well, my job is to -- to recommend to this Commission the company's actual cost of capital, which is a weighted cost of capital, weighted cost of, in Empire's case, their long-term debt, their preferred securities -- or their trust preferred securities, and their cost of equity. And that number that is calculated by myself or analyzed and developed by myself is then, if adopted by this Commission, is then multiplied by the rate base, which is then used to come up with the revenue requirement for this company.

Q. Okay. So if there were any prudence issues and reasonableness issues in the case, those would be addressed in other components?

A. Yeah, those are not -- those would be addressed in the costs of the company, which is not something that -- that I've analyzed.

Q. Okay. You were asked a couple of questions about the major differences between the method you employ and the method Mr. Murray employees on behalf of the Staff. And you discussed the six-week period that you developed for a stock price. Can you explain how that six-week period compares to the period that Mr. Murray used to develop stock prices?

A. As far as the results?

Q. As to how those time periods relate to each other.

A. Well, Mr. -- or Staff witness David Murray, I believe, calculated a period from -- I don't really know exactly his period, but what he did was he calculated a high-low average stock price over a six-month period, whereas what I did was I calculated the closing price for Empire over a six-week period, so it's -- first of all, witness Murray did the high-low average whereas I did a closing price average, and I believe the result of -- of Mr. Murray resulted in a higher stock price than that of what I developed.

Q. Was the time period that you reviewed on average more recent than Mr. Murray's time period?

A. Yes, it was. It -- it is more recent and consequently, I believe, is better representation of investor -- current investor expectation. Mr. Murray -- or Staff witness Murray, I pointed out in my surrebuttal testimony, not only does he give weight to less historical information as far as stock prices go, but he gives equal weight to that information -- the older information as well as the new information in his six-month period, which I don't believe is appropriate.

Q. And -- but as to the growth rate, I believe you testified that you and Mr. Murray came to very similar conclusions as to that component.

A. That's correct. I came to an expected growth rate for Empire, I used three percent growth rate, and witness David Murray came to a growth rate estimate for Empire of 2.25 to 3.25 percent.

Q. Okay. And did you confer or collaborate in any way with David Murray in the development of your recommendation?

A. No, I did not.

Q. It was totally independent?

A. It was a complete independent analysis. Mr. Murray and I are -- I consider Mr. Murray a friend of mine, but we have a professional relationship when it comes to making our recommendations and we do not discuss the specifics of our analyses with each other.

Q. Thank you very much.

MR. COFFMAN: That's all I have.

JUDGE THOMPSON: Thank you, Mr. Coffman. Thank you for your testimony, Mr. Allen. You may step down.

THE WITNESS: Thank you.

JUDGE THOMPSON: You are excused. We're now at the point where we need a break for the reporter. Why don't we come back at 10:15 for opening statements on the depreciation issue. We are in recess.

(A BREAK WAS HAD.)

JUDGE THOMPSON: We're ready for opening statements on the depreciation issues. Mr. England.

MR. ENGLAND: Thank you your Honor, I'm glad to see that I have a blank slate for my art work. Thank you.

May it please the Commission. My name is Trip England, I'm representing the Empire District Electric Company today. As I understand the issue before you is depreciation. In that regard, the company has two witnesses, first Don Roff, an outside expert with the accounting firm of Deloitte & Touche, who has prepared a depreciation study and attached that as part of his direct testimony. In addition, we have the testimony of Greg Knapp.

The -- as I mentioned, the study that Mr. Roff has performed is attached to his direct testimony. As a result of that study, Mr. Roff has determined that the appropriate rates for depreciation for Empire District would increase existing annual accruals by approximately $25 million a year. These increases or this increase is due primarily to a shorter life for production plant, treatment of net salvage, that is what I refer to as the traditional method of handling net salvage as part of the depreciation rate. And I might say as an aside the current rates do not contain any allowance for or accrual for net salvage as a result of a decision by this Commission in the company's 2001 rate case.

And then finally, Mr. Roff's study is based on a remaining life technique. By contrast, Staff and Public Counsel have used a whole life technique and they have proposed or support longer lives for production plant and little, or in the case of Staff, no net salvage allowance as part of their depreciation allowance. Staff and Public Counsel's case would essentially maintain the status quo. As a matter of fact, I think if their rates were applied, they would actually result in a slight decrease, if you will, in annual accruals.

For purposes of this case, however, the company recognized that it could not seek the full recovery of the $25 million depreciation expense that it believes is appropriate and has modified that request to approximately $10 million on a total company basis. Those modifications are described in Mr. Roff's rebuttal testimony, and they include primarily a whole life technique.

Mr. Roff has capped net salvage percents at 100 percent for the four accounts where his study would indicate a net salvage percent in excess of 100 percent. And finally, he has extended the final year of retirement for the Asbury plant from 2014 to 2020.

Now, the issue of lot -- as a result, the only issues, as I understand from our statement of position, is an issue of lives. As I mentioned, lives primarily related to production power plant facilities, and the issue of net salvage. The issue of lives is primarily centered on the company's use of the life span analysis, which is dependent upon the estimate or projection of final year of retirements for the plants.

The issue of net salvage is what I would call the traditional issue that you all have heard over the last several years in a number of rate cases. So I -- in order to keep this brief, I will not bore you with all of the reasons why what we're proposing is good and why all of the reasons supporting Staff and Public Counsel's positions are bad. I'll leave that to my brief to bore you.

I would note, though, however, in closing, one significant thing that I -- that I'm not sure has gotten enough attention. The very last schedule in Mr. Roff's direct testimony is a comparison of composite depreciation rates for Empire versus approximately 27 other electric utilities. This information was taken from annual filings with the Federal Energy Regulatory Commission, the FERC, and I think it's pretty telling.

It reveals that Empire's current depreciation accruals on an annual basis are approximately, or at least composite, are approximately 2.27 percent, while the average for all of the other companies are three percent. So when you hear other parties criticize the company's proposal as excessive, unreasonable, I think you need to put it in perspective with what the rest of the industry is doing and what the rest of the industry has allowed. And I think when you do that, at least from this type of comparative analysis, the company's position is far from excessive. In fact, I would submit to you or suggest that Public Counsel and Staff's position are willfully inadequate.

Thank you very much.

JUDGE THOMPSON: Thank you, Mr. England. I believe Staff is next.

MR. WILLIAMS: May it please the Commission. My name is Nathan Williams, and I'm representing the Commission Staff here today on the depreciation issues in this case.

As quoted from the US Supreme Court by this Commission at page 29 of its Report and Order setting rates for the Empire Electric District Company, in Case No.

ER-2001-299, where depreciation was a contested issue decided by this Commission, broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence. Annual depreciation is the loss which takes place in a year. In determining reasonable rates for supplying public service, it is proper to include in the operating expenses, that is in the cost of producing the service, an allowance for consumption of capital in order to maintain the integrity of the investment and service rendered.

In this case, the Staff's positions on the depreciation issues would result in approximately $7 million dollars less in annual revenue requirements than the positions of the Empire District Electric Company. Approximately two and one-half million of that difference is attributable to the differences in how Empire and the Staff determine service lives for generation plant.

Both the Staff and Empire use empirically derived standard curves known as Iowa curves, and compare them to existing mortality data to determine the service lives of mass property, property such as pulls and transformers, for purposes of determining depreciation rates. The Staff also uses these Iowa curves to determine the service lives of the property at Empire's generation plants.

Rather than using existing mortality data to determine service lives for the property at its generation plant, the Empire District Electric Company assumes the life of the property at each of Empire's generation plants will end on a date specific to that plant. The result is that the service lives that Empire estimates for its generation plant property are unreasonably shorter than those estimated by the Staff, thus increasing the revenue requirement.

The remaining approximately four and one-half million dollars difference between the Staff and Empire is due to their positions on how to treat cost of removal that exceed salvage. Staff takes the position that the difference between cost of removal and salvage should be measured by recent historical data and that the cost of removal less salvage should be treated as an expense for rate-making purposes. Under the Staff's approach, depreciation rates would not include a cost of removal less salvage component.

In contrast to the Staff, Empire takes the position that cost of removal and salvage should be measured as of the end of the plant service life through estimates, that the cost of removal less salvage estimated for that point in time should be subtracted from the capital value of the plant being depreciated and the result used to determine depreciation rates. Under Empire's approach, depreciation rates include a cost of removal less salvage component, including the depreciation rates it proposes for its generation plant.

Notably, the Staff and Empire each approach these depreciation issues in this case in the very same way that they approached them in Case No. ER-2001-299. In its Report and Order in that case, which was made effective October 2nd, 2001, the Commission stated at pages 29 to 30, the Commission finds that in this particular case, Staff's position regarding cost of service depreciation is more persuasive; however, the Commission's conclusion in this case should not be taken as a final endorsement of Staff's approach. Both the approach adopted by Staff and by the company have merit. And the Commission will use the one that fits the particular circumstances.

Now as then, the Commission should find that the Staff's approach of stating cost of removal less salvage based on recent historical experience as an expense separately from depreciation rates in using average service lives rather than fixed retirement dates for generation plant is more persuasive than Empire's approach of including cost of removal less salvage as a component and depreciation rates based on estimated cost of removal less salvage at a future date and using predicted final retirement dates for plant.

And in response to a statement made by Mr.

England regarding the last schedule attached to Mr. Roff's testimony, which I believe is DSR-4, I note that the -- most of the depreciation rates on that schedule do reflect net salvage as a part of the depreciation rate. In other words, net salvage is a component in those rates. The evidence will bear that out.

Nothing further.

JUDGE THOMPSON: Thank you, Mr. Williams. Ms. O'Neill.

MS. O'NEILL: Good morning, your Honor, Commissioners, and counsel. My name is Ruth O'Neill, you haven't seen me yet in this proceeding. I am from the Office of Public Counsel, and I am here for the purpose of discussing and the evidentiary portion of this hearing related to depreciation.

As you know, Empire's current depreciation rates are straight line, whole life depreciation rates and notably they do not include a net salvage factor. We propose the Commission should continue to require Empire to set its depreciation rates by using the whole life method of depreciation.

Public utility depreciation expense is typically straight line over an asset service life and results in an equal share of the cost of assets being assigned or allocated to expense each year over the service life of the assets, which allows the company to recover the cost of asset as they're being used. And that service life, of course, is the period of time during which plant and equipment are in service and being used and useful to provide service to customers.

I expect we'll be having quite a bit of discussion here today and possibly tomorrow about the request to change the way net salvage is recovered by the company. Net salvage is that number which is a result of subtracting the cost of removing an asset from service from its salvage value. That is, the amount that remains over the depreciated asset that it can be sold for. Sometimes that calculation results in a positive number, but when the cost of removing an asset is greater than its salvage value, the result is negative net salvage.

Public Counsel recommends that the cost of removing depreciated assets from service should be treated as a specific, identifiable allowance reflecting Empire's actual recent experience with the cost of removal net salvage. This is the way in which Empire currently recovers its net salvage expense. Returning the net salvage component to depreciation rates, as proposed by Empire, is unreasonable because it would produce excessive depreciation expense and amounts to borrowing funds from customers without any obligation to pay back those funds.

By adopting Public Counsel's proposal, the company will be allowed a $29.1 million depreciation expense, which includes a little bit over $1.7 million in net salvage expense. This level will result in approximately $400,000 per year decrease from the annual depreciation expense in current rates.

Public Counsel's recommendation regarding depreciation is being presented by witness Michael Majoros. Mr. Majoros is Vice-President of the firm of Snavely, King, Majoros, O'Connor, and Lee, an economic consulting firm. Mr. Majoros provides consulting services on a variety of accounting and financial management issues and has testified and participated in cases before a number of public utility Commissions around the country.

He's provided expert assistance in a wide variety of issues, and also has been responsible for developing his firm's services in the area of depreciation and other capital recovery issues. His schedule, MGM-1 to his direct testimony provides some insight into the scope of his qualifications and experience, and we are pleased to be able to present Mr. Majoros to the Commission in this proceeding to assist you in evaluating this significant issue. Mr. Majoros is aware that depreciation has become a big issue in Missouri and he'll be please to share his insight and information as you continue to evaluate this issue.

Thank you.

JUDGE THOMPSON: Thank you, Ms. O'Neill.

COMMISSIONER CLAYTON: May I ask a question?

JUDGE THOMPSON: Yes, you may.

COMMISSIONER CLAYTON: Ms. O'Neill, I apologize, I'm multi-tasking is what I am doing, but I wanted you to refresh my memory and define for me the differences, if any, between Office of Public Counsel's position on the various issues involving depreciation, whether there is a difference or not.

MS. O'NEILL: There are -- Mr. Majoros will probably go into this in greater detail. Mr. Majoros recognizes that there are some legal asset retirement obligations that may -- that need to be accounted for in a way that's different than what the Staff suggests; however, the vast majority of the assets that are being discussed in this case do not fall into that category, so our positions are very similar.

COMMISSIONER CLAYTON: On each of the -- there are various issues in dispute on depreciation, so substantially, your positions are the same?

MS. O'NEILL: We are -- for the most part, we are the same. I believe that Mr. Majoros would testify that regarding -- well, regarding whole life, we are the same.

Regarding service lives, I don't think Mr. Majoros takes issue with Staff's position at all. And regarding whether or not net salvage should be bundled into depreciation as a whole, we agree. There are some minor differences in how we come to those conclusions.

COMMISSIONER CLAYTON: And what's the dollar difference between Staff and OPC on the various legal plant retirement obligations which you had suggested?

MS. O'NEILL: It's about --

COMMISSIONER CLAYTON: An approximation.

MS. O'NEILL: I'm not sure, I think it's a couple hundred thousand dollars.

COMMISSIONER CLAYTON: Okay.

MS. O'NEILL: It's not very big.

COMMISSIONER CLAYTON: So in a scope of a seven million dollar issue, it's not too much.

MS. O'NEILL: Right, it's fairly close.

COMMISSIONER CLAYTON: Okay. Thank you.

JUDGE THOMPSON: Commissioner Murray.

COMMISSIONER MURRAY: Ms. O'Neill, I just wanted to clarify something. You indicated, I thought, that there was a -- the company's position was an additional $29 million.

MS. O'NEILL: Actually, the company's position is closer to -- is not that high, their original -- well, I

-- actually, what I said was that our recommendation would result in a $29.1 million total depreciation, that the whole issue would be $29.1 million in total. That is -- I believe that after all the adjustments that the company has made regarding what they're presenting today, it's somewhere more -- it's somewhere closer to 10 -- a little bit less than 10, I believe, maybe 8 or 7 million dollars.

COMMISSIONER MURRAY: Okay. So you're not really sure?

MS. O'NEILL: I'm not really sure, to tell you the truth.

COMMISSIONER MURRAY: Okay. I won't ask you to clarify.

MS. O'NEILL: Thank you.

JUDGE THOMPSON: Other bench questions? Thank you, Ms. O'Neill. Mr. Conrad told me he had no opening statement. I believe DNR is not here. Mr. McCartney.

MR. MCCARTNEY: Good morning, and may it please the Commission. I'm here today on behalf of Aquila. Aquila is a Missouri regulated company that provides electric and gas services to Missouri customers. Aquila has intervened in this case solely to address the issue of depreciation and specifically to address the proper accounting method for net salvage.

As the Commission is well aware, the issue of depreciation as it relates to the cost of removal, net of salvage has been a contentious one over the last few years, and it's an issue that's of great concern to Aquila and to the power industry. Aquila supports Empire's position in this case and specifically Aquila believes that the Commission should return to the traditional method of accrual so that net salvage rates are included as a component of the depreciation accrual rate.

Aquila witness Davis Rooney, who testified on behalf of Aquila in Aquila's case earlier this year, will provide testimony in this case that the accrual method is the appropriate regulatory policy and proper accounting methodology under state and federal rules. Thank you.

JUDGE THOMPSON: Thank you, Mr. McCartney. Mr. Byrne.

MR. BYRNE: Thank you, your Honor. May it please the Commission. My name is Tom Byrne and I'm the attorney representing AmerenUE in this proceeding only on the issue the net salvage.

I am here, once again, to ask you to reject the Staff and now the Office of the Public Counsel's short-sided and improper proposal to treat net salvage effectively as a cash item rather than as an accrual to be included in the depreciation rate as it should be.

I've only five minutes and that's not long enough to explain all the problems we see with the Staff and OPC proposals, so I will limit my discussion to the four main problems with their approach.

First, Staff and OPC's treatment of net salvage defeats the fundamental purpose of depreciation accounting, which is to rateably allocate full cost of capital assets to the customers who use those assets. Under Staff and OPC's approach, today's customers are paying for the cost of retiring assets retired in the past, I think in the past five years in this case, that are no longer used to serve customers.

Because utility assets are long-lived, the universe from which these assets that were retired in the past five years comes from is a universe of plant that was installed 20 or 30 or 40 years ago, a universe of plant that's much smaller than the universe of plant used to serve customers today. The current customers' fair share of the net salvage cost of the much larger universal plant which is actually used to serve them is improperly and unfairly deferred to burden future generations of customers. That is not consistent with the fundamental principles of depreciation.

Second, Staff and OPC's approach is inconsistent with the uniformed system of accounts, which this Commission has adopted and which require both accrual accounting and the inclusion of net salvage and depreciation rates. This should raise a big red flag for the Commission. Any party that asks the Commission to depart from the uniformed system of accounts bears a heavy burden and it's a burden which, in this case and other cases involving net salvage, the Staff and the Office of the Public Counsel have not sustained.

Third, Staff and OPC's proposals are far, far outside of the mainstream. Almost all of the other states, depending on who you talk to, 45, 46,47 states in the United States, basically all the authoritative texts and experts in the field support the standard or traditional approach, not the approach advocated by the Staff and Public Counsel. The Commission should not accept the Staff and the Office of Public Counsel's invitation to move to the cutting edge of this issue and thereby adopt depreciation rates materially lower than just about any other jurisdiction.

Fourth, Staff and OPC's approach to net salvage is demonstrably harmful to Missouri utilities. Empire and Laclede Gas Company are the only two utilities that have been ordered by the Commission to adopt this approach, and both of their credit ratings have been downgraded by credit rating agencies that specifically cited the depreciation orders.

Empire was recently suffered an unusual two notch downgrade that specifically talked about the Commission's ordered depreciation rates. In other words, to the limited extent that the Staff and OPC's approach has been actually adopted in Missouri, it has directly and adversely affected those utilities' financial company and their access to capital markets to finance necessary infrastructure improvements.

As in previous cases, Staff's only justification for adopting its unusual approach to net salvage is to say that future net salvage costs are not known and measurable. Of course they're not, but neither are numerous other items that are routinely included in the rate-making process, such as estimates of future pension costs, estimates of the future growth of dividends used in the DCF model, which is used to establish the return on equity, or perhaps most on point, estimates of average service lives that go directly into calculating the depreciation rate. All those are based on estimates.

The estimates of net salvage are based on rigorous engineering analysis of reams of historical retirement data. They are not speculative as the Staff and the OPC say. Instead, they are reliable estimates that should be used in the rate-making process. To the extent that even these reliable estimates turn out to be incorrect, ratepayers are protected with a variety of safeguards in

Missouri, including the requirement that depreciation studies be updated every five years, the treatment of the depreciation reserve as an offset to rate base, and that effectively provides ratepayers with a return on funds they may have advanced for net salvage, and the ultimate true-up of estimated and actual net salvage through the depreciation reserve.

I urge you to reject the Staff and OPC's unsupported approach to net salvage and employ the accrual method recommended in this proceeding by Empire and Aquila witnesses.

Thank you.

JUDGE THOMPSON: Thank you, Mr. Byrne. Question -- I'm sorry, Commissioner Murray? Commissioner Clayton.

COMMISSIONER CLAYTON: Thank you. I just wanted to get a couple of clarifying things to start off with. I've never seen anyone speak so passionately about depreciation before.

MR. BYRNE: I spent the last six years on the issue, so I have some passion.

COMMISSIONER CLAYTON: You need to get out more.

First of all, does Ameren have a witness that's going to be providing testimony or are you supporting the testimony of someone else?

MR. BYRNE: We're supporting the Empire and Aquila testimony, we didn't submit testimony.

COMMISSIONER CLAYTON: Okay. And I'm assuming that you're -- you are advocating for each of the depreciation issues, not just the cost of removal net salvage issue?

MR. BYRNE: No, your Honor, we didn't -- we didn't even look at the other depreciation issues, it's only net salvage.

COMMISSIONER CLAYTON: Only net salvage cost of removal?

MR. BYRNE: Yes.

COMMISSIONER CLAYTON: Ameren has participated in several cases outside of its own rate case or otherwise. Could you give me an idea of how much this issue would mean to Ameren in a rate case?

MR. BYRNE: Well --

COMMISSIONER CLAYTON: These differences of position?

MR. BYRNE: I can't tell you exactly. It's tens of millions of dollars in cash flow. I mean, it doesn't -- because it's depreciation, it doesn't affect income, it's a cash flow item, but it's tens of millions of dollars, so 40 or 50 million dollars in cash flow.

COMMISSIONER CLAYTON: Okay. How do you -- how do you respond to an assertion by one who says that the accrual method of dealing with cost of removal and net salvage does not have ample safeguards to protect a ratepayer in the event plant is not removed or the costs are less or nonexistent for the eventual removal of that property? What is your response to that?

MR. BYRNE: I guess --

COMMISSIONER CLAYTON: I ask you this because you don't have a witness.

MR. BYRNE: Right, sure, that's fair. And I --

COMMISSIONER CLAYTON: And your passion, I figured you'd have an answer.

MR. BYRNE: Yes, I do have an answer. And you know, part of not having a witness is we were given a pretty full opportunity to address this issue with witnesses in the Laclede case, and we didn't think it was appropriate to burden the record case after case with the same testimony, so that was why we don't have any witnesses.

COMMISSIONER CLAYTON: That's -- I'm not faulting you.

MR. BYRNE: Okay.

COMMISSIONER CLAYTON: I wanted to ask your opinion, since you have worked on it for six years, if you could just give me a brief answer.

MR. BYRNE: Well, first of all, I think the safeguards are very adequate. You know, and again, the ratepayers get a return on the money that they advance that, you know, if -- there's a timing difference, obviously, if you estimate future net salvage. So to the extent that they've paid ahead of the company incurring the cost, they're receiving a return equal to the utility's overall rate of return.

Every five years, you do the -- you do the update of the depreciation study, or at least every five years, and there's an opportunity to correct for, you know, or update any assumptions where you have new data, so I think those are pretty good protections.

I guess the other thing is, and again, we don't have a witness, but eventually, you know, as depreciation is paid and as the depreciation reserve grows, it's a cumulative effect. So as time goes on, eventually, the impact on the depreciation reserve can offset the expense in a given year, so over a period of time, you know, could be ten years or so, it -- it becomes a lower rate for the ratepayer because of the impact on the rate base. So I think all those things together provide pretty good protection for ratepayers.

And you know, the other thing you've got to realize is cash is leaving utilities much faster than it's coming in. And in this case, Empire has testimony to that effect, but it's true of all utilities. We spend more money on new infrastructure than we're taking in through depreciation rates. So net the utilities are, you know, reaching into their pockets more than they get from the ratepayers.

COMMISSIONER CLAYTON: Should there be a connection between the depreciation rates and the investment in new plant? Would that be an appropriate way to deal with this?

MR. BYRNE: Well, I mean, you know, I think -- I think the utilities are always going to have to pay more for new plant than they're going to get for depreciation, and I don't know that there's necessarily a connection. But to my mind, it's a common sense thing that suggests it's fair to get a fair amount of net salvage from the customers. It's not like we're collecting a whole bunch of cash beyond what we're spending and it's sitting in a bank somewhere.

COMMISSIONER CLAYTON: Would it matter if a utility were not spending increased amounts on infrastructure? Does that make any difference? What happens if they use the cash flow for other purposes?

MR. BYRNE: The cash flow is a fairness argument. Depreciation theory and depreciation engineers don't care, you know. They just want to get it right. But to my mind, the cash flow thing is sort of a fairness argument.

COMMISSIONER CLAYTON: So it's not connected to the investment infrastructure?

MR. BYRNE: I think if you ask depreciation engineers, they would say not necessarily, you know, the science of depreciation doesn't consider that.

COMMISSIONER CLAYTON: Well, do the engineers care more about the issue or do the accountants care more about this issue?

MR. BYRNE: Well, I think they both do.

COMMISSIONER CLAYTON: Okay. I look forward to the testimony, and I would add just as a highlight to the attorneys who are going to be asking questions of these witnesses, that I have a particular interest in these safeguard issues on both sides, and I hope that they are explored thoroughly by each of the parties and I look forward to that testimony. Thank you.

JUDGE THOMPSON: Other bench questions? Very well, Mr. Byrne --

MR. BYRNE: Thank you.

JUDGE THOMPSON: -- thank you very much for your opening statement and your testimony.

Okay. We're ready for the first witness, who

I believe will be Mr. Roff; is that correct?

MR. ENGLAND: That is correct, your Honor.

JUDGE THOMPSON: Very well.

(THE WITNESS WAS SWORN.)

JUDGE THOMPSON: Do you understand that if you were to give false testimony in this proceeding, you could be prosecuted for the crime of perjury?

THE WITNESS: Yes, sir.

JUDGE THOMPSON: Would you please spell your last name for the reporter?

THE WITNESS: R-O-F-F as in Frank.

JUDGE THOMPSON: Thank you. You may inquire.

MR. ENGLAND: Thank you, Judge. Before I do, I've got an extra copy of the witness' direct, rebuttal, and surrebuttal testimony, which I understand have been premarked as Exhibits 18, 19, and 20. And I'm not sure if copies have previously been provided to the Reporter.

COURT REPORTER: They have.

MR. ENGLAND: Thank you. Then I'll begin.

DIRECT EXAMINATION

BY MR. ENGLAND:

Q. Would you please state your full name and business address for the record, please?

A. My name is Donald S. Roff. My business address is 2200 Ross Avenue, Dallas, Texas, 75201.

Q. And by whom are you employed and in what capacity?

A. I'm a director with the accounting firm of Deloitte & Touche, LLP.

Q. And have you been retained by the Empire District Electric Company to present testimony on its behalf in this case?

A. Yes, I have.

Q. In that regard, have you caused to be prepared and filed in this case three pieces of testimony designated prepared direct, prepared rebuttal, and prepared surrebuttal testimonies?

A. Yes.

Q. Taking your prepared direct testimony, which I understand has been marked for purposes of identification as Exhibit No. 18, do you have any changes or corrections to that testimony?

A. Yes, I do.

Q. Could you please identify those by page and line number, please?

A. Certainly. There's only one change with respect to Exhibit 18, the direct testimony. That would be on Schedule 5 of Exhibit DSR-3, and the change is in column five for the Iatan Unit One plant. The retirement date should say 2020, not 2014.

Q. Schedule 5 also have a page number designation of 15 at the bottom?

A. Oh, I'm sorry, yes, it does.

JUDGE THOMPSON: That should be 2015 you said?

THE WITNESS: 2020.

JUDGE THOMPSON: Thank you.

COMMISSIONER MURRAY: Judge, what line was that, again?

JUDGE THOMPSON: There is no line number, it's page 15.

THE WITNESS: Of the report.

JUDGE THOMPSON: Of the report on Schedule 5.

MR. ENGLAND: Under the first category of steam production plant, it's the last line item, I believe.

COMMISSIONER MURRAY: Thank you.

MR. ENGLAND: Final column to the right.

JUDGE THOMPSON: Proceed.

MR. ENGLAND: Thank you.

BY MR. ENGLAND:

Q. Does that complete your corrections to the prepared direct testimony?

A. Yes.

Q. Okay. Turning your attention now to the prepared rebuttal testimony, which I believe has been marked for purposes of identification as Exhibit No. 19. Do you have any changes or corrections?

A. Yes, there's a few typographical changes. The first is at page 13 of Exhibit 19, that footnote should be footnote 10, not No. 9. On page 31, line 10, the first sentence should read there are three reasons. On page 32, line 9, the case number referenced should be TO-82-3, so I guess strike the Y in that line. And that's all for the rebuttal testimony.

Q. Okay. Then let me turn your attention, finally, to your prepared surrebuttal testimony, which has been marked, I believe, Exhibit 20 for purposes of this proceeding. Are there any corrections to that testimony?

A. Yeah, a few minor typographical changes. At page 5, line 4, the reference should be Schedule DSR-1 SR. At -- also on page 5, line 11, the word cost in the middle line should be plural, C-O-S-T-S. At page 7, line 7, insert the word the between that and company. Also on page 7, line 15, at the very end of the line, insert word the for, F-O-R, between accrual and negative. Also on page 7, line 20, the word if near the end of the line should be in. At page 17, line 2, insert the word age after maximum. At page 17 also, line 10, the last word there need should be been, B-E-E-N. And finally, on page 20, line 17, I believe the word does should be do, D-O, and that is all the corrections that I'm aware of.

Q. Thank you, sir. With respect to all three pieces of testimony, were they prepared by you or under your direct supervision?

A. Yes, they were.

Q. And given the corrections that you've made here on the record today or taking that into consideration, would your answers as appearing in this testimony be the same here under oath as they are in the prepared testimony?

A. Yes, they would.

Q. Is the information in that testimony true, correct, to the best of your knowledge and belief?

A. Yes.

Q. As well as the information in the schedules attached thereto?

A. Yes.

Q. Thank you, sir.

MR. ENGLAND: I have no other questions of the witness. Would offer Exhibits 18, 19, and 20, and tender the witness for cross-examination.

JUDGE THOMPSON: Thank you, Mr. England. Do I hear any objections to the receipt of Exhibits 18, 19 or 20?

MR. WILLIAMS: Judge, Staff has an objection to Exhibit No. 19.

JUDGE THOMPSON: And what is that objection?

MR. WILLIAMS: That the question and answer that appears on page 34, the question is there any other topic that you wish to address, and then the answer begins yes, because neither the Staff nor the OPC witness testimony discusses this issue. I ask this Commission to review my direct testimony, and so forth. This is rebuttal testimony, and I object -- Staff objects on the ground that this is beyond the scope of proper rebuttal.

JUDGE THOMPSON: Mr. England.

MR. ENGLAND: Technically, it probably does not address any of the testimony that was filed in direct by Staff or Public Counsel, but it then appears in surrebuttal, so I don't -- whatever prejudice that I believe Staff may feel it suffers as a result of this being in rebuttal, my opinion is minimal. It could have just as easily been in surrebuttal, and in fact, I think we do address it in surrebuttal as well as our direct testimony. So I guess my -- my response would be no harm, no foul.

JUDGE THOMPSON: Okay. Mr. Williams, how do you respond to the no harm, no foul theory?

MR. WILLIAMS: It's also present in his direct testimony. It's inappropriate in response to Staff's direct case.

JUDGE THOMPSON: I'm going to sustain the objection, and we will strike the testimony that appears on page 34 from line 11 through line 23, and on page 35 lines 1 through 5. Any other objections?

MR. WILLIAMS: No, Judge.

JUDGE THOMPSON: Hearing none, Exhibits 18, 19, and 20 are received as corrected and subject to the objection that has been sustained. Cross-examination, Mr. Byrne.

CROSS-EXAMINATION

QUESTIONS BY MR. BYRNE:

Q. Good morning, Mr. Roff.

A. Good morning.

Q. I just have a couple of questions. First of all, my understanding is the value of the net salvage issue in this case is basically $4.6 million; is that correct?

A. I think that was the Staff determination, yes.

Q. Okay. Okay. And I guess that reflects the difference between sort of the net difference between where the company is on net salvage and where the Staff is?

A. I believe that's correct.

Q. Taking into account that the Staff is allowing some as an expense?

A. Yes.

Q. And of that $4.6 million, do you know what part of that relates to net salvage associated with mass property accounts versus the terminal salvage for electric generating plants?

A. I don't have that specific quantification with me, but my recollection is it's roughly equal, approximately the same level of net salvage for production plant as for the mass property.

Q. So of the $4.6 million, roughly $2.3 million applicable to mass property and roughly $2.3 million applicable to terminal?

A. Correct.

Q. Okay.

MR. BYRNE: Thank you, that's all I have.

JUDGE THOMPSON: Thank you, Mr. Byrne. Mr. McCartney.

MR. McCARTNEY: No questions, thank you.

JUDGE THOMPSON: I don't see Mr. Conrad. Mr. Williams.

MR. WILLIAMS: Thank you, Judge.

CROSS-EXAMINATION

QUESTIONS BY MR. WILLIAMS:

Q. Good morning, Mr. Roff.

A. Good morning.

Q. I want to turn your attention to the Schedule DSR-4 where you have listed composite depreciation rates for a series of electric utilities. And with regard --

A. Is that the schedule that was just struck in part?

Q. No, sir.
A. Oh, I'm sorry then. DSR?
Q. An attachment to your direct testimony.
A. I'm having trouble locating exactly what you mean.
Q. It has at the title of it comparison of depreciation amounts and rates source --
A. Okay. I have it. It just wasn't labeled on my copy here.
Q. In your direct testimony on page 7 at lines 16 through 18, you state I have conducted no extensive evaluation of the factors influencing any particular company composite depreciation rate, and that's with regard to schedule DSR-4?
A. That's correct.
Q. And further, on lines 19 through 20 of that same testimony, you state a composite depreciation rate of at least 3.00 percent seems to be an adequate average composite depreciation for an electric utility. That's a clause out of a sentence; is that correct?
A. That's correct.
Q. Did you determine what the factors are that influenced the composite depreciation rates of the companies that you included in schedule DSR-4?
A. No, as stated in the prior sentence, I did

not.

Q. Then you didn't evaluate those factors, either, did you?

A. That's correct.

Q. Did you use the mix of generating units by fuel type of as a criteria for Schedule DSR-4?

A. Not specifically. The basis for the selection of these companies was -- is described in my testimony and represents essentially companies somewhat adjacent in geography to Empire District, and companies of similar size. So having said that, it would seem a conclusion to reach would be that the generation would be a reasonable mix of comparable size.

Q. And that's the basis for your conclusion?

A. The basis for the conclusion regarding the rate is not that basis, no.

Q. No, the basis for your conclusion that they are comparable generation mixes in proximity to the Empire Electric?

A. Of relative size, yes.

Q. And you've anticipated my next question. On that list, there's listed Niagra Mohawk Power, is there not?

A. That's correct.

Q. Where is the service territory of that company?

A. It's in New York state.

Q. Where is the service territory of New York State E & G?

A. It's in New York state as well, southern New York state, I believe.

Q. Where is the service territory of Puget Sound Energy?

A. In and around the Seattle area.

Q. Where is the service territory of Pennsylvania Electric?

A. Western Pennsylvania.

Q. Where is the service territory of Sierra Pacific Power?

A. Sierra Pacific Power would be the Reno, Carson City, northern Nevada area.

Q. And where is the service territory of Interstate P & L?

A. I believe that's in Utah.

Q. And where is the service territory of Portland Energy?

A. It's in Portland, Oregon. Portland General Electric I believe is the company.

Q. Other than Empire and Pennsylvania Electric, do the depreciation rates that are shown on Schedule DSR-4, the composite depreciation rates, include both the factor for recovery of origin investment and the factor for recovery of cost of removal less salvage?

A. I believe that's correct, and that was part of the purpose of this was to illustrate the difference between what Empire District depreciation rates represent and other companies are receiving on a somewhat less than comparable basis for that point.

Q. The rate you have reflected for the Empire Electric -- Empire District Electric Company does not include -- the composite rate does not include net salvage; is that correct?

A. I didn't look at the component of depreciation expense, so I can't say for certain whether that rate includes the net salvage treatment that this Commission has ordered or not. My guess is it does.

Q. Did you determine what retirement dates to use for Empire's production plant in your depreciation study?

A. No.

Q. Who did determine those retirement rates?

A. They were -- those retirement dates were developed based upon discussions with a company planning personnel, in particular Mr. Beecher.

Q. So you obtained them from Empire?

A. Yes.

Q. What did you rely -- what did you rely on for accepting those dates that were provided by Empire?

A. Well, there's really, I guess, two factors. One is I value the opinion of Mr. Beecher. We had thoughtful discussions regarding what those plants contain, what factors influence their retirement dates and the lives relative to each of those facilities. He was very knowledgeable in the area of operations and capital activity at those facilities. He was very familiar with environmental requirements, and then subsequent to that, just looking at the lives that resulted from those retirement dates. They were consistent with my experience in this field, so both reasons influenced the acceptance of those dates.

Q. Does Empire have any witness here that's going to testify as to how Empire arrived at those dates?

A. You'll have to ask Empire that question.

Q. Is your answer that you don't know?

A. That's correct.

Q. I want to turn your attention to Schedule 5 of Schedule DSR-3 to your direct testimony.

A. Okay.

Q. I believe that's page 15. Are you there?

A. Yes.

Q. On that schedule, you list a series of Empire production units. Would you begin with the top of that list, which is Riverton Unit 7 and describe the unit and state what you consider to be a reasonable range for the life span for that unit?

A. Riverton Unit 7 is described here as a coal-fired unit with a capacity of approximately 38 megawatts, originally installed in the early 1950's. It's been my experience for those type of units that a service life span in the range of 40 to 60 years is standard. Once again, it depends on a number of factors including the environmental requirements, fuel availability, demand, other things.

Q. Can you provide any more description of that unit beyond that which is shown in the schedule?

A. Well, it's an old, coal-fired unit with a brick power house. I guess that's about as much as I would recall of the -- my visit there.

Q. Would you continue with Riverton Unit No. 8?

A. Riverton Unit 8t, also a coal-fired unit, slightly larger, 53 megawatts, approximately, installed roughly four years later, with a projected retirement date of 2008, producing a life span of about 55 years, that would be in the range of what I've seen for these types of facilities.

Q. And my question was for you to provide a reasonable range of life span, in your opinion.

A. And I thought I just said that.

Q. You said 55 years, I'm asking for a range.

A. I guess I would say upwards to 60 years would be a range, 50 to 60 years is a range for those types of facilities. Once again, there are factors including the environmental requirements, demand, fuel supply, and cost that influence those lives as well, but that would be a reasonable range.

Q. And for Asbury Unit 1, description and your reasonable range of life span for that unit.

A. Asbury Unit 1 is a newer unit or a more modern unit compared to the Riverton sites, and also of significantly larger facility, 191 megawatts, built in 1970, and it would seem that a reasonable range for those types of large base load coal units would be 30 to 45 years, I suppose. Once again, there are numerous factors which influence those lives.

Q. And Asbury Unit 2?

A. Asbury Unit 2, I think is only -- the company only owns a proportional share of this. I may not be correct on that. Smaller unit, 20,000 kilowatts -- or 20 megawatts built in 1986. And the life span for this one would be much shorter because I think it's probably used more as a peak unit, but.

Q. Would you give me your reasonable range of life span for that unit?

A. 25 to 35 years. Once again, I hate to keep repeating this, but there are numerous factors which influence those dates and could make them change at any point in time.

Q. For Iatan Unit 1, would you please describe that plant, and in your opinion, a reasonable range of life span for that plant.

A. Iatan Unit 1 is, I believe this is a jointly owned unit. Capacity is -- Empire District capacity is 180 megawatts, built in 1980, projected retirement date as corrected on here, 2020. Based upon the size of this unit and its vintage, I would say 35 to 45 years as a reasonable life span.

Q. And before you go on --

A. Subject to the same constraints I've already described.

Q. Before we go on to the hydraulic production plant, you made a change in the projected retirement date for Iatan Unit 1. When you filed your -- prefiled it, it was 2014, and you've corrected it to 2020. Was that an error or has something changed?

A. No, that was an error. I believe there was a data request that also addressed that.

Q. Okay. For the hydraulic production plant for Ozark Beach Unit No. 1, would you describe the unit and provide your reasonable range of life for that unit?

A. Well, first of all, I would look at all four of these units in concert. They're all identical, they're all constructed at the same point in time, all of the same size, so 4 megawatts each, small hydro units, low head hydro as it might be described. Built in 1931. So they are currently in excess of 70 years old, depending upon water supply and environmental requirements and other related factors, has a service life span of 100 years could be reasonable.

Q. I asked you for a range, not just a specific.

A. 80 to 100 years.

Q. Thank you. Then other production plant, description of the unit and your reasonable range of life span for that unit, beginning with Riverton Unit 9.

A. Riverton Unit 9 is a gas turbine, I guess would be the way to describe it. Small capacity peak unit, approximately 15 megawatts, built in 1964. Depending upon the -- usage of this facility would be a factor influencing its life, but 30 to 40 years would be a reasonable range.

Q. Are you familiar with how Empire has used and is using Riverton Unit 9?

A. I don't have the specific capacity usage over the last couple years, but it's my understanding that it's a peak unit.

Q. Would you continue with Riverton Unit 10, provide a description of the unit and what you consider to be a reasonable range of life span for that unit?

A. Yes, I would -- for brevity sake, I would combine Riverton Units 10 and 11. Those are identical units constructed at the same time. Approximately 16 megawatts each, gas-fired turbines, built in 1988, peaking unit as well, so the same life span would apply. Whatever I said, 25 to 35 years.

Q. And same life span as compared to what other unit?

A. Riverton 9.

Q. And would you continue with Energy Center Unit No. 1, and if you find it convenient to do so, combine units, provide a description of the units and what you believe to be a reasonable life span for those units, range?

A. Yes, I would. I would combine Energy Center Unit 1 and Unit 2. They're basically the same type of units, 90 megawatt gas turbines, built within three years of each other in the 1980 time frame. A little bit larger unit than the Riverton units, but still operated essentially the same way. I would say 25 to 35 years is a reasonable range.

Q. Then Energy Centered Jet Engine 1, Energy Centered Jet Engine No. 2, and State Line Unit 1 and State Line Unit 2, the combined cycle, would you, for each of those units, describe the unit and provide your opinion as to a reasonable range of life span for each of those units?

A. Yes, I would combine the two jet engines. They were built in the same time frame, 50 megawatt jet engines. They're peak units because of their ability to be brought online quickly, built in 2003, just last year, and I would say the same basic life span range, 25 to 35 years.

Q. State Line Unit 1?

A. State Line Unit 1 is essentially the same as the Energy Center Units, approximately 90 megawatts, built in 1995, and I would offer the same range, 25 to 35 years.

Q. And State Line Unit 2, the combined cycle unit?

A. Combined cycle unit, totally gas fired, a large unit, 300 megawatts, installed in 2001. This unit would be -- factors influencing it would be the number of starts and stops the cycles it has to go through as it either follows load or becomes a base load unit. I would say 25 to 35 years also for that unit, it's a reasonable range.

Having said all of that, those are just my thoughts relative to those lives. I relied entirely on the estimates provided to me by Mr. Beecher.

Q. On page 17 at lines 21 to 22 of your direct testimony, you state company engineers provide an estimated retirement date for each production unit. And beginning at line 20 on page 7 of your rebuttal testimony, you state is

Mr. Majoros correct in saying that this Commission found the life span method to be inappropriate in Case No. ER-2001-299, and that it was specifically rejected by this question. You have an answer no, I believe the Order and Report in that case stated that the Commission found the unit retirement dates sponsored by Empire's consultant were not credible. The Commission did not reject the life span methodology.

What makes the retirement dates that you have used in your life span methodology credible? Based upon my discussions with company personnel the retirement dates provided to me were based upon consideration of economic and operating factors enforced today and represent the company's best estimate of a life span for cost allocation purposes, for depreciation expense determination recognizing routine maintenance and normal capital replacement. Thus these dates represent Empire's particular experience and planning.

Have I correctly stated what your testimony says?

A. I believe so.

Q. Do you know what unit retirement dates Empire's witness in Case No. ER-2001-299 sponsored?

A. I do not recall, no.

MR. WILLIAMS: Judge, I'd like for the Commission to take official notice of testimony in Case No. -- exhibits in Case No. ER-2001-299.

JUDGE THOMPSON: Do you have copies of those?

MR. WILLIAMS: Yes, I do, sir, we can also make it an exhibit in this case.

JUDGE THOMPSON: How many of them are there?

MR. WILLIAMS: I have copies of direct, rebuttal, surrebuttal, and volume five of the transcript.

JUDGE THOMPSON: Okay. We will assign each of those a different number. What is this?

MR. WILLIAMS: It is direct testimony of Empire's witness L.W. Loos, which was marked as Exhibit No. 11 in Case No. ER-2001-299.

JUDGE THOMPSON: Okay. This will be Exhibit No. 126.

(STAFF WITNESS EXHIBIT NO. 126 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

MR. WILLIAMS: May I approach the witness, your Honor?

JUDGE THOMPSON: You may.

BY MR. WILLIAMS:

Q. Mr. Roff, I'm going to hand you what's been marked as Exhibit 126 --

JUDGE THOMPSON: 126.

BY MR. WILLIAMS:

Q. -- and direct your attention to page 4-4 of Schedule LWL-1, which is attached to that testimony.

JUDGE THOMPSON: What's the page?

MR. WILLIAMS: It's Schedule LWL-1 and page 4-4.

BY MR. WILLIAMS:

Q. It's titled Table 4-2, Empire District Electric Company summary of production plant characteristics.

MR. WILLIAMS: While we're at it, let's go ahead and do the other exhibits.

JUDGE THOMPSON: Okay. This is the rebuttal. This is Exhibit No. 127.

(STAFF EXHIBIT NO. 127 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

JUDGE THOMPSON: Loos surrebuttal will be Exhibit 128.

(STAFF EXHIBIT NO. 128 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

JUDGE THOMPSON: Okay. Volume five of transcript Case ER-2001-299 will be Exhibit No. 129.

(STAFF EXHIBIT NO. 129 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

JUDGE THOMPSON: You may proceed, Mr. Williams.

BY MR. WILLIAMS:

Q. Mr. Roff, I also want to give you copies of these exhibits.

A. Are those in order?

Q. Should be. Mr. Roff, I've given you a copy of Exhibit 126, which is the direct testimony of L.W. Loos in -- that was an exhibit in Case No. ER-2001-299. In fact, it was Exhibit No. 11, it was entered into evidence in that case. And direct your attention to Table 4-2 of Schedule LWL-1. Have you had an opportunity to look at that table?

A. Yes.

Q. And I've also provided you with copies of Exhibit No. 127, 128 and 129, which are Mr. Loos' rebuttal testimony, Mr. Loos' surrebuttal testimony, and I believe the portion of the transcript that includes Mr. Loos' testimony during that hearing, and his testimony begins about page 130.

The purpose of you having Exhibits 128 -- I'm sorry, 127, 128, and 129 at this point is to give you an opportunity to look to see that Mr. Loos' Table 4-2 was not changed during that proceeding. In other words, that what's on that table is the retirement dates that he was sponsoring in that case. If you'd like an opportunity to go ahead and do that.

MR. WILLIAMS: We may want it take a brief recess, I don't know, Judge.

THE WITNESS: I have no reason not to believe that, your Honor.

BY MR. WILLIAMS:

Q. Okay.

A. I believe it's also pronounced Loos, by the way, no offense.

Q. I'm sorry. I gather you're familiar with Mr. Loos then.

A. I know Larry, yes.

Q. Would you take at look at Schedule LWL-1 on Exhibit 126 and compare the dates -- projected retirement dates that appear on that table to the projected retirement years that you set out on Schedule 5 to your Schedule DSR-3 by plant, please? Plant and unit?

A. Let's see, Riverton 7 and 8 seem to be the same.

Q. And that date is 2008?

A. Yes. Asbury 1 and 2 is the same, 2014; Iatan is different, 2020 versus 2014 for Mr. Loos. Hydraulic units, the hydro units 2022 is the same. Riverton 9 is 2008, that is the same; Riverton 10 and 11, 2014 in my schedule, 2017 in Mr. Loos'. Energy Center Unit 1, 2002 is the same, Energy Center Unit 2, 2015 is the same.

Q. I believe you made a misstatement, isn't Energy Center Unit 1 2012 instead of 2002?

A. Oh, I'm sorry, yes. The jet engines were, I guess, installed after this proceeding, so there's no date for those. State Unit -- State Line Unit No. 1, 2029 is the same; State Line Unit Two Combined Cycle, I have 2031 and Mr. Loos has 2035.

Q. Now what information did the company provide to you -- they provided to you their projected retirement date. What information did they provide you that you accepted as verifying that to be an appropriate date?

A. I don't understand your question.

Q. You didn't just -- did you just accept the date they provided without looking behind how they arrived at that date?

A. No, I participated in the discussions with Mr. Beecher where he provided those dates and was cognizant of the logic and reasoning that he used to develop those. That was one.

Secondly, I compared those life spans to other facilities that I've been involved with in my career and determined that those retirement dates produced a reasonable life span.

Q. Are you finished with your answer?

A. Yes, I am.

Q. What specific information did Mr. Beecher provide to you that you found reliable to support the retirement dates that he gave you?

A. I was not handed a piece of paper that provided a specific documentation of factors or specific items that influenced his decision-making. I was involved in the discussions, and the subject of those discussions dealt with what types of factors influenced the lives of Empire's facilities. And those included the fuel supply, the cost of fuel, the age of the plant, the operation of the facility, environmental requirements, capital requirements, and all of those things contributed to the determination of the retirement dates that Mr. Beecher provided.

Q. Were there any other factors that you have not listed?

A. I don't recall any specific other factors, but there may have been.

Q. Could you explain what you meant when you said -- mentioned the factor of operation of the facility?

A. For example, the combined cycle unit may have, should we say, operating peaks and valleys where the load on that unit changes from time to time throughout the day. Well, that particular type of facility is very susceptible to those load changes as terms of maintenance cost and its ultimate life, and so that would be one factor -- or that is how that factor would influence the life. It's called a cycle.

Q. Do you know what Mr. Loos relied upon for the unit retirement dates he sponsored in Case No. ER-2001-299?

A. I do not.

Q. Would you take a look at page 135 of Exhibit No. 129?

A. 129? I'm sorry.

Q. It's the volume five, the thick one.

A. What page?

Q. Page 135.

Q. And beginning with line 19.

A. All right.

Q. Would you read from there through line 25 of page 137?

A. Okay.

Q. And then would you skip to page 156, commencing with line 10 through page 160, line 21?

A. 160, what was the ending line?

Q. 21.

A. Okay.

Q. Page 178, line 16 through page 179, line 8.

A. Okay.

Q. Also, page 181, line 12, through page 182, line 5.

A. Okay.

Q. Have you finished that?

A. Yes.

Q. And if I captured it correctly, that set out Mr. Loos -- the information he relied upon for the retirement dates he provided in schedule LWL-1. Does it appear that way to you?

MR. ENGLAND: Objection, this witness doesn't know the answer to this question. He hasn't had an opportunity to read all this.

JUDGE THOMPSON: Do you know the answer to that question?

THE WITNESS: I don't believe that that dialogue that I just read accurately describes the determination of retirement dates for all those facilities.

JUDGE THOMPSON: Okay. I'm going to overrule the objection. Please proceed.

BY MR. WILLIAMS:

Q. Were there any factors that were set out in any of that testimony that differ from the information you obtained from Empire that you relied upon for accepting the retirement dates they provided to you in this case -- for this case?

A. I don't know that this series of transcripts reflects all the factors that were considered by Mr. Beecher, no, I don't know that.

Q. Well, did he relate to you any factors that are not included in that -- those transcript portions?

A. To the best of my recollection, I think I've described all the factors that we discussed, so I don't believe so, no.

MR. WILLIAMS: I offer Exhibits 126, 127, 128, and 129.

JUDGE THOMPSON: Any objections to the receipt of Exhibits 126, 127, 128, and 129?

MR. ENGLAND: Before I make an objection, if I have one, can I inquire as to the purpose for all these exhibits?

JUDGE THOMPSON: You certainly may.

MR. WILLIAMS: The reason I offered them is to provide a complete information I believe that was in the record as to what Mr. Loos relied upon for the retirement dates that he's sponsored in the 299 case. And Mr. Roff has stated that Mr. -- that the Commission found the dates that Mr. Loos -- Loos sponsored to be incredible, many of those dates are the very same dates that Mr. Roff had relied upon in this case. That's the only purpose for why they're being offered.

MR. ENGLAND: I guess I have no objection then.

JUDGE THOMPSON: Anyone else? Okay. Hearing no objections, Exhibits 126, 127, 128, and 129 are received and made a part of the record of this proceeding.

(EXHIBIT NOS. 126 THROUGH 129 WERE RECEIVED INTO EVIDENCE.)

BY MR. WILLIAMS:

Q. I want to direct your attention to page 21 of your direct testimony.

JUDGE THOMPSON: Are we done with all these exhibits, then?

MR. WILLIAMS: I think for the moment.

JUDGE THOMPSON: Okay.

BY MR. WILLIAMS:

Q. It appears on my copy that line 4 of that testimony, you refer to a figure of $50 per kilowatt as being used in your study to estimate dismantlement cost for Empire steam production units, a figure of -- or in that part of your testimony, and the figure of $13 per kilowatt is being used for dismantlement of all other production units except the State Line Combined Cycle Unit, and a figure of $20 per kilowatt is being used for the State Line Combined Cycle Unit; is that correct?

A. Yes.

Q. How did you arrive at your figures for $50 per kilowatt, $20 per kilowatt, and $13 per kilowatt for the dismantlement for each of these types of production units?

A. I have over my career, in fact, my recent career, collected a number of dismantlement cost estimate studies of other utilities, other production facilities, and that collection of studies form the basis for the determination of that $50 per KW for the steam production units, $13 per KW for the other production units, and $20 per KW for the combined cycle unit.

Q. Were any of these studies based on actual dismantlement costs?

A. If you mean for the studies or -- were the studies from the actual dismantlement of a facility, I don't believe that those facilities have reached the end of their life yet, but my understanding of those estimates is that is what certain of those contractors would charge to do that, so it would seem to be a reasonable surrogate for that activity, even though it hasn't occurred yet.

Q. So the answer is that the studies were not based on actual dismantlement costs of a plant but based on estimates for the dismantlement of the plants?

A. Yes.

Q. Were all of those -- were the same assumptions made as to the final state of the site, that is whether it will be Greenfielded or taken to some other state of remediation the same in each of those studies or did it vary?

A. No, there are varying assumptions for each of those studies.

Q. And do you know what extent those states of remediation vary?

A. I don't recall the specifics of every one.

It's quite a number of studies, but it ranges from, I don't know, three feet below grade to one foot below grade, to complete Greenfield, I think, for a couple of the sites, but there's a range of options.

Q. Have you compared any of the decommissioning costs of estimates in the studies to any actual decommissioning costs?

A. Well, first I would say that these estimates are very specific relative to the type of plant and the type of facility, so there may not be a good parallel between actual dismantlement of a facility and these estimates. But having said that, there's also been relatively few plants dismantled in this country, in particular those with a comparable size and fuel type to Empire, so I guess the short answer is no, I didn't make those comparisons.

Q. Do you have multiple decommissioning cost estimates for the same plant that were done at different points in time?

A. No, no, these are one time -- either one time or the most current estimate.

Q. How many decommissioning cost estimate studies did you rely upon for your $50 per kilowatt for steam production plant dismantlement?

A. As I recall, there's approximately 200 units in that population, so -- and some of them are multiple unit sites, so there's probably 70 or 80 different dismantlement studies that are reflected in that total.

Q. I'm sorry?

A. In that total.

Q. Are you finished with your answer? Where are the plants for which steam production plant estimates were developed located?

A. Across the country. There's some in California, Florida, Georgia, Alabama, New Jersey, Indiana come to mind.

Q. Is a large part of a dismantlement cost labor?

A. A very large portion of dismantlement cost.

Q. And do labor rates vary across the country?

A. I'm sure they do. That would be one of the factors that would produce a difference.

Q. Do you know who made these estimates?

A. Yes. In some cases, it's a demolition contractor. In other cases, it's the utility itself.

Q. On whose behalf would a demolition contractor have made the estimates?

A. On behalf of the utility.

Q. How many decommissioning cost estimates did you rely upon for your $20 per kilowatt for the State Line Combined Cycle plant dismantlement?

A. The $20 per kilowatt for the Combined Cycle plant was an estimate that I developed. There -- first of all, there's very few combined cycle units in this country, and there's even fewer dismantlement cost studies for those, so.

Q. How did you arrive at your estimate?

A. I took the information that I had for the gas turbine sites, I think it was $13, and I just increased that by 50 percent. And that was my judgment based upon the fact that the combined cycle unit is a little bit different, it's got a little bit more equipment, and therefore would result in a higher unit cost.

Q. Were there any other factors you considered for your mark-up from $13 to $20 per kilowatt?

A. No.

Q. How many decommissioning cost estimates did you rely on for your $13 per kilowatt for your dismantlements for all production units except the State Line Combined Cycle Unit?

A. I don't recall the exact number, somewhere in the -- I would think it was around 80 units, if I remember right.

Q. Where were those plants located?

A. A similar distribution of locations. I can recall Florida, Alabama, Georgia, California, I don't -- Connecticut. I don't recall the specific locations.

Q. Throughout the United States?
A. Yes.
Q. Who made the estimates?
A. Once again, it was either by the -- a demolition contractor or the utility itself.
Q. And on whose behalf would the demolition contractor have conducted the study?
A. I believe those were also all for the utility, or a utility.
Q. Do the cash flow needs of a company have any bearing on the depreciation expense?
A. The specific calculation of depreciation expense, no.
Q. Doesn't the study you filed in this case support an increase in annual depreciation expense of about $25.6 million?
A. Yes.
Q. Hasn't Empire sought to increase annual depreciation expense by 12.2 million for purposes of setting rates in this case?
A. I thought it was a little bit different number than that, but I'll accept that.
Q. What number do you think it is?
A. I thought the comparable number was around 10 million myself, but.

Q. Isn't it your opinion that the appropriate level of annual depreciation expense for Empire is $25.6 million?

A. Yes, it is.

Q. If you're correct that the appropriate level of depreciation expense for Empire is $25.6 million, and this Commission awards Empire the roughly $10 million per year that it's requested, won't that create intergenerational inequity?

A. I would say yes and no. Yes in that I believe the correct level of depreciation for Empire District is, in fact, the $25.6 million annual figure; however, if the determination of this Commission and under regulatory accounting and GAAP is that it's a lesser number, then that is the correct number to utilize, and therefore, there would not be an intergenerational equity argument.

JUDGE THOMPSON: Let me break in for a moment and ask you if you've got a bunch more.

MR. WILLIAMS: Yes.

JUDGE THOMPSON: Very good. In that case, we'll take lunch recess now and come back for the continuation of your cross. Why don't we come back at 1:15.

MR. WILLIAMS: Thank you.

JUDGE THOMPSON: Thank you.

(A LUNCH RECESS WAS HELD.)

JUDGE THOMPSON: As I recall when we broke for lunch, Mr. Williams was crossing Mr. Roff. You may inquire.

MR. WILLIAMS: Thank you.

BY MR. WILLIAMS:

Q. Good afternoon, Mr. Roff.

A. Good afternoon.

Q. I'm afraid that I had some difficulty with your last answer. If I understood you correctly, your response was yes and no to my question that if you were correct, that the appropriate level of annual depreciation expense for Empire is 25.6 million, and this Commission awards Empire the roughly 10 million that it has requested, won't that create an intergenerational inequity. Empire won't be awarded more than what it's requested, will it?

A. I sincerely doubt that.

Q. So it's already set up to where it can't obtain from this Commission more than the roughly 10 million it's requested in depreciation, can it?

A. That's unlikely.

Q. So is your answer still yes and no?

A. Yes.

Q. Is Empire then going to be forced to forego -- in that hypothetical, would it be forced to forego the 15 million difference?

A. Yes.

Q. So it could never seek recovery of that in the future?

A. Oh, no, I don't believe that's true.

Q. So it would forego it in the particular case, but it could come back and raise the issue again in a future case?

A. Raise the issues and the underlying parameters that derive those amounts or drive those amounts, yes.

Q. And let's say it comes back in the future and seeks 25.6 million and is awarded that. Wouldn't there have been an intergenerational inequity?

A. And I stand by my original answer that, yes, I think there is and no, I think there isn't. I think it's a double-sided answer.

Q. I agree with that. Isn't about 20 million of the $25.6 million increase in annual depreciation expense that you've recommended or that's -- let me rephrase that.

Isn't about 20 million of the $25.6 million increase in annual depreciation expense supported by your study for gross salvage less cost of removal?

A. I think that's the approximate amount, yes.

Q. And isn't Empire currently experiencing, on average, annual gross salvage less cost of removal of expense of approximately $2 million?

A. Yes, but those are two different things.

Q. Do you agree with the statement that there is no one way to conduct the depreciation study?

A. Yes.

Q. Didn't you calculate average life group, equal life group, whole life and remaining life depreciation rates for Empire's property except general plant and present four sets of depreciation rates for consideration by Empire's management?

A. Yes.

Q. Who determined which approach would be used in the study that you filed in this case?

A. Empire management.

Q. Do you agree that the formula that you used to calculate net salvage cost of removal is parentheses gross salvage less cost of removal close parentheses divided by original cost of property retired?

A. Would you repeat the first part of that? I got the last part, but ...

Q. Parentheses gross salary --

A. No, what was the question?

Q. Do you agree that the formula you used to calculate net salvage cost of removal is parentheses gross salvage less cost of removal?

A. I understand. I'm having trouble with the term formula. I think that's a relationship, but I will agree with that statement. That's the relationship that I calculated.

Q. Do you agree that if you multiply the percentage that's a result of that relationship by the account balance, the product is the total amount that would be needed to retire all the property that's in that account in the future, all the property that's in that account at in a point in time? It will be a future retirement, but all the property that's in that account at that point in time?

A. There's really two parts of that in my mind. One is we're calculating a historical relationship. Now, the question is whether we use that specific number or not and apply it to the balance that you're describing, but if you do that, yes, you would get an estimate of the total net salvage relative to the existing asset base.

Q. I want to refer you to your direct testimony, Schedule 3.

A. Okay.

Q. And that would be, I believe, Schedule 3 of Schedule DSR-3.

A. Okay.

Q. Are you there?

A. Uh-huh, yes.

Q. Is the average service life of account 368, line transformers, 39.9 years?

A. The existing approved average service life for that account is 39.9 years.

Q. Okay. Does that average service life suggest that some property in that account at the end of 2003 will last less than 39.9 years and some will last longer than 39.9 years?

A. Yes.

Q. Do you agree that the relationship you've used, and I'm referring to the gross salvage less cost removal over original cost of property retired, attempts to estimate the cost to remove line transformers more than 40 years from now?

A. The net salvage factor that we have developed would apply to all future retirement.

Q. And some of that would be for plant that's more than 40 years from now?

A. Most likely, yes. It would be for some that retires next year, could be one year old, so both possibilities.

Q. I wanted to refer you to Schedule 1 attached to your surrebuttal testimony. Do the retirements that are listed in the second column represent a single vintage of property?

A. In general, not. There may be certain totals on here that, in fact, represent one vintage but in general, not.

Q. For the period of 1994 to 1998, was the distribution property retired all from a single vintage?

A. No.

Q. For the distribution plant that was retired in 1991, how much had been collected in depreciation expense since 1984 for the purpose of net salvage cost of removal?

A. Let me get the pieces of it. The question was the retirement in 1991 --

Q. The distribution plant.

A. -- for distribution plant, and what was the next part of it.

Q. How much had been collected in depreciation expense since 1984 for purposes of net salvage cost of removal?

A. I have no idea.

Q. For --

A. It would be almost impossible to identify that amount.

Q. For distribution plant retired in 1991, how much had been collected in depreciation expense over the entire life of that plant for net salvage cost of removal?

A. I have no idea. It would be very difficult to determine that amount.

Q. Have you ever added up the net salvage cost of removal accruals for a single vintage of even a single property account for Empire and compared them to the actual cost to remove that property?

A. No, there would be no reason to.

Q. Do you agree, then, that you have never reconciled the amounts collected with the amounts actually expended for net salvage cost of removal?

A. That's correct, because it would be impossible to determine the amounts collected.

Q. Would you turn to page 6 of your surrebuttal testimony, in particular, lines 7 and 8? You state there the formula is inherently accurate. Is that correct?

A. Yes.

Q. And do you agree inherent means intrinsic?

A. I suppose.

Q. And do you agree that means belonging by nature or habit, that it's essential in its constitution?

A. Yes.

Q. And do you agree that accurate means conforming exactly to a truth or a standard?

A. I'm not sure that's the only definition of accurate, but.

Q. Would you agree accurate means free from error?

A. Okay.

Q. Would you demonstrate that the relationship you used of gross salvage less cost of removal, that total divided by the original cost of property retired accurately predicts the entire net salvage cost of removal over the next 45 years for the property that is an account 368 at the end of the test year?

A. I can't do that. What I can say is based upon that history and my experience and judgment and that historical relationship, that that is a reasonable estimate of the net salvage for that account.

Q. Is it true that only cost of removal and salvage actually incurred is deductible for income tax purposes?

A. Well, I'm not an expert on tax depreciation, but I'm not sure that salvage is deductible for income tax purposes. I'm fairly certain that cost of removal is.

MR. WILLIAMS: No further questions of this witness at this time.

JUDGE THOMPSON: Thank you, Mr. Williams. Ms. O'Neill.

MS. O'NEILL: Thank you, your Honor.

CROSS-EXAMINATION

QUESTIONS BY MS. O'NEILL:

Q. Good afternoon, Mr. Roff.

A. Good afternoon.

Q. Now, when you performed your depreciation study, the original study before these adjustments, you proposed depreciation rates that would produce almost $53 million in depreciation expense; is that correct, $52,958,490?

A. And where are you getting that number from?

Q. I think it's column seven of your Exhibit DSR-1R, I think it's column seven.

A. 52.9 million, yes.

Q. Okay. And that was a pretty substantial increase over what the depreciation rates are now for Empire; is that right?

A. Yes, for a number of reasons.

Q. As much as maybe 90 percent?

A. Yes.

Q. But Empire knew it couldn't justify that amount in a rate case, and so when they filed the rate case, they only asked for an amount that's less than half of this recommendation that you initially made; is that correct?

MR. ENGLAND: Objection, form of the question, argumentative, asking witness information he has no basis or foundation to answer.

JUDGE THOMPSON: I'm going to overrule that objection. You may answer, if you're able.

THE WITNESS: I don't know that the amount that they requested was half of that number, first of all, but I think the actual requested number was in the range of a $10 million increase, if I recall correctly.

Q. About 10.2 million?

A. Perhaps.

Q. Something like that? And that's -- and that 10.2 million would be -- would be an annual amount, so it would be something that the company would hope to collect each year; is that correct?

A. Yes. I'm being careful with the word collect there, but I think they would be entitled to record that amount, yeah.

Q. And a significant portion of the reason for this increase has to do with the net salvage issue; is that right?

A. Yes.

Q. Your original proposal also suggested about a $5 million increase due to a change from whole life to remaining life method of calculating depreciation; is that right?

A. I don't recall that the number was 5 million. I don't remember what that number was, but yes, there was a difference because of the use of remaining life technique.

Q. Okay. Are you proposing that the Commission not consider remaining life technique and go -- and use a whole life technique or instruct Empire to adopt a whole life technique? Is that your recommendation?

A. My recommendation would be that Empire utilize the remaining life technique. But as I understand the filing, I believe that Empire has asked for use of the whole life technique.

Q. So you're not asking the Commission today to enter an order that says Empire should use remaining life?

A. I believe that that's the correct and more appropriate technique to utilize.

Q. So you are asking them to use remaining life?

A. My recommendation to the company is to use remaining life. I believe the company is seeking the approval of the -- of rates based upon a whole life technique.

Q. So -- so Empire received your depreciation study and looked at your recommendations, and is asking the Commission for a significantly lower amount than what you recommended and they're asking the Commission to not adopt your recommendation about remaining life. Is that your understanding of your client's recommendations to the Commission or their position in this case?

A. I would say it's Empire's request in this case, yes.

Q. So Empire is not actually asking the

Commission to adopt your recommendations in this case?

A. With respect to that topic, I believe that's correct.

Q. You also -- did you also propose to abandon average service life approach for production plant and instead adopt life span approach?

A. We're crossing some technical jargon here, but I think the short answer is yes.

Q. And are you aware that this Commission rejected the life span method in Empire's last tried depreciation case about three years ago?

A. I don't -- my opinion is that this Commission did not reject the life span methodology, that they rejected some of the assumptions that go with it.

Q. Specifically, you had some discussion with Mr. Williams, and I won't go through all of that again at this point, regarding some life span years that the Commission rejected in that last case. Do you recall that, for some retirement dates for production plant?

A. I do recall that.

Q. And other than one change that you made to your testimony, it appeared that the retirement dates that you've proposed track those that were rejected in the last tried rate case; is that correct?

A. I'm not sure I would characterize it that way.

I think that I would say that the retirement dates that I have used are -- are similar to those, but they weren't prepared with that in mind.

Q. Are you aware of any specific plans Empire has that supports those retirement dates?

A. I don't understand your question.

Q. Do you know whether or not Empire has any specific plans or studies?

A. Plans, I'm sorry, I thought you said plants.

Q. Plans, I'm sorry.

A. Plans. That's a difficult question for me to answer. I can't speak entirely for Empire's plans on that regard.

Q. Okay. Do you know whether or not Empire has promised to retire those production plants on the dates that you've proposed?

A. I don't believe that's true.

Q. And I think you testified earlier today that you received all those dates from Empire; is that correct?

A. Yes, ma'am.

Q. And you also have testified that you are aware that the Commission, In that last rate case, found that those retirement dates were not credible, correct?

A. That's correct.

Q. You're asking the Commission to make a major change in the way Empire currently treats net salvage in this case. Is that true?

A. Certainly it's a major change from what they're doing now.

Q. Major change from the way Empire is currently treating net salvage?

A. Currently the way the Commission has ordered Empire District to handle net salvage.

Q. And are you aware that your proposal for the treatment of net salvage was rejected by the Commission in that last tried rate case?

A. I think there was some language in there that talked about facts and circumstances relative to individual utilities, so I hesitate to say that that method was specifically rejected by this Commission.

Q. Okay. Now, of the proposal that you made as opposed to the position Empire's taking in this case, proposal that you made regarding depreciation, about $20 million of your proposal was related to net salvage, correct?

A. I believe that's approximately the number, yes.

Q. And under your original proposal, that would have been $20 -- $20 million each and every year that these rates would be in effect if that proposal was adopted; is that right?

A. I believe that's correct. That's the net salvage accrual amount.

Q. Isn't it true, however, that on average, the actual experience that Empire's had over the last five years regarding cost of removal and net salvage has been significantly lower than $20 million a year?

A. Those are two different numbers, two different items, but in fact, the amount of cost -- net salvage that Empire has recorded is -- incurred is different from the $20 million accrual for net salvage as part of a depreciation expense, but those are two different ideas.

Q. And in fact, as far as the cost of removal goes, that average cost of removal over the last five years is less than $2 million a year. Isn't that correct?

A. The average net salvage over the last five years is less than $2 million a year, yes.

Q. And are you aware of what Empire projects it will actually spend on cost of removal over the next five years, whether that's going to be the $10.2 million a year that they're asking for from this Commission?

A. Well, again, you're confusing two numbers, but I would suppose that if history is an indicator, and I believe that it is, that the actual net salvage experience that will occur for Empire over the next five years will be in excess of $10 million, but that's not the $10 million that you're referring to as their request for depreciation expense.

Q. $10 million a year?

A. $10 million in total of incurred net salvage over the next five years.

Q. Over five years?

A. That's my estimate -- that's my estimate, yes.

Q. Okay. Okay. Fair enough, and that $10.2 million that Empire's asking for an increase of its depreciation rates, that's not the total depreciation they're asking for, 10.2 million, right?

A. That's correct.

Q. That's the increase from what they're currently getting, right?

A. It's the increase from what the existing approved rates are applied to the test year balances.

Q. Okay.

A. I suspect that they're actually incurring or accruing less than that, recorded -- collecting less than that.

Q. You are -- of that $10.2 million increase that's being requested, would you say that a small percentage or the majority of that increase or something else is attributable to changing the way that net salvage is recognized?

A. I would say that the majority of it relates to that.

Q. Would it be in a ratio greater than the 20 of the 25 million in your study or would it be about the same? That would be 80 percent.

A. I would think it's a little less than that.

Q. Less than 80 percent?

A. Yes.

Q. Are you aware of whether or not Empire's made any projections regarding what expense -- what it expects to incur in cost of removal over the next five years?

A. I'm not aware that they have.

Q. Did they share any information like that with you?

A. I am not aware that they have done that.

Q. Did you seek such information when you were preparing your depreciation study or any part of your testimony in this case?

A. No, and nor did I think it was applicable.

Q. You're aware that cost of removal is actually negative net salvage, which is cost of removal less whatever gross salvage value there is, as we know, is separately accounted for on an annual basis right now under Empire's rates, correct? The net salvage is separately accounted for?

A. I believe -- we're talking about rate-making here, I think, but Empire was allowed a net salvage expense amount in their prior rate case. I'm not clear that that's how they account for it, if you asked that question.

Q. Okay. Is the way that allowance was arrived at based on an annual amount of actual net salvage?

A. Yes, it's actually a five-year average, I believe.

Q. Okay. And to reach that annualized amount of net salvage, would the annual cost of removal also be a relevant figure?

A. Yes.

Q. But since -- but you chose not to investigate projections for actual cost of removal over the next five years or estimates for cost of removal over the next five years?

A. That's correct, and it would be difficult to do that.

Q. Did you ask Empire to do that?

A. No, I didn't.

Q. Do you think if you asked them, that they would be able to give you any information about it?

A. I don't think that they would be able to give me any different information than what I had already obtained.

Q. Okay.

MS. O'NEILL: Your Honor, may I have an exhibit marked, please?

JUDGE THOMPSON: All right. This will be Exhibit 130.

(OPC EXHIBIT NO. 130 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

JUDGE THOMPSON: How shall we describe this?

MS. O'NEILL: This is Empire's responses to Public Counsel Data Requests 833 and 877.

BY MS. O'NEILL:

Q. Mr. Roff, if you would just take a second to look through that exhibit.

A. All right.

Q. Have you had a chance to look at that?

A. Yes, ma'am.

Q. And Mr. Roff, are you aware of Kelly Walters, who's an Empire witness in this case?

A. I do know Kelly Walters.

Q. Okay. She is employed by Empire?

A. Yes.

Q. Are you also aware of Nancy Moger (ph. sp.) at Empire?

A. I do not know Nancy Moger.

Q. Okay. Would you agree with me that the first page of this is styled as a Data Request from Public Counsel to Empire District requested from Kelly Walters from Michael Majoros?

A. Yes.

Q. And attached to that is their four pages of response regarding Data Request 833?

A. Yes.

Q. And then also behind that, is there a Public Counsel Request No. 877 also to Kelly Walters from Michael Majoros?

A. Yes.

Q. And does 877, the information requested, a follow-up clarifying -- explaining where cost of removal is shown in the attachment to 833?

A. That's the way I interpret this, yeah.

Q. And the information provided said that retirement budget 2004 to 2008 in the spreadsheet, this is the cost of removal?

A. That's what it says.

Q. Okay. And on the third page of Exhibit No. 130, is there a tab, retirement?

A. A tab?

Q. Or is there a title?

A. A title, yes.

Q. Is there a title retirement?

A. Yes.

Q. And are there numbers for each of the years 2004 through 2008?

A. Yes, there are.

Q. So it appears that Empire's able to provide at least estimates of cost of removal for the next five years; is that correct?

A. It would appear.

MS. O'NEILL: Your Honor, I'd move for admission of Exhibit 130.

JUDGE THOMPSON: Any objections to the receipt of Exhibit 130?

MR. ENGLAND: No objection.

JUDGE THOMPSON: Hearing no objections, the same is received and made a part of the record in this proceeding.

(OPC EXHIBIT NO. 130 WAS RECEIVED INTO EVIDENCE.)

BY MS. O'NEILL:

Q. Okay. Mr. Roff, are you familiar with financial accounting standards or SFAS No. 143 accounting for asset retirement obligations?

A. I am.

Q. Was that No. 143 issued June of 2001?

A. I believe that's the correct date.

Q. And Deloitte and Touche, as an accounting firm, would be familiar with this pronouncement, would you agree?

A. Yes.

Q. Are you also familiar with the FERC Order No. 631?

A. I am.

Q. And was FERC Order 631 issued in April of 2003?

A. I believe that's the correct date. 2003? I guess it was 2003.

Q. So you and your firm are aware of the information contained within that Order as well?

A. I can't speak for everyone else in my firm, but I am aware of what's contained in Order 631. I'm sure that there are several people in our firm that are familiar with it as well.

Q. Now, SFAS No. 143 addresses financial accounting, right?

A. Yes.

Q. And FERC Order 631 addresses regulatory accounting?

A. I think FERC Order 631 addresses a variety of topics as mentioned in its title.

Q. Among it -- among them regulatory accounting?

A. Yes.

Q. Is --

A. Rate-making and financial reporting I believe are the three topics.

Q. Uh-huh. Is Empire subject to both 143 and 631?

A. Empire is certainly subjected to 143. I believe Empire is subject to the FERC Order.

Q. Okay. And would you agree that both of these -- these orders, these pronouncements perhaps, would be a better word, mentions words and phrases like depreciation expense and accumulated depreciation?

A. I believe those words are mentioned in at least 631. I don't recall how much of that is mentioned in 143.

Q. Okay. Do both of these pronouncements have potential impact on Empire's depreciation expense and depreciation accounts?

A. I don't believe 143 would have any impact on Empire's depreciation expense, at least currently. Going forward, it will. 631, I don't believe it does either for the same reasons.

Q. Are we asking this Commission set rates that will be in effect on a going-forward basis?

A. I believe so.

Q. And while those rates are in effect, do you

expect that SFAS 143 will apply to Empire?
A. I have no reason to believe it wouldn't.
Q. That it would not?
A. I have no reason to believe that it would not be applicable.
Q. Thank you. Do you have any experience in assisting a public utility in -- well, let's talk for a minute about 143. 143 talks about asset retirement obligations; is that correct?
A. Uh-huh, yes.
Q. Okay. And those asset retirement obligations, they talk about legal retirement obligations in 143, correct?
A. Yes.
Q. And what is a legal asset retirement obligation?
A. Well, I have the standard in my bag, but my recollection is that a legal obligation, that is one that comes about as a result of a contract or a statute or a law or potentially under the concept of promissory estoppel.
Q. Okay. So if, for example, a public utility had a contract that it would retire an asset in 2008, that could be a legal retirement obligation?
A. If they had an obligation to remove that asset.
Q. Okay. If they were -- if there was an order

from a Public Service Commission or a Public Utility Commission telling a utility to retire and remove an asset on a certain date, would that be a legal asset retirement obligation?

A. I'm not aware of any Commission in the country where that has occurred, but if that were the case, yes, in my view that would be a legal obligation.

Q. Okay. That's not something that you see, typically, though?

A. As I just stated, no.

Q. You say said something about promissory estoppel, would that encompass a situation where a utility would promise its regulatory authority that it would retire and remove an asset on a date certain?

A. I'm not sure that it would be limited or necessary to be to the regulatory body. The example that's in 143 talks about a -- someone making a promise to the city council, a mayor, or something like that, but it's been my experience that there are no examples of promissory estoppel that I've seen under 143.

Q. So in your experience, there are no orders from Public Utility Commissions that would qualify as an ARO, or an asset retirement obligation?

A. Well, first we were talking about promissory estoppel, and now you're talking about orders from

Commissions. I am not aware of any Order from a Commission that requires a utility to remove a facility and therefore create an asset retirement obligation.

Q. And you're not aware of any promissory situations either; is that right?

A. Under any circumstance, no.

Q. Okay. There are some things like -- would, like, decommissioning a nuclear plant be considered an ARO?

A. That would certainly be a legal requirement from the NRC -- Nuclear Regulatory Commission.

Q. Okay. Do some utilities have, for one reason or another, these legal asset retirement obligations?

A. Yes.

Q. Have you personally been involved in assisting a utility to -- to consider FAS 143 regarding separating out those legal retirement obligations from its other assets for depreciation purposes?

A. I have not been involved with a utility to separate its legal obligations for 143 purposes.

Q. How about for any other purposes?

A. Yes.

Q. Okay. Anywhere in Missouri?

A. I have reviewed them, Empire District calculation. Nowhere else in Missouri.

Q. Okay. Did you discuss legal asset retirement

obligations in your direct testimony?
A. I don't believe that I did.
Q. Did you reference SFAS No. 143 in your direct testimony?
A. I don't believe that I did.
Q. Did you reference FERC Order 631 in your direct testimony?
A. No.
Q. Okay.
A. Nor was it necessary to.
Q. Did you discuss SFAS 143 or FERC Order 631 with Empire as part of the depreciation study that you did for this case?
A. Yes.
Q. And did you include any information about SFAS 143 or FERC 631 in your depreciation study?
A. No.
Q. Was that because you believe that there's no obligation to discuss either of these pronouncements in a depreciation study in connection with a regulatory proceeding?
A. I don't believe that it's necessary to include those in a depreciation study that's developing depreciation rates. It wasn't necessary at the time, no.
Q. And when did you do the study?

A. The study was conducted in the first quarter of 2004, I guess is the time frame.
Q. This calendar year?
A. I was going to look at the date of the report, April 2004 my report is dated, so.
Q. Okay. So would it be fair to say as far as you know, the first time that anyone identified or explained issues relating to SFAS 143 and FERC Order 631 in this proceeding was when Mr. Majoros filed his testimony?
A. No, I'm not -- that's not true at all. I've had discussions with the company about 143 and 631, but it wasn't relative to this depreciation study, wasn't necessary.
Q. Mr. Majoros was the first witness to identify it in testimony -- those two pronouncements in testimony, though, in this case; is that correct?
A. I don't know whether that's true or not.
Q. Okay.
A. I didn't read the testimony of every witness.
Q. Okay. You didn't read anybody's testimony prior to reading Mr. Majoros' testimony that raised those issues?
A. I guess the answer to that would be yes. I did not. But once again, I didn't read every witness' testimony in this case.
Q. And you have some testimony in rebuttal, and I

think in surrebuttal as well, indicating that you don't agree with Mr. Majoros' conclusions; is that correct?

A. That's absolutely correct.

Q. Now, is that you, Donald Roff, who doesn't agree or is that a position of your accounting firm?

A. This is my testimony, so it would be my opinion.

Q. Okay. Is that your opinion that's personally held or is it the position that you're setting forth for purposes of your client, Empire, in this case?

A. I don't believe that Empire disagrees with my position.

Q. Okay. Do you know whether or not Empire has done any -- made any filings regarding issues raised in SFAS No. 143?

A. I don't know what you mean when you say filings, but in their financial statements that were filed with the FAC, Empire has identified, I believe, one or -- one asset retirement obligation.

Q. Okay. Would that be a form 10-K or would that be another form?

A. It's either -- I'm thinking originally it would have been a 10-Q, but it's probably in both a 10-Q and a 10-K.

Q. Okay.

MS. O'NEILL: Can I have an exhibit marked?
JUDGE THOMPSON: You may. This will be 131. What is this exhibit?
MS. O'NEILL: This is an excerpt from Empire's form 10-K for fiscal year-ending December 31st, 2003.
(OPC EXHIBIT NO. 131 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)
BY MS. O'NEILL:
Q. Mr. Roff, have you had a chance to glance through that Exhibit 131 that's been marked?
A. Okay.
Q. Okay. I direct your attention to the second page of that exhibit, which is labeled 60 of 160. Do you see that?
A. Yes, I do.
Q. Okay. And under the heading recently issued accounting standards, does that paragraph discuss SAF -- SFAS No. 143?
A. It does.
Q. Okay. Could you read the second statement -- the second sentence in that paragraph, please, into the record?
A. The one that begins with this?
Q. This statement establishes.
A. This statement establishes standards for

accounting and reporting for legal obligations associated with a retirement or anticipated retirement of tangible long-lived assets.

Q. Okay. And could you also read the next sentence?

A. It requires us to record the estimated fair value of legal obligations associated with the retirement of tangible long-lived assets in the period in which the liabilities are incurred and to capitalize a corresponding amount as part of the book value of the related long-lived asset.

Q. And those are legal asset retirement obligations that it's talking about; is that correct?

A. Legal obligations, yes.

Q. Yes. If you turn to the next page in Exhibit 131, which is labeled 61 of 160, are you there?

If you look through that -- if you look at that first paragraph at the top of the page, would you go -- let's see, it looks like three sentences from the end of that paragraph where it says also comma we reclassified. Could you read that sentence, please?

A. Also, we reclassified the accrued cost of dismantling and removing plant from service upon retirement, which is not considered an asset retirement obligation under FAS 143 from accumulated depreciation to a regulatory liability.

Q. Okay. And what's a regulatory liability?

A. A regulatory liability in one sense is the difference between financial accounting and a regulatory accounting.

Q. So regulatory -- I'm sorry, could you repeat that?

A. The difference between financial reporting, GAAP, and regulatory accounting, G-A-A-P.

Q. Is a regulatory liability one that's imposed as a result of a regulatory process?

A. Yes.

Q. Okay. And just before we leave Exhibit 131, could you look at the first page there and could you tell us whose form 10-K this is taken -- this excerpt is from?

A. The Empire District Electric Company.

Q. And that's the company that you're here as a witness for today; is that right?

A. Yes, ma'am.

Q. Now, FERC Order 631, I want to talk to you about that a little bit. These obligations that were reclassified under this 10-K exhibit --

MS. O'NEILL: Oh, your Honor, I'd move for the admission of 131 for the record.

JUDGE THOMPSON: Any objections.

MR. ENGLAND: No objection, your Honor.

JUDGE THOMPSON: Very well, Exhibit 131 is received and made a part of the record of this proceeding.

(OPC EXHIBIT NO. 131 WAS RECEIVED INTO EVIDENCE.)

BY MS. O'NEILL:

Q. Now, these reclassifications that are talked about in this Empire filing, this 10-K, does FERC Order No. 631 identify those types of prior charges as nonlegal asset retirement obligations?

A. I believe that it does.

Q. So although it didn't appear in your direct testimony, you do have some familiarity with these concepts that are found in this order?

A. I have a great deal of familiarity with these concepts. I should point out that that reclassification was not a part of 143, it was an interpretation of the SEC, Securities and Exchange Commission.

Q. Now, because of your familiarity with these concepts, would the change from using the whole life method to remaining life method have any kind of effect requiring any of these reclassifications? Would it require reclassifications?

A. Not in my opinion.

Q. Okay. Is accumulated depreciation used to calculate remaining life depreciation rates?

A. Yes, it is.

Q. Going back to Exhibit No. 131, back to that first paragraph on page 61, there's a question there that -- if you look at the last sentence in that first paragraph, could you read that, please?

A. Yes. This estimated liability may be subject to further refinement pending further analysis, including the results of our depreciation study expected to be completed in the first quarter of 2004.

Q. Okay. And that sentence refers to the regulatory liability that was reclassified; is that right?

A. I believe so.

Q. Okay. And the depreciation study expected to be completed in the first quarter of 2004, does that refer to the depreciation study that you completed?

A. As far as I know, yes.

Q. Okay. Now when the 10-K form cites to further refinement in that sentence, is that a warning that the level of regulatory liability may go up or down?

A. You would have to ask whoever filed this 10-K, but my -- my opinion would be that, yes, that that is a possibility that that amount may change.

Q. And do you agree with me that as a result of your depreciation study, if your recommendations were to be adopted, the regulatory liability would increase by about $20 million a year?

A. I don't know that that's true at all. I think what this sentence really means is that Empire was seeking my opinion on how to estimate that liability and we determined, I think, that their calculations were accurate. That's the only caveat that goes along with this.

Q. Well, as a result of your -- of a combination of your depreciation study and the rate request that Empire actually filed in this case, would it be your understanding that the regulatory liability would increase whatever part of that $10.2 million is attributable to net salvage?

A. Once again, 10 million -- $10.2 million is the annual increase that was proposed by -- or requested by the company. The quantification of that regulatory liability takes into consideration a number of factors, so I don't believe all of that $10 million would be reclassified.

Q. Would you agree, though, that a portion of that 10.2 million that would be attributable to net salvage, would be the figure that would be the increase in the amount of regulatory liability?

A. No, because that amount would be offset by actual cost of removal incurred.

Q. And that, again, would be that cost of removal over and above whatever is already allowed in the current number; is that correct?

A. No, has nothing to do with that. It would be the cost of removal that's actually recorded by Empire in calendar year 2004.

Q. Not the cost of removal actually incurred?

A. Absolutely.

Q. Okay. You know, you were confused about some of my terms and I want to make sure that I'm right. When you're talking about cost of removal recorded, you're talking about recording what actually it costs to remove an item from service, correct?

A. That's one piece of it, yes.

Q. Okay. You're not talking about just a book entry about something that may happen somewhere down the road?

A. Well, I don't know that there's any book entries about something that might happen somewhere down the road.

Q. Okay. You're not talking about an estimate about some future cost that may be incurred?

A. No.

Q. You're talking about an actual experience?

A. Yes.

Q. Okay.

A. The regulatory liability that is recorded represents the difference between what has been recorded and accrued for cost of removal and accumulated depreciation, and the difference between the actual cost of removal that is -- has been incurred.

Q. So --

A. So when you mention the $10 million increment as composed of a number of items, including changes in life, and therefore the regulatory liability would not increase by $10 million. It would be something less than that.

Q. Okay. So we're talking about -- we appear to be talking about the same thing and getting there at different ways, but let's move on.

Obviously 143 and FERC Order 631 are not the only things that come into play as far as pronouncements by outside entities when companies are determining what their liabilities are or what their recording obligations are; is that correct?

A. Well, if you speak in general terms, yeah, there are a number of pronouncements that affect liabilities and what gets recorded.

Q. And we've been talking about SFAS 143, but the Statement of Financial Accounting Standards, there's a whole bunch of those; is that right?

A. Clearly there's at least 143.

Q. Are you familiar with Statement of Financial

Accounting Standard No. 71?
A. I am.
Q. Okay. And what is SFAS 71?
A. SFAS No. 171 deals with the accounting for the effects of regulation.
Q. Would this be 71?
A. 71.
Q. Okay.
A. Did I not say 71?
Q. 171, but we were dealing in three digit numbers for a while. I understand.
A. And there are certain criteria that you have to meet to be able to employ SFAS No. 71.
Q. All right.
MS. O'NEILL: May I have an exhibit marked?
JUDGE THOMPSON: You may. It will be 132. This is SFAS No. 71; is that correct?
MS. O'NEILL: Yes, your Honor.
(OPC EXHIBIT NO. 132 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)
JUDGE THOMPSON: Do you have another copy of Exhibit No. 132?
MS. O'NEILL: I'm sorry.
JUDGE THOMPSON: Thank you.
MS. O'NEILL: Uh-huh.

BY MS. O'NEILL:

Q. Mr. Roff, is exhibit -- what's been marked as Exhibit 132 -- can you tell me what that is for the record?

A. I can try. It appears that this is a partial reproduction of FAS 171 -- FAS 71.

Q. Okay. And it includes the cover sheet and pages 7 and 8; is that correct?

A. Yes.

Q. Now, SFAS 71 deals with regulatory assets and regulatory liabilities; is that correct?

A. I'm not sure that FAS 71 deals with regulatory assets and regulatory liabilities. It deals with a number of things.

Q. Would you turn to the second page of that marked exhibit, which is marked as page 7, paragraph 11?

A. Okay.

Q. Does that paragraph 11 address regulatory liabilities?

A. It doesn't state it directly, but I think that's the intent of that paragraph.

Q. Would you read the first two sentences of paragraph 11, please?

A. Rate actions of a regulator can impose a liability on a regulated enterprise. Such liabilities are usually obligations to the enterprise's customers.

Q. So those two sentences do refer to regulatory liabilities; is that right?
A. I'm not trying to be -- I don't see the term regulatory liability, that's why I'm not going to be so quick to agree.
Q. Okay. At any rate, they are -- it's discussing liabilities that are imposed by a regulator. Would you agree with that?
A. I would agree with that.
Q. Okay. And to whom is a regulatory -- who would these liabilities be owed to?
A. These are usually obligations to the enterprise's customers.
Q. So if as a result of changes in depreciation rates in this case, some part of your proposal was adopted and the regulatory liability that we talked about earlier went up, that would be a liability to the customers of Empire District Electric, correct?
A. If I accept all of those hypotheses, yes.
Q. Yeah. And a liability represents an amount that's owed to some other party; is that correct?
A. You could say it that way.
Q. You can incur liabilities in different ways. For example, if you borrow money, you incur a liability?
A. That's not necessarily a regulatory liability,

but yes, you could incur a liability if you did that.

Q. For example, Empire's long-term debt would be considered a liability?

A. I would certainly think so.

Q. And Empire treats its long-term debt as a component of its capital structure; is that right?

A. I believe they do.

Q. Okay. And those long term-debts have repayment obligations and a repayment schedule. Is that your understanding?

A. That would be my understanding.

Q. Now, the regulatory liability that would be proposed regarding depreciation, this liability owed to customers, that doesn't have a repayment schedule, though, does it?

A. Not in the same way.

Q. It doesn't have a repayment schedule at all, does it?

A. Not specifically in that sense, no.

Q. Now when a utility seeks capital to make investments in their infrastructure, in their plant and various things, is that capital generally supplied by investors or by customers?

A. Well, if you say that the company sought capital, I would assume that would come from investors.

Q. Okay.
A. Or some financial source.
Q. And the financial source would expect some sort of return on that investment; is that correct?
A. Absolutely.
Q. Now the net salvage that you're proposing to be included in depreciation rates is an estimate, right?
A. Yes.
Q. And the company's seeking to have that estimated amount paid now and on an ongoing basis by its customers, correct?
A. To the extent that a depreciation rate would include a component for net salvage and that expense were allowed in a revenue stream, then, yes, that amount would be paid by customers.
Q. It's not being paid by investors?
A. No.
Q. So it would be paid by customers?
A. I just said that.
Q. Okay. You seemed a little bit hesitant there like you weren't really sure maybe the customers wouldn't have to pay, but you're sure, right, the customers are going to pay?
A. I wasn't hesitant, I was trying to be clear.
Q. Okay. Now, because those costs are estimates,

we don't have a guarantee that those costs are ever going to be incurred, right?

A. Well, first I would say that they are well-founded estimates based upon substantial history and experience in judgment, and the expectation is that those costs will be incurred.

Q. But to the extent they are not legal asset retirement obligations, there is no requirement that they be incurred?

A. Well, the fact that they are not legal obligations does not limit the fact that they will be incurred.

Q. Okay. And in fact, even if they are incurred, because many of them -- there will be some retirements, and there will be -- there could very well be costs associated with that, but we don't know whether the cost being estimated will be the costs that are incurred, do we?

A. We do not know today that the estimated costs will be the amounts actually incurred, that's correct.

Q. And --

A. That's why it's an estimates.

Q. And to the extent that the amounts are overestimated, the difference is not refunded to the customers who pay that in, is it?

A. Well, I'm not sure that I can accept the hypothesis that the amounts would be in excess of what was estimated, in particular when we've -- the company has reduced its request in this case. But if that were the case, I believe that the remedy would be an adjustment in the next depreciation proceeding to adjust those rates accordingly.

Q. Well, what if you're -- what if you have an estimate for a cost of removal that you don't expect to incur for 20 years and you estimate that it's going to cost $1,000 for that removal, net, and either there's no need for the removal after 20 years or it only costs $100. How are the customers refunded their extra money, that excess money they've paid in?

A. I don't know how that's done in this jurisdiction. I don't think it's ever come up, so I don't know how it would be handled.

Q. Okay.

A. But the fact that you're talking about something that's 20 years from now, we have the opportunity to adjust those estimates at periodic intervals.

Q. But if your estimate remains $1,000 in this depreciation study and the one 5 years from now and the 10 years from now, and the one 15 years from now, but at the end of 20 years, doesn't happen, there's been no adjustment to the benefit of the customers, has there?

A. I don't want to agree that there's been no benefit. The fact that a rate base has been reduced because of a higher depreciation charges has been a benefit to the customer.

Q. The customers who have paid more in toward depreciation -- toward cost of removal, excuse me, will not get that money back, correct?

A. I can't say whether that's true or not.

Q. If the costs are never incurred, is there a refund mechanism in your proposal?

A. Well, first of all, my proposal has nothing to do with this regulatory liability that you're talking about, but to the extent that my estimates are revised in the future, there's a process for adjusting those at that time, so I can't say that that won't happen.

Q. Do those adjustments result in a refund to customers?

A. I don't know. I can't say. I don't think they do.

Q. Okay. Now, the net salvage that you proposed to be included in depreciation rates, you don't separate that out and have that in a dedicated account that can only be used for cost of removal, right?

A. No, I don't believe that there's a requirement to do that.

Q. In fact, there's not a requirement that companies separate that net salvage out and use that money for cost of removal, is there?

A. I think I just said that, but I'll be happy to repeat that answer.

Q. Company then, therefore, could use the funds generated through the depreciation rates for any purpose, whether it be cost of removal, plant replacement, employee salaries, anything they want to use it for, it's okay?

A. And I believe that's what happens today, that the revenue stream that is received by the company is used to take care of operations, take care of its business.

Q. Well, let's look at your net salvage estimates from another way and let's say you're right. Let's say that 20 years from now it does cost $1,000 to remove that item of plant, but the $1,000 is gone. Where's the $1,000 come from?

A. It would come out of current operations, I assume.

Q. Who pays for the current operations revenues?

A. The same customers that paid for the depreciation expense.

Q. So technically under that scenario, customers could, in fact, be paying twice for the same cost of removal?

A. No, because the other charges would have been spent on other assets or activities, so they're only paying once.

Q. But they're paying a rate based on, in part, the net salvage that you've calculated, correct?

A. They're paying a customer rate.

Q. The customers that are paying the rates, because they're the ones that are giving the company the money that's the revenues, right? They get the revenues from the customers?

A. That is true.

Q. And the rates that are set include depreciation?

A. And a number of other things.

Q. One of the things is depreciation, right?

A. And a number of other things.

Q. And under your proposal, one of those things included in setting rates is net salvage estimates for future cost of removal?

A. And a number of other things.

Q. Yes.

A. We don't segregate --

Q. Is that a yes?

A. Let me finish my answer. We don't segregate the revenue stream into components.

Q. But when we --

A. We don't have a portion of our rate that relates to depreciation, we don't have a portion of our rate that relates to return, we don't have a portion of our rate that relates to operation expense. We have a composite revenue rate, so we can't segregate those out.

Q. So you can't really say whether or not those costs of removal when they incur are going to be paid for twice by the customers because you don't segregate it out, right?

A. I don't think I said it exactly that way.

MS. O'NEILL: No further questions.

JUDGE THOMPSON: Thank you, Ms. O'Neill. Did you mean to offer 132?

MS. O'NEILL: Yes, I did. Thank you.

JUDGE THOMPSON: Any objections to 132?

MR. ENGLAND: I believe I do, your Honor.

JUDGE THOMPSON: What's your objection, Mr. England?

MR. ENGLAND: Well, it appears that it is -- the exhibit is only an excerpt of SFAS No. 71, and I think if we're going to make this an exhibit, it ought to be in its entirety.

JUDGE THOMPSON: Well, I'm going to overrule that objection and give you an opportunity to file the remaining portions of this, if you feel that's necessary. Any other objections? Exhibit 132 is received.

(OPC EXHIBIT NO. 132 IS RECEIVED INTO

EVIDENCE.)

JUDGE THOMPSON: Ready for questions from the bench. Chairman Gaw.

CHAIRMAN GAW: Thank you, Judge.

QUESTIONS BY CHAIRMAN GAW:

Q. Good afternoon, sir.

A. Good afternoon.

Q. I have got a few questions for you that -- and bear with me here -- I think it's your Schedule DSR-4.

A. Is that the comparison of depreciation rates?

Q. Yes, I think so.

A. Okay.

Q. Your recommendation for a composite rate for Empire is 4.72 percent; is that right?

A. I don't recall that that's the exact number. It's somewhere in that general range.

Q. Okay. Is it accurate to say that you also acknowledge that three percent seems to be an adequate average composite depreciation rate?

A. Yes, based upon this sample and just my broad kind of sanity check of Empire's rates, it would seem that a three percent composite rate is a reasonable norm.

Q. All right. Would it be -- on the -- on the list of comparables that you have different depreciation rates, do you have any noted there that are four -- or around

4.7 percent or higher?

A. These are arranged in ascending order, sir, so the bottom rates would be the highest, no, none approach that level. Close, but.

Q. What's the closest one?

A. The bottom one, 4.44 percent.

Q. All right. And the lowest one?

A. 1.72 for Kansas Gas and Electric.

Q. All right. You have a depreciation rate on that schedule for Empire of 2.27 percent; is that correct?

A. That's what was computed based upon the numbers that I inputted, yes.

Q. All right. And this is for purposes of clarification. On your Schedule DSR-3, I know that's got several pages to it, but I believe that you have provided a depreciation rate for Empire of 2.53 percent.

A. Yes.

Q. Can you explain the difference between those two figures for me?

A. I think the difference is in two -- two areas. One is the depreciation expense that is shown on DSR-4 is a total amount for the year. Secondly, the average balance is the sum of the beginning balance and the ending balance divided by two, so I don't know that they're exactly on the same basis relative to the asset base.

And I think that the DSR-4 schedule probably includes some nondepreciable asset categories, which is why that 2.27 rate is lower than the comparable -- comparable rate shown on DSR-3. But those, I think, are the three primary reasons for the difference.

Q. Are both of those figures confined to Missouri portions of Empire or not?

A. I think that they would be system totals.

Q. Both of those figures?

A. Both, yes.

Q. And could you provide some clarification for that in maybe how you arrived at those figures?

A. Right now or?

Q. No, before you're done with things here, I mean, not before you're off the stand, but if you could give some backup to that so I'll understand.

A. I will try.

Q. In Schedule DSR-4, would it be true that many of the utilities that you -- that you have cited there have nuclear operations?

A. I would say few have nuclear operations.

Q. Can you -- can you let me know which ones do and which ones don't?

A. I can take a quick stab at this right now. Kansas Gas and Electric would have a nuclear operation, Illinois Power would. I believe Niagra Mohawk has sold their nuclear operations; Public Service of Colorado, I think they retired their nuclear plant. Cincinnati does; I believe UE does, New York State Electric and Gas does not; PSI Energy does not; Puget Sound Energy does not; Pennsylvania Electric does not; Public Service Oklahoma does not; KC -- Kansas City Power and Light, I don't believe they have a nuclear facility. Aquila, I don't believe does; Oklahoma Gas and Electric does not; Sierra Pacific does not; Louisville does not; Antergy Arkansas does; Dayton Power and Light does not; United Illuminating, I don't believe; Southwestern Electric Power does not; Central Illinois Public Service, I don't believe has nuclear; Interstate P & L does not; Central Illinois Light, I believe does; Metropolitan Edison does; Portland General Electric does not; and Rochester Gas and Electric does.

Q. All right.

A. To the best of my current knowledge.

Q. All right. I have a feeling that there may be others in the room that will -- will offer their advice.

A. Some corrections.

Q. So?

A. I'm about 95 percent sure on those.

Q. Okay.

A. I may have missed a couple.

Q. It would be true, wouldn't it, that in most cases, nuclear plants have their life -- life set at 40 years representing the initial license life?

A. Except for those that have applied for a renewal of their license, yeah.

Q. What happens then?

A. It depends on the NRC decision, but for those that are in a position to apply for that, my experience has been they've granted an additional 20 years.

Q. Yeah. Would it be -- would it be accurate to say that the units may have longer lives than 40 years?

A. Only for those where they have applied for the license renewal.

Q. Well, even if they have not, it doesn't mean that they will not, does it?

A. I hesitate to say.

Q. Well, okay. When you say if they haven't, are you talking about from an accounting standpoint or from the standpoint of what's really happening out there?

A. From a physical application standpoint.

Q. How many nuclear reactors have -- are you aware of that have been closed within 40 years -- closed down permanently?

A. I believe the Trojan plant was just closed down in Oregon.

Q. Is that the only one you can think of?

A. The Big Rock Point for Consumers Energy recently retired --

Q. Two?

A. -- at the end of its life.

Q. Two?

A. Well, there's only about a hundred total.

Q. Okay. Two out of a hundred then. Are -- and how many of them do you think are -- that are out there may be seeking renewals of licenses, do you know?

A. Yeah, I had looked at the NRC website fairly recently. There's about a, I believe, around a dozen that are in process right now.

Q. Okay. Would it be fair to say that given the abbreviated life associated with a license and the amount of rate base tied up with these units, that -- that that has a significant impact on a depreciation rate and what it looks like in comparison to what else is in the equation?

A. Looking at this list, I don't believe that that nuclear rate would have a significant impact on this composite result.

Q. Would it have in regard to those utilities that have nuclear?

A. It's hard to say. Once again, I would have to split the nuclear units into two pieces. Those that have gotten in for extension and those that haven't. So, you know, if you were a 40 year life nuclear unit with some recognition of component replacement, I suppose I would think that that life would be, you know, more than the 2.5 percent and could approach three, so I would estimate that it doesn't have that big of an impact, but I didn't -- it would be difficult to pull that out or to ferret that out.

Q. All right. Would it be fair to say that depreciation rates might be affected by the operation of an electric utility in a deregulated state?

A. I would think that that may be true; however, these asset bases, I think, are all related to regulated operations.

Q. Tell me what you mean by that answer. I'm not sure I understood it.

A. Well, I think that the reporting requirement on the Form-1 relates to the FERC regulated operations or jurisdictional regulated operations, so there would be no need to file unregulated operations in that report. That's why I say I think these balances all reflect regulated operations.

Q. They're not all -- are all of these utilities operating exclusively in regulated states?

A. Well, I would say no.

Q. Okay. And are you saying to me that you don't think any of these figures represent assets that are in operation in a deregulated state?

A. Well, you know, I -- I live in Texas. We have a deregulated state, but I'm guessing that the TXU, for example, Form-1 that gets filed, contains only regulated assets, even though we are a deregulated state.

Q. I'm not sure --

A. So I'm struggling --

Q. I'm not sure I'm following your answer, and it's probably because my question is not specific enough, but I'm not sure I understand what you're telling me in regard to -- to whether or not an asset is treated as regulated.

A. It seems to me you're trying to make a distinction between a regulated and deregulated operation.

Q. Right now I'm just trying to understand the answer that you're giving me. If I am doing in business in Texas, do I have -- I don't know what the status of a vertically integrated utility is in Texas. Do they still have vertically integrated utilities in Texas? The answer is no?

A. No, I'm sorry. In fact, I think most of the utilities in Texas had to sell off their generation or large portions of it.

Q. Yes, okay, so when you're telling me that -- that the generation asset is still treated as a regulated

asset, I'm struggling to understand what you're saying.
A. Oh, I didn't mean to say that.
Q. You may not have, but I'm trying to follow you, so tell me what you were trying to say and maybe in different words.
A. Well, with respect to Texas, I was merely trying to say that even though we are a deregulated state, as opposed to, let's say, I don't know, Nevada, where perhaps there is no choice, there are still substantial amounts of regulated assets that are reported to the FERC, it just may be a little bit different than what gets reported for, say, Nevada Power.
Q. So there might be something different reported to FERC than what's reported -- but there's nothing -- what's reported to Texas, to the Commission there --
A. PSC in Texas would only deal with regulated operations, I'm sure.
Q. And they don't have regulated operation on the generation units?
A. For most of them, as far as I know.
Q. But you're telling me the figures on the schedule would be FERC figures?
A. Right, and it's also from a couple years ago, so there --
Q. Before deregulation?

A. Maybe less of an impact of deregulation, yes.

Q. Well, if you have a generating unit in a regulated state, wouldn't you expect that -- that that might tend to have a longer life expectancy for some units than an operation in a deregulated stated?

A. I'm not sure I have a straight answer for that.

Q. All right. And I might just give you a scenario and you can tell me if you tend to agree with it or not. Would you think that an electric utility might find that a generating unit is perhaps not as economical in a deregulated state because of the existence of other more efficient generating units, and therefore, it's usefulness without a captured customer may diminish and therefore not be as useful over as long a period of time?

A. That scenario makes sense.

Q. Okay.

CHAIRMAN GAW: And Judge --

JUDGE THOMPSON: Yes, sir.

CHAIRMAN GAW: I apologize to you and the witness, but I have something I need to attend and I will be back, but I am going to have to quit for the time.

JUDGE THOMPSON: I understand. Do you have further questions for this witness?

CHAIRMAN GAW: I think I do, yes.

JUDGE THOMPSON: We will take ten minutes.

(A BREAK WAS HAD.)

JUDGE THOMPSON: We'll go back on the record, I'll remind you you're still under oath, Mr. Roff.

THE WITNESS: Thank you.

JUDGE THOMPSON: Commissioner Murray.

COMMISSIONER MURRAY: Thank you.

QUESTIONS BY COMMISSIONER MURRAY:

Q. Good afternoon.

A. Good afternoon.

Q. It's hard to believe that we've been struggling with this issue for something like six years.

A. I've been struggling with it for 31.

Q. But are you familiar with ER-2001-299, Empire's last rate case?

A. A little, yes.

Q. And then you recognize that in that last rate case, their treatment of net salvage was changed as a result of a Commission Order; is that correct?

A. Yes.

Q. So when anybody asks you about Empire wanting to change its -- the methodology, they're asking to change back to the traditional methodology that they had prior to the last rate case in which they were ordered to change against their will; is that right?

A. I would say yes.

Q. Okay. In your testimony, it appears that in an attempt to minimize the effect on rates that the depreciation would have, there's a recommendation to cap the net salvage at 100 percent. Is that -- do you have any experience with any other utilities treating net salvage capped in that manner?

A. I know that in -- I think it's New York, there's some certain provisions relative to gas operations where they've capped the net salvage amount. I'm not aware of any other state where there's a limitation. I would recharacterize your statement of minimize to mitigate the experience change, but.

Q. And explain in a little more detail, if you would, that 100 percent is 100 percent of what?

A. It's 100 percent of the asset.

Q. Okay.

A. So if we had an account with $1,000 in it, we would also need an additional $1,000 for future cost of removal.

Q. And then going forward based on estimates that are made according to certain methodologies accepted by the industry, it is expected that the cost of removal will be greater than 100 percent of assets; is that correct?

A. For those four categories, I believe that's correct.

Q. And then what happens if -- if the accrual is capped at 100 percent, what happens to that excess amount of net salvage when it actually occurs?

A. Those amounts would be recorded into accumulated depreciation per the instructions, the accounting instructions.

Q. You mean the difference at the time of retirement?

A. Well, the difference or the total, either one, yes.

Q. So in other words, if it had been -- if the net salvage that was accrued over the life of the asset was capped at $1,000 and the actual cost of removal was $1,500, there would be $500 at that time that would be accounted for; is that correct?

A. Well, I think there would be the $1,500 of cost of removal would be recorded as a debit to accumulated depreciation, and if that were the only asset, there would only be $1,000 in the accumulated depreciation for that --

Q. And then --

A. -- removal and we'd have a $500 difference.

Q. Is that an expense item or how would it be treated?

A. Well, it's balance sheet item, first of all, because it's on the balance sheet in accumulated depreciation. It would, in effect, I suppose stand as a permanent rate base item.

Q. Permanent rate base item?

A. There would be a $500 balance in accumulated depreciation and a 0 asset base.

Q. And the effect on that -- the effect of that to rates would be -- what would that effect be to rates?

A. Customer rates or depreciation rates? I try to keep them separate.

Q. I'm sorry, customer rates.

A. Well, the customer rate would still reflect whatever was allowed in the rate-making process, so you would recover whatever the charge is to customers, and that would be in the form of revenue that the accumulated depreciation balance would still sit at $500.

Q. But --

A. And at the point of the next determination of rate base, there would be this mismatch.

Q. Okay. So you're saying for an accounting treatment at the time of retirement, that extra $500 would just go into accrued depreciation?

A. Yes, you would debit accumulated depreciation, credit cost of removal.

Q. And that at the next rate case --

A. When you went to determine the rate base, if there were no assets, there would be a $500 charge in there, in accumulated depreciation, if rate base is just the difference between plant and service and accumulated depreciation.

Q. So then the ratepayers going forward would pay the difference between the actual cost of removal and the amount that had been accrued for it. Is that --

A. I'm not sure how the ratepayers would pay for that. The ratepayers would have paid their $1,000 through depreciation charges.

Q. But it cost 1,500.

A. And the company would have paid out this additional $500 to remove those assets.

Q. But they would get it back from the ratepayers at some point, would they not?

A. If they ask for it, yes.

Q. And that would be ratepayers going forward rather than ratepayers who used the asset?

A. I believe so, yes.

Q. So it still results in some generational inequity, but not as much as the method that Staff and Office of Public Counsel are suggesting; is that correct?

A. Absolutely.

Q. The modification of the request down to

approximately $10.2 million -- well, let me start again with that question.
If -- if Laclede had not -- Laclede? If Empire had not been ordered in its last rate case to change its method of treatment of net salvage, what kind of a change to depreciation would be required in this rate case to continue with the traditional method?
A. That's an excellent question. Had the methodology not been changed, it would seem that Empire would have accrued more depreciation in the past, and therefore, the differential in this case would have been less.
Q. Do you know how much less?
A. I do not.
Q. Would you think it would be a substantial amount?
A. Well, we're only talking about, what, a year and a half, two years of time, approximately, from whenever those rates went into effect? I don't have a feel for how much -- it would be less.
Q. Okay.
A. And perhaps substantially less.
Q. So at least a part of the reason that Empire feels the need to reduce the amount that they're seeking through depreciation is that they've been, since the last rate case, having to expense net salvage rather than accrue

it. Is that your understanding?
A. I don't know that that's the only reason, but it's certainly a reason.
Q. I said at least a part of it.
A. Yes.
Q. You were repeatedly asked questions about whether you had done any calculations about the actual cost of removal over a period of recent history and you indicated that you had not. And is the reason that you did not the fact that that is irrelevant to a traditional method of treatment of net salvage?
A. Well, I think there's two -- two parts to that question. One is that the quantification of this regulatory liability that was required by the SEC, the reclassification of accumulated cost of removal in the accumulated depreciation account, so I am familiar with what calculations Empire made to quantify that, but we also did look at actual cost removal incurred. That was the basis for our net salvage recommendation, so we did look at maybe not in the sense that was asked, but -- and I'm not sure I answered your question.
Q. Well, the new requirement that you just spoke about with the SEC's reclassification --
A. Uh-huh.
Q. -- does that require a separate accounting for

the accumulated deferrals for constant removal separate from the other?

A. First of all, that reclassification requirement is only on the financial books.

Q. Yes.

A. Okay. It's not on the regulatory books.

Q. Okay.

A. So in that sense -- in my view, there is not a separate requirement to maintain those -- or accumulate those amounts in separate buckets, if you will. There are ways to quantify that, but there's not a requirement to maintain those records or those accounting entries separately.

Q. Okay. For a nonaccountant, would you explain what that classification does for the financial books?

A. Okay. The SEC interpreted certain sections of 143 in a very particular way and they said that utilities -- and all entities for that matter, but primarily utilities have an accumulated cost of removal amount imbedded in accumulated depreciation that they wanted to see on the balance sheet as a liability.

So they -- companies were asked to determine the amount of accumulated -- or accumulated cost of removal imbedded in the accumulated depreciation amounts, and that's what the reclassification represents. The difference between what had been accrued and what had been incurred.

Q. Okay. So if they have accrued more than they have incurred, that shows up on their balance sheet as a liability?

A. That's correct, and if it were the other way and they were consistent, it would be a regulatory asset.

Q. And does that do anything to their financial rating, their rating by any of the financial analysts by having to change that?

A. I don't know that the financial community had viewed that entry with any interest at all, so, no, I don't think it impacts. It's really a classification issue. You have either this amount in this account or in some other place on your balance sheet.

Q. But with the expensing method for treatment of net salvage that Staff and OPC are taking the position that should be employed here, that does effect the way the analysts look at the company; is that correct?

A. Well, if the past two years have been any indication, yes, the decisions that were pushed on Empire District were, in fact, recognized by the financial community as having an impact on their financial rating -- credit rating, excuse me.

Q. And is that at least partially because it drastically affects cash flow?

A. I'm sure that's part of it, yes.

Q. What would any other part be?
A. Well, I don't really know what the financial community looks at when they look at rating, but certainly cash flow would be the primary reason.
Q. And depreciation traditionally is used for cash flow, is it not?
A. I would tend to look at it -- I think depreciation is a financial reporting requirement, it's a -- therefore, a GAAP requirement, it's a regulatory accounting requirement, and cash flow is -- is a part of that when you get into their rate-making process. The depreciation in and of itself is an accounting concept.
Q. To account for the complete cost of an asset over the life of the asset?
A. Right, to allocate the cost of an asset over its life.
Q. Is there any reason -- or let me phrase it this way.
Are mass accounts and what I believe is remembered to as terminal property, are they treated differently?
A. From a net salvage perspective?
Q. Yes.
A. I don't believe so. We have developed the same type or same kind of estimates of a net salvage

percentage for the mass assets as we have for generation assets. I just think they represent kind of different points in time, if you will, from a kind of a practical standpoint. But, you know, from a mass asset standpoint, every retirement is a terminal retirement, if you want to look at it that way, and for production facilities, we have really one terminal retirement, and a lot of little ones over the course of a life of an asset.

Q. Okay. Do you understand why some people seem to be very concerned about the safety mechanisms in the traditional approach about whether they're sufficient to make sure that the company doesn't benefit if an asset happens to never be retired?

A. Yeah, I think I know what you're asking, and I think there are probably three processes in place, I guess, to safeguard those amounts.

Q. Since that seems to be such a concern, would you mind going through those three --

A. Certainly.

Q. -- safeguards?

A. I think that the first safeguard that the Commission has is the -- is merely the periodic review of depreciation rates and depreciation parameters. I think that's probably the purest way to kind of -- I don't like to use the term regulate, but regulate those activities on a periodic interval basis.

The second is through the rate-making process and the rate base effect of depreciation and accumulated depreciation wherein if you accrue more than you estimated, the rate base is reduced and the customer is protected and vice versa. If you accrue less than is required, then the rate base is -- goes the other direction, and the company is protected. So I think the safeguards exist in both ways there.

And then I think the traditional approach probably provides a better cash flow process, so I'm not sure that's a safeguard, but it does aide the company in the sense that they are not required to make external funding.

Q. Okay. Let's look at an asset that was a $100,000 asset.

A. I'm sorry, how much?

Q. A 100,000.

A. Okay.

Q. And the accrual for net salvage was capped at a 100 percent.

A. Okay.

Q. So over the life of that asset, $100,000 for the original cost of the asset plus $100,000 for cost of removal was accrued.

A. Uh-huh.

Q. But let's assume that either the asset lives forever and continues to be functional forever, or it ceases to function and is retired but is never removed?

A. Okay. Two different options, I guess. One is -- I know of -- I know of no asset that has an infinite life, okay, so I think the first one is probably improbable, the first scenario. Every asset will be retired at some point in time. I'm convinced of it. So we'll discount that one.

The second one, I think you have to decide, and if you do these periodic reviews, and in fact, the life of that asset is substantial, you know, 30, 40 years, but you have the opportunity to adjust those estimates as you move forward through time and you get to the consideration where an asset is not removed when it is retired, you'll have to make a decision at that point in time.

I struggle with this because I think there are many assets for which the accrual of cost of removal will take place and the asset will be retired but not necessarily removed immediately. I mean, I don't think a nuclear plant is going to be removed the day it's retired. It's going to take some period of time for that activity to take place, so should we wait until that time to accrue for those costs? That doesn't make sense to me.

Q. Actually, I'm sorry, but actually at the time it's retired, whether it's removed then or not, that is the time -- that is actually the life of the asset from which the customers received service, is it not?

A. That is true. I cannot debate that.

Q. So that if you were following --

A. I'm just thinking from a practical standpoint, that's what's going to happen.

Q. But if you're following the purpose of depreciation, which is to depreciate the full cost of the asset including cost of removal over the life of that --

A. Maybe nuclear is not a good example because of the trust fund accounting.

Q. Yes, I would separate nuclear out of our discussion.

A. Let's take a fossil plant, for example, that has three units of maybe different vintages. It's unlikely to me that you will remove the first unit until the third unit retires, is probably not safe to do that. So you will have an asset for which you have accrued a certain level of removal cost and you're going to retire it, it's no longer used and useful, but yet you have not incurred the cost of removal that you estimated for that asset. And I think that's a fairly common issue.

Q. Okay. And if you have estimated accurately or the adjustments have been made over time so that the estimate is accurate at the time the asset is retired, that additional accrual for cost of removal that doesn't occur for, say, five more years, does that harm the ratepayers in any way in the meantime that that has been accrued and not actually expended for another five years.

Q. In my view, it doesn't. You know, the customer has provided the full coast of that asset. It's just when that last component of cost is incurred. From a rate base perspective, I would think that rate base is 0, because we'll probably keep that cost removal separate with -- separately identified.

Q. So that at the time the asset is actually retired, it has been fully depreciated, including the cost of removal?

A. Yes.

Q. And that is during its useful life, which is during the time that the ratepayers who paid for it, including its cost of removal, had use of it?

A. And to me, that's equitable.

Q. It's traditional also, is it not?

A. To the best of my knowledge, the vast majority of utilities in jurisdictions use this -- if you call it the traditional approach. Even Empire's jurisdiction in Arkansas does that, and Oklahoma, and Kansas.

Q. I understand that Missouri is very unique, and I don't enjoy being unique in instances like this, but anyway, thank you very much?

A. You're very welcome.

QUESTIONS BY JUDGE THOMPSON:

Q. Mr. Roff.

A. Sir.

Q. Your testimony is very straightforward. I like that. As I understand your testimony, it is your finding from the depreciation study that you did that annual depreciation expense should be increased by about 25.6 million?

A. That's correct.

Q. This is based on your conclusion that the appropriate overall depreciation rate should be 4.72 percent?

A. Something in that range, yes.

Q. Okay. Whereas the existing rate is 2.53 percent?

A. Correct.

Q. Okay. And I'm sure that your testimony explains in detail how you arrived at those figures, but I wondered if you could just summarize the method or methods that you used in reaching those conclusions for me now.

A. I will try. And this is described in our depreciation study report, Exhibit DSR-3 of my direct testimony, but there are really four phases to a depreciation study.

One -- the first phase would be the data collection phase, where we've gathered the historical information, the accounting transactions, and relative to plant and to accumulated depreciation and salvage and cost of removal. And we put them in a format that's suitable for depreciation analysis, for mortality analysis in this salvaging cost of removal analysis that we discussed earlier.

And the second phase is, in fact, an analysis phase where we process those historical transactions through some software modules to, in effect, measure history. And in many cases, that's where a lot of people stop. I've got the results, it came out of a computer, it must be correct. Well, we go a little bit beyond that.

The third phase of our study, which is called the evaluation phase, where we try to get an understanding of that history, get an understanding of the types of assets that are surviving, the types of assets that are being retired, the types of assets that are being added, and what the kind of near term future for those assets would be. And then we make a selection of what we call the mortality characteristics, the average service life and retirement patterns and net salvage factors.

And all of those role into the fourth phase, which is called the calculation phase, in which we plug those parameters into some depreciation formulas, whole life or remaining life or whatever group procedure we choose to calculate and develop depreciation rate recommendations.

So that's kind of the nutshell of the depreciation study process. Now, in this case, our results produced a depreciation expense that the company felt was probably not going to be accepted, so they chose to mitigate that by modifying some of those parameters. And that resulted in the difference between 25 million to 15 million or whatever the 10 million the increase was requested.

Q. But that decision by the company was strategic, was it not, and did not reflect any doubt by you or on your part as to the accuracy of your study?

A. Yes to both parts; yes, it was strategic, and no, I had no doubt about my study result.

Q. Okay. So you would agree, then, that the current depreciation rate is too low?

A. In my view by almost any measure, it's too low.

Q. And what is the effect on Empire of having its depreciation rate, and consequently its depreciation expense, too low?

A. Well, clearly one result that came about was that their credit rating was reduced, in particular, for an observation by the credit agencies that inadequate depreciation was in place.

Secondly, it would seem that because of the reduced cash flow that occurs, that there are less internal funds to be used for ongoing operations, so that would be a detrimental effect.

And I think we could look at history and see that, in fact, the rate of growth of Empire has exceeded its depreciation expense, so that would require, I would think, external financing. Now, the company only has access to so much external financing, so that would be the third detriment.

Q. I'm making notes here, so. Now, those are essentially operational effects. In other words, those are effects might hinder management and limit the courses of action management can take; is that correct?

A. Well, I would think that one of them is also a financial effect.

Q. Okay. Is there also an effect on the shareholders? In other words, are the shareholders not being compensated for the exhaustion of their property dedicated to the public service?

A. I would think the effect on the shareholder would be more in terms of stock price being reduced because of the reasons we've just discussed.

Q. Okay. Now, I wonder if you have been able to form any opinion based upon your study as to what parameters in the various depreciation calculations in the past were erroneous or need to be corrected?

A. Well, first -- my first response would be that the net salvage treatment has been obviously different, but I would say it inadequate -- I don't believe the service lives have changed that much over time.

There's a general upward trend, I think, to the life that because of -- maybe the inability to replace assets that because of the cash flow limitations, that assets are living longer and -- and then I think just the methodology that was utilized, there is a -- quite a difference between the whole life technique and the remaining life technique, and I believe that the remaining life technique provides a better process for recognizing change over time.

Q. And you are an advocate of the remaining life technique?

A. I think it's a better approach, yes.

Q. And the technique that has been in place so far as you know has been the whole life technique?

A. Yes.

Q. And can you tell me briefly what the difference is between the two techniques are?

A. The whole life technique merely takes gross asset amount, and if you include net salvage, adjust it for net salvage and allocates that cost over the life. And the remaining life technique takes that same asset base but reduces it by past accumulation of depreciation and allocates those costs over the future life, so there's a twofold benefit, I guess.

One is that you never overdepreciate your asset because the gross base is reduced by accumulated depreciation, and the second benefit is that any changes in life or retirement activity or net salvage activity are embedded in accumulate depreciation and there's an automatic adjustment that tanks place because that's in the numerator of your depreciation base.

Q. So far as you know in accounting practice, are both techniques equally acceptable?

A. The short answer would be yes. I think there are some jurisdictions or jurisdictions that would tend to look at the status of accumulated provision, the reserved difference. And when it reached a certain level, there would be an adjustment, so in that regard, they're not exactly equivalent.

Q. Okay.

A. If that's clear.

Q. About as clear as most accounting testimony is to me.

A. Thank you.

Q. Tell me about the net salvage problem that you identified. Is that -- are you referring to the Commission's change in the way that net salvage has been accounted for?
A. Yes.
Q. And as I understand it, the traditional way that net salvage is -- that this issue is handled is that there's an estimate that is part of rates; is that correct?
A. Part of depreciation rates?
Q. Well, ultimately, part of rates paid by ratepayers.
A. Yes.
Q. Perhaps you can explain it better than I've been able to put it.
A. Well, I think the approach that would be advocated or has been advocated by the Staff in the past was part of the 2001 decision was that the cost of removal component of depreciation expense or the net salvage component of depreciation expense would be limited to the full amount of cost of removal incurred over some prior period, and that case it was a -- I believe, a five-year average.
And to me, that would be called cash accounting. You recover what you spend. And that's not the traditional approach where we develop an estimate of net salvage and add that to our depreciable base, and in effect,

spread that total cost over the life of the asset rather than, in effect, recouping that one amount after the asset has been retired.

Q. Okay. Now, the method that Staff advocates, so far as you know, is that method in use in other jurisdictions?

A. Very limited usage.

Q. And so far as you know, does that method comport with Generally Accepted Accounting Principles?

A. Only, in my mind, if you consider FAS 71, which says the action of regulators are allowable, if you will, in GAAP, so I'm not sure that that's GAAP accounting.

Q. Okay. So it may not be. If the net salvage treatment were changed by the Commission in this decision and if it reverted to the traditional technique that the company advocates for, but otherwise there was no change --

A. Uh-huh.

Q. -- how much of an effect would that have on the depreciation expense deficit?

A. Well, I think I remember the amount from this morning's discussion that approximately 80 percent of that difference, $25 million increment, is related to net salvage, so if net salvage were approved on the company's request, I'm going to say somewhere in the range of $8 million, actually, a little less than that because the request reflects whole life, so a little bit less than that.

Q. Well --

A. Five or six million.

Q. Isn't 80 percent of 25 million closer to 16 million?

A. I would say 80 percent of 25 million is 20 million.

Q. Okay.

A. But the company's only requesting 10.

Q. I understand what the company's requesting, but I'm not talking about that.

A. Yes, yes, roughly 20 million.

Q. I'm talking about the deficit you've identified.

A. Yes. I misunderstood your question.

Q. That's quite all right. Thank you very much. You've been very helpful.

JUDGE THOMPSON: That's all the questions I have for this witness. I know that Commissioner Gaw has additional questions. I believe that Commissioner Clayton also has questions, so there's no point in going further with this witness at this time. So why don't we allow you to step down, Mr. Roff, and why don't we have Mr. Knapp, since he is the next witness, take the stand.

Now, is Mr. Roff going to be available

tomorrow?

THE WITNESS: Yes.

JUDGE THOMPSON: Okay. Very good. Thank you, sir.

Good afternoon.

THE WITNESS: Good afternoon.

JUDGE THOMPSON: You've been here already on a different issue, haven't you?

THE WITNESS: Yes, sir.

JUDGE THOMPSON: Very good. I will remind you that you are still under oath. I don't think there's any need to swear you again. Go ahead and take your seat.

THE WITNESS: Thank you.

MR. ENGLAND: And Judge, I believe his testimony has been identified, and to the extent there were any corrections, those have been made; is that correct, Mr. Knapp?

THE WITNESS: Yes.

JUDGE THOMPSON: They have been received?

THE WITNESS: There were no corrections.

JUDGE THOMPSON: Let me check.

MR. ENGLAND: Exhibits 28 and 29, I believe.

JUDGE THOMPSON: Yes, offered and received, no objections.

MR. ENGLAND: All right. I think the only thing I need to do is offer the witness for cross-examination.

JUDGE THOMPSON: Thank you, Mr. England.

MR. ENGLAND: Thank you.

JUDGE THOMPSON: Mr. Byrne.

MR. BYRNE: No questions, your Honor.

JUDGE THOMPSON: Thank you. Mr. McCartney.

MR. McCARTNEY: No questions, thank you.

JUDGE THOMPSON: Mr. Conrad is still absent. Mr. Williams.

MR. WILLIAMS: Thank you, Judge.

CROSS-EXAMINATION

QUESTIONS BY MR. WILLIAMS:

Q. Good afternoon, Mr. Knapp.

A. Good afternoon.

Q. My name is Nathan Williams, I'll be asking you a few questions on behalf of Staff.

In what years have the Empire District Electric Company recorded a net operating loss?

A. We've never, that I know of, reported a net operating loss.

Q. On page 3 of your rebuttal testimony, you state technical and theoretical arguments aside, depreciation is a source of cash to partially fund the construction of utility infrastructure. If depreciation includes cost of removal less salvage as requested by Empire, how will Empire pay for future cost of removal less salvage if it funds a construction of utility infrastructure with the money it receives in rates for future cost of removal less salvage?

A. Well, I might approach it two different ways. Number one, cash is fungible, so cash today, cash tomorrow. Two different things. But the better answer, really, is in today's world, as depreciation is a noncash item that basically allows us to -- I said that wrong.

Depreciation is an adjustment to net income that provides cash, so that cash that's provided allows us to have to borrow less from bondholders or actually go to the market and sell less stock, provides more cash for us today. In the future will have had a lower balance of that debt and equity, and at that point, to the extent the funds aren't provided internally, the funds are borrowed, they'll be borrowed to pay for that expense.

Q. Are there any limitations on how Empire can spend the cash it receives from depreciation?

A. No.

Q. Are you aware that most residential housing lenders require borrowers to make payments based on estimated property taxes?

A. Yes.

Q. And aren't those payments typically escrowed so the funds are available to pay the real estate taxes due on that property at the end of the year?

A. I believe you can opt, in many cases, opt to escrow is it or opt if pay it yourself, yes.

Q. If Empire is allowed to collect money from ratepayers now for future cost of removal less salvage, why shouldn't it be required to escrow the amounts it receives from ratepayers to exceed what it actually spends on cost of removal less salvage?

A. I believe we're spending cash today for cost removal, and as I said, the cash is fungible. I think that the way the rate-making model would work, that cash is provided today allows us to build the assets and the infrastructure today that would then serve as the basis for us to borrow the money in the future, if that's required or have the cash provided internally in the future.

Q. Wouldn't the scenario I just described provide additional safeguards to assure that the funds are available when they are needed?

A. Well, I guess you could go a step further and we could take every dollar that comes in the door and put it in a can someplace to pay for salaries, property taxes, whatever it might be, but that's not the way the -- the efficient way to work the place, operations of the business.

Q. I don't believe you've answered my question.

A. I'm sorry, ask it again, please.
Q. Isn't the scenario that I described provide additional -- wouldn't it provide additional safeguard that doesn't exist currently?
A. I think it would assure that there was a certain amount of cash available, whether that cash were enough, too much, or not enough in the future, it wouldn't address that, but it would address the fact that that cash would still be there.
Q. Isn't it true that only the cost of removal and salvage that is actually incurred by Empire deductible for tax purposes?
A. The cost of removal is currently deductible.
Q. That's the actual cost of removal that's incurred?
A. Yes, as a current expense.
Q. Is that offset by salvage, realized?
A. I don't know the detail of that calculation.
Q. If approximately 6 million of future accrued cost of removal and salvage is included in depreciation expense as the company supports, is only approximately 1.6 million of the actually incurred cost removal and salvage deductible for tax purposes?
A. I think that's correct. Again, I'm not totally sure. I'm not totally familiar with that, but I

believe that is correct.

Q. Doesn't Pennsylvania require that net salvage be treated as an expense on a current basis?

A. I do not know.

Q. Don't credit rating agencies downgrade or have a negative report based on if -- let me try rephrasing that.

If there's some action by regulatory body that has an impact of reducing cash flow, wouldn't that be viewed negatively by credit reporting agencies?

A. Yes.

MR. WILLIAMS: No further questions of this witness at this time.

JUDGE THOMPSON: Thank you. Ms. O'Neill.

MS. O'NEILL: Thank you.

CROSS-EXAMINATION

QUESTIONS BY MS. O'NEILL:

Q. Good afternoon, Mr. Knapp.

A. Good afternoon.

Q. Now, when I was looking at your rebuttal, I believe you testified that you believe Empire's current depreciation with rates are too low; is that right?

A. Yes.

Q. Now isn't it true that Empire's current depreciation rates are set at a level that allows the company to recover a return of its investment in its capital cost in a plant that had its assets?

A. If you're asking if we're earning our return of capital, then I'd have to say the answer is no, we're not earning our return.

Q. You're receiving a return of the investment through the depreciation rates?

A. We are receiving a return of the investment through the depreciation rates.

Q. Yes, and I'm sorry if I was not clear. Isn't it also true that Empire's current depreciation expense is designed to allow recovery of the expenditures that Empire actually incurs related to cost of removing depreciation -- depreciated plant on an annual basis?

A. I think current rates reflects an amount that was estimated for cost of removal. I don't know off the top of my head what that is, but you're correct.

Q. And you spoke a little bit earlier about it, and I'm going to bring you back to page 3 where you say depreciation is a source of cash to partially fund the construction of the utility company's infrastructure. Is that your position regarding depreciation as a source of cash for the company?

A. Yes.

Q. Now, and I think you discussed that a little bit with Mr. Williams, I'll try and not be repetitive, but I might be a little bit.

Is construction of new utility infrastructure a capital expenditure?

A. Yes?

Q. And is this new infrastructure generally considered to be part of plant and service once it's online?

A. Yes.

Q. Is new infrastructure, once it becomes used and useful, included in the capital plant that is depreciated on the company's books over time?

A. Yes.

Q. And if depreciation -- so through those depreciation rates, that new plant -- Empire will also receive a return of that investment as well over time, correct?

A. At the time of the next rate case for that plant service would be put into rates.

Q. And on a going-forward basis after that?

A. Right.

Q. Now, if depreciation doesn't provide cash to fund these capital investments, what are the other possible sources of funding?

A. The cash from the normal operations of the business is the cash from the bills that the customers pay less all the operating expenses, then there's the cash that's

available as we go to the debt or equity markets.
Q. Okay. And does the company currently issue debt in order to construct or install capital improvements?
A. In part.
Q. Okay. And do the holders of those debt instruments expect to be paid?
A. They expect to get an interest payment.
Q. Expect eventually to get their principle back?
A. Eventually when the terms of the arrangements run.
Q. Okay. And the repayment of that debt, the interest on that debt is part of the cost of capital the company incurs to provide service, right?
A. Yes.
Q. And one of the things that was discussed earlier this week related to the cost of capital and those issues include the cost of debt, correct?
A. Yes.
Q. And the cost of that debt, therefore, will be included in this Commission, who are setting the company's rate of return on a going-forward basis?
A. Yes.
Q. Okay. Now, if shareholders provide the capital that you use to make the improvements, they also have an expectation of a return on their investment?

A. Yes.
Q. And that's the cost of equity?
A. Yes.
Q. And that was also discussed at length the last few days in this hearing, correct?
A. Correct.
Q. Okay. Now, are you familiar with SFAS No. 143?
A. Generally.
Q. Okay. Are you familiar with FERC Order 631?
A. Less so.
Q. Are you familiar with the concept of asset retirement obligations?
A. Generally.
Q. Okay. Do you agree that Empire does not have any legal asset retirement obligations for the cost of removal proposed in Mr. Roff's study?
A. That's my understanding at this point.
Q. Okay. Do you know -- to your knowledge, does FERC Order 631 identify items such as the assets that Empire holds as nonlegal ARO's?
A. Again, I'm less familiar with the FERC Order. My general understanding was that it just confirmed 143 for use by the utility, and I just really don't know much deeper than that.

Q. Okay. Do you know whether or not Empire would have any legal obligations concerning the -- concerning a nonlegal asset retirement obligation?
A. I don't believe so, but I don't know.
Q. Okay. To the extent that you're aware, do you agree that Empire does not have any conditional liability relating to nonlegal ARO's?
A. Conditional liabilities?
Q. Do you have any -- other than maybe a law that says you have to remove or -- retire and remove something at a certain point, any other types of liabilities?
A. We have a couple of assets specifically identified and that's all I'm aware of at this point in time.
Q. Okay. Do you know if you have any construction obligations regarding items that are nonlegal ARO's?
A. At this point in time, I'm not aware of it.
Q. Okay. Do you know whether or not Empire's made any promises to the Public Service Commission that the money that will be collected under rates for net salvage will actually be used for cost of removal?
A. I'm not aware of that specifically.
Q. Do you know whether or not Empire's made any promises like that to their customers or the public at large or the financial community?

A. Not that I'm aware of.
Q. Okay. Now you said you had some familiarity with SFAS 143 that's -- is that correct?
A. To the extent that we have implemented it in the company, I do.
Q. Okay. And the company has taken some steps to implement 143?
A. Yes.
Q. And has the company, to your knowledge, sought any advice about whether or not there may be some issues regarding net salvage accruals that have implications?
A. In our implementation of 143, we had the two specific required asset retirement obligations that we dealt with. Subsequent to that, based on our external auditors' consultation with us and the understanding of the SEC interpretation of SFAS 143, we moved to reclassify what our estimate of the accumulated dollars for cost removal, we reclassified that to the liability side of the balance sheet to regulatory liability in accordance with our understanding of the SEC interpretation.
Q. And who is your outside auditor?
A. Price Waterhouse Coopers.
Q. And have you received any correspondence from Price Waterhouse Coopers regarding concerns about estimated net salvage and how it should be addressed in the future on a

going-forward basis?

A. At this point, I think we're -- they're satisfied with what we have recorded on the books. I don't know of anything else.

Q. Okay. Who is Daryl Coit?

A. Controller of the company.

Q. Okay. Do you know who Steve Korn is?

A. Yes.

Q. Who is Steve Korn?

A. Steve Korn was formerly a manager at Price Waterhouse Coopers who worked on our account.

Q. Okay.

MS. O'NEILL: May I have an exhibit marked?

JUDGE THOMPSON: Yeah. This will be Exhibit No. 133. What shall we call this exhibit?

MS. O'NEILL: Daryl Coit e-mail.

JUDGE THOMPSON: Okay.

(OPC EXHIBIT NO. 133 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

BY MS. O'NEILL:

Q. Mr. Knapp, I've handed you what's been marked as Exhibit 133, and at the top of the page is the name of Daryl Coit. And it appears to be an e-mail from Steve Korn; is that correct?

A. Yes.

Q. And it appears that you also received a copy of this e-mail?
A. Yes.
Q. What's the date?
A. January 30, 2003.
Q. And is the subject of this e-mail FAS 143 implementation issues?
A. Yes.
Q. And did you review this e-mail at the time you received it?
A. I don't have any recollection, I'm sorry, at this time.
Q. To your knowledge, would you have received this e-mail if you were listed as CC?
A. I should have, yes.
Q. Okay. Does it -- do you have any recollection about what it -- about reviewing it when you received it?
A. I'm sorry, I don't.
Q. If you would take a minute and just kind of review this document, see if that refreshes your recollection about whether or not you have any information regarding the contents. Have you had a chance to look at it?
A. I've skimmed through it, yes.
Q. Okay. Does that appear to be the information that was provided to Empire by Price Waterhouse Cooper?

A. Obviously.

Q. Okay.

A. Given who the e-mail was from.

Q. Okay. To your knowledge, has Empire taken any steps to implement the advice contained within this e-mail?

A. Well, if I'm understanding right, we have -- it's saying a couple of things, and I've read this awfully quickly.

Q. Sure.

A. But one item was making sure we had engaged legal counsel's --

MR. ENGLAND: Objection, excuse me, I don't want the witness to read from the exhibit because I do have an objection with respect to the exhibit.

JUDGE THOMPSON: Okay. Very well. What's your objection?

MR. ENGLAND: There is no foundation with respect to admitting this exhibit. It is from a nonparty, an individual apparently with Price Waterhouse to Empire District Electric. Although Mr. Knapp was recipient, it's not his e-mail, he had no involvement in creating this e-mail, and it's clearly hearsay. And I'm afraid if he's going to start reading from it or putting anything else from that, that it's going to defeat the purpose of my objection, so I am going to launch that at this time.

JUDGE THOMPSON: Okay. Your response?

MS. BYRNE: I'd like to join in the objection and point out that he could not even identify the document, so I would join in Mr. England's objection.

JUDGE THOMPSON: Is there, like, a slightly different objection?

MR. BYRNE: It's the same objection.

JUDGE THOMPSON: Okay. Response to either or both?

MS. O'NEILL: Well, I haven't moved for admission yet, I'm not sure whether I'm going to.

JUDGE THOMPSON: I think he has a good objection with respect to if he reads it, it gets into the record that way, and there's no limitations on how it can be used once it's in the transcript, so I think that's a good objection.

MS. O'NEILL: Sure, I understand that, and I will -- because there is an objection pending, if I choose to offer this for admission, I will not ask him to read at this time. I think that may resolve that issue as far as --

JUDGE THOMPSON: So you're withdrawing your request that he read from the document?

MS. O'NEILL: Did I just ask him to read from the document?

MR. ENGLAND: In fairness, she didn't ask him to read from the document. She asked him if he was implementing any of the recommendations contained in it, and my witness was going to start reading from it and say they're recommending this and I'm not sure what he's going to say after that.

JUDGE THOMPSON: Thanks for helping me get back on the same page with everyone else. You can answer the question but don't read from the document.

Go ahead.

BY MS. O'NEILL:

Q. Okay. Perhaps I could break that question up into some smaller questions.

A. Okay.

JUDGE THOMPSON: Do whatever you need to do.

MS. O'NEILL: All right.

BY MS. O'NEILL:

Q. First of all, does Empire apply FAS 71 accounting for the effects of certain types of regulation?

A. Yes.

Q. Okay. And you discussed earlier that there were a couple of items that Empire believed they should specifically account for under 143 as some sort of legal ARO?

A. Legal obligation, yes.

Q. Do you know if those are Missouri jurisdictional or just in general for the company?

A. Well, they're both related to generation plants, so they would be an allocated item.

Q. Okay. Are you aware of whether or not there has been -- that FAS 143 has raised questions regarding the accounting practice of depreciating certain assets, such as transmission and distribution assets, using a negative net salvage approach and recognizing accumulated depreciation? Excess of historic cost?

A. I'm not aware of that as it relates to 143.

Q. Okay. Do you know whether or not Price Waterhouse Cooper has given any advice to Empire regarding that?

A. How do I say that without getting in trouble from my attorney? I -- as of five minutes ago, I didn't know that.

Q. What is your position with Empire?

A. I'm Vice-President of Finance, CFO.

Q. And what are your duties as Vice-President of Finance, CFO?

A. The financing budgeting, accounting, treasury.

Q. Okay. And what do you do with those things?

A. I'm sorry, what?

Q. And what do you do regarding those areas?

A. I am responsible for those areas.

Q. What does that mean? Does that mean that you're actively participating in policy decisions regarding those areas?

A. Yes, it means I'm responsible -- there's a staff of individuals that I work with who obviously have assigned different tasks and conduct those things and I am responsible for that aspect of the organization.

Q. And who is Mr. Coit?

A. He is the Controller of the company.

Q. And where is he in connection with you in the -- in the organizational chart?

A. Mr. Coit reports to me.

Q. Okay. And if he were to inquire of an outside auditor regarding information on a new financial accounting statement, would it be unusual for you to be copied on a reply to that?

A. It won't be unusual for me to be copied on a reply, but it would be -- I don't think proper to characterize that I would review in detail all the ones I get.

I get copied on an awful lot of them, and as far as, from my perspective in managing that, if I had comfort that the issue were being addressed between our Controller and external auditor, unless there was some reason for me to dig into it, I very well might not.

Q. If the company were to make any changes in its accounting practices as a result of advice from an outside auditor, would you be involved in that decision?

A. Depends on the magnitude. More than likely, yes, but it depends on the magnitude.

Q. How about the decision regarding how to treat net salvage and depreciation?

A. I don't recall having that specific discussion.

Q. Okay. When you get cc'd on e-mails that are sent to your Controller, do you have a general practice about what you do with those -- with those e-mails? Do you, like, scan them to see if it's something you're working on, do you just move them to a file, have somebody else take care of it?

A. I don't really have a certain specific practice. It really just would depend on what the subject was. I wouldn't ignore it, but I would like to see what the subject, and again, if it's something I'm aware of and comfortable that it's being handled or it's something that would be not of an issue that I would be concerned with, then I would certainly just let Mr. Coit handle it.

Q. If your Controller came to you and said, hypothetically, our outside auditor says that as a result of a financial accounting statement that's been issued, we need to change the way we account for net salvage and treat it as a regulatory liability, would that be something that you would recall?

A. If we're talking about, and maybe I misunderstood the previous question, but the -- the -- at the time when the decision was made to reflect the SEC interpretation FAS 143, by estimating the amount of net salvage that had been collected in rates that had not yet been expended and identify that and move that out of cost removal onto the -- and move it to the liability side of the balance sheet, categorized as a regulatory asset in accordance with what the SEC from a transparency standpoint, I was kept informed as to what was going on, and maybe the language over the exchange of the last few questions, wasn't clear on -- we were missing each other a little bit.

Q. And I apologize for that, I'll try to be more clear so we don't have that misunderstanding.

So you are Mr. Coit's boss, right?

A. Yes.

Q. And how Empire accounts for net salvage and depreciation is the issue that we're here to talk about this afternoon?

A. Yes.

Q. And that's one of those issues that's within your area of supervision?

A. Yes.

Q. And there's been some pronouncements and some concerns raised about how net salvage accrual should be accounted for with this SFAS 143 in combination with 71 that you've heard testimony about earlier and that we've talked about, right?

A. That's correct.

Q. And you've had discussions with Mr. Coit regarding those matters. Is that your recollection?

A. Yes.

Q. Did you direct Mr. Coit to find out what Price Waterhouse Coopers had to say about that issue?

A. I wouldn't know whether I directed him or -- as a normal course of business, that's pretty much the way it would go on something that would be something different. That would be within his realm of responsibility.

Q. And if he received a response, he would share that with you in the normal course of business?

A. Again, it depends a little bit on the level of detail, if he felt comfortable with the advice he had, if he and the folks he worked with and the auditors were satisfied with everything, I can't characterize exactly what would happen in every case.

Q. Well not in every case, but this is kind of a big issue, isn't it?

A. Well, actually, it -- the implementation of FAS 143 and what we did here, wasn't really that big of an issue. It was an SEC interpretation of one of the many FAS statements that have been promulgated. We looked at it. I think as I'm understanding it, with some guidance from Price Waterhouse, understood what needed to be done and did that and made a change in geography on the balance sheet for a dollar amount, and prepared the proper disclosure for the 10-K.

Q. Well, considering the fact that per Commission orders in the last couple of rate cases, including the one that last -- that was tried about three years ago, where this Public Service Commission separated out net salvage and made it into an annual expense as opposed to continuing to approve it under the prior method that Empire used, would that may be a reason that you would be less concerned about how you were going to implement 143 than you would be otherwise because you're already separating it out?

A. Well, and under the -- under the situation that we have been under and are currently under, that dollar amount is getting smaller, also.

Q. In part because of that expense?

A. Yes.

Q. Or is it mostly -- or is it all because of that expense?

A. It's all because of that expense.

Q. So you're actually a lot closer today to meeting those requirements of separating those things out to see if you've got a regulatory liability -- utility that had never done this?

A. No, I'm sorry, we have, I think, determined a pretty good estimate for what that dollar amount was, and that's what has been transferred, so that's -- that is done.

Q. And in fact, you've done a pretty good job of trying -- your company of trying to estimated on an ongoing going-forward basis what your annual cost of removal is going to be; is that right?

A. I'm not sure I'm following.

Q. Okay. Your company has been able to make estimates on a going-forward basis of what cost of removal is likely to be for the next five years?

A. I think it's part of our capital budget in process. We try to look at that because it's a use of cash to spend, you know, the dollars to remove the -- whatever assets have to be removed, so we like to have a rough idea of what that's going to be so we can plan the cash piece of it.

Q. In your discussions with Mr. Coit about what to do regarding 143 and regardless of whether or not you ever recall receiving this e-mail, do you recall any conversations in which the two of you discuss the fact that Price Waterhouse Cooper believe that 143 does not allow an entity to recognize accumulated depreciation in excess of historic cost and therefore a company is accruing the cost of renewal --

MR. BYRNE: Your Honor, I'm going to object to -- from Ms. O'Neill reading from a document that she hasn't offered yet, and we know there's going to be an objection if she does offer it, as part of the question.

MS. O'NEILL: I'm asking whether or not he got this information. I don't really know how else to ask it.

MR. ENGLAND: As a matter of fact, I'll make the objection as asked and answered. She's asked him on several occasions if he's gotten this, and I think his initial reaction was no, and she asked him to look at it, and she asked him about conversations he's had with Daryl. I think we plowed this ground pretty fully.

JUDGE THOMPSON: Are we still talking about this?

MS. O'NEILL: Actually, I'm asking him about his company's response to his auditor's advice and whether he had any discussion with his auditor about this.

MS. BYRNE: She's reading out of the document that, in my mind, she hasn't a laid a foundation for, and is hearsay, and she couldn't get in and the way she's trying to get it in is to read it in the form of a question.

MR. ENGLAND: It also assumes facts not in the record. She's asked if he had a conversation about something Price Waterhouse told him about this subject.

MS. O'NEILL: I think the witness has already testified that he and Mr. Coit had discussions regarding this, so I'm asking whether this was part of the discussion.

JUDGE THOMPSON: Okay. So you're asking whether or not he recalls a conversation with Mr. Coit regarding whether or not Price Waterhouse Cooper take the position that 143 does not allow something; is that right?

MS. O'NEILL: Uh-huh, yes.

JUDGE THOMPSON: Okay. I am going to overrule the objections and allow that question. You may answer, if you're able.

THE WITNESS: Would you ask me again, please?

BY MS. O'NEILL:

Q. Sure. Asking you whether you recall in your conversations with Mr. Coit about Price Waterhouse Coopers' position, as was previously just read back, whether the position was that the standard 143 does not allow an entity to recognize accumulated depreciation in excess of historic cost, and therefore a company should be precluded from recurring the cost of removal in excess of salvage value either as a liability or in depreciation rates.

A. I honestly don't remember a discussion like that.

Q. Okay. Has Empire, other than the two instances we've talked about where there was a restatement, taken unit salvage accruals that still exist and recorded them as a regulatory liability?

A. I'm not sure I follow the question or maybe I just didn't pay attention for a second or two. If you could ask me that again.

Q. Okay. Has Empire changed its practices to reflect accruals for net salvage as a regulatory liability?

A. We have reclassified what we've estimated to be the amount of net salvage in accumulated depreciation that has not been spent to a regulated -- to a regulatory liability, if that's responsive to your question.

Q. Actually, it is.

A. Okay.

Q. But as far as that goes, would there be -- would it then be a great leap to -- for regulatory accounting purposes to take that liability and somehow recognize that as funds set aside for future cost of removal so that the customers know that what they are paying in for cost of removal is actually going to be spent for cost of removal?

A. Again, I don't see how that would be particularly useful.

Q. Okay. Well, let's talk for a minute about what a regulatory liability is. Can you tell us your understanding of that term?

A. I'm sure there's a really good definition of that out there. I'm struggling a little bit. I think, you know, in the environment today, to try to be as -- as transparent as possible in the financial statements, that in this case, the SEC has -- would like to see this dollar amount that pertains to customer provided funds segregated in a way that can be identified so that you've got just a few more pigeon holes in the balance sheet for people to look at and see what's there. I think that's the purpose of this.

Q. And you talked about transparency, why is transparency important?

A. Well, in the environment of the last few years, transparency has become kind of an important concept as investors look at -- at investing in a company to make sure that they can have a better opportunity to fully understand what the company is all about.

Q. And for a regulated utility who is a monopoly service provider, would transparency also be of assistance to the company's customers so they know what the dollars they're paying for that service are being spent on?

A. I would think that anyone who would have an interest in the company, stockholders, anyone, would.

Q. Including customers?

A. Yes, anyone.

Q. And regulatory bodies?
A. Yes, anyone.
Q. Sure. Now, in your surrebuttal testimony at Page 3, you talk about the fact that Empire is supporting the position that -- that Mr. Roff has on treatment of net cost of removal at line 8. Do you recall that?
A. Yes.
Q. Okay. And I take it by that statement, what Empire supports is its modified filing based on Mr. Roff's study as opposed to what Mr. Roff would recommend the Commission do, right?
A. Okay. Would you say the -- my sur reply?
Q. Surrebuttal.
A. Surrebuttal. I'm sorry. And that was page?
Q. Page 3.
A. Page 3. Okay. Uh-huh.
Q. Okay.
A. Ask me again, I'm sorry. I was looking at the wrong document.
Q. Just for clarification, the position that Empire is supporting is the one that Empire filed the tariffs on, not the full recommendation of Mr. Roff?
A. Yes, ma'am, that's correct.
Q. Okay. But you have an alternative proposal beginning at line 11 on that page as well; is that right?

A. Yes.

Q. Okay. And you're asking that the company's rates include a provision for Missouri jurisdictional net cost of removal, that's $1.6 million per year?

A. Yes, that's what this says.

Q. Okay. And is that consistent with the recent experience of Empire?

A. I think it is. From a Missouri jurisdictional standpoint, I'm really not sure, but I would assume it is or that number -- that would be the number that I picked up.

Q. Okay. And you asked that the difference between that 1.6 million and the actual experience of net cost of removal be tracked separately as a regulatory asset and/or liability each year, which can then be included in rate base in the next rate case and amortized over a five-year period; is that right?

A. Yes, if our preferred methodology would not be accepted.

Q. Okay. And if the company receives this treatment, will it be able to continue its depreciated worn out plant in replacing it with new plant, continue to do that?

A. You mean continue in business?

Q. Sure.

A. Yes, we will.

Q. Okay. It's not going to put you on the brink of bad stuff, right?

A. Well, now, that's a different question.

Q. So many things could be bad stuff.

A. So many things could be.

Q. Yeah.

A. But the better position, I want to be clear it's understood, that what we feel like is the proper treatment for this issue is as Mr. Roff testified and is reflected in our tariffs of some number around $10 million of additional expense because we, again, feel like that's the proper way to handle the cost of removal issue. Because if the Commission would determine that that's not the direction they're going to go, then we would ask that this be an alternative considered.

Q. Well, looking at this alternative that you've proposed, why is it that you believe that all the variation between experience and allowed net cost of removal should be tracked as a regulatory asset or liability, however it turns out to be for a given year?

A. Because cost of removal can be volatile, it can be 1.6 million this year, or in our case, you know, 3 million next year, whatever it might be, and what we would hope to do -- it could go down, too, I should say, because this is kind of a factor of just whatever needs to be done, and our intention in this would be that the difference between what's in rates and what the actual experience is be tracked and we be allowed to recover or that be refunded as we move into the future, if again, if the preferred method isn't chosen.

Q. Okay. And isn't it also true that this kind of record-keeping would help the Commission on a going-forward basis in assessing whether or not depreciation expense is greater than, less than, or similar to the net salvage allowance in the company's rates?

A. I think it adds another step in the bookkeeping and record-keeping process that I don't think is necessary if the proper net salvage methodology is used, but it is something of a tin can to put the dollars in and keep track of it.

Q. And it would certainly provide some empirical evidence down the road as to, you know, whether a particular method is designating cost of removal on an accurate basis?

A. I think it would just track the difference in experience and what we have in rates. I'm -- and I'm not a depreciation person, so I don't know that I can go much further than that.

Q. Okay. Well, I think I won't either then.

MS. O'NEILL: I have no more questions.

JUDGE THOMPSON: Any questions, Commissioner

Appling?

COMMISSIONER APPLING: No questions, Judge.

JUDGE THOMPSON: Okay. I think what we're going to do is recess for the day and we will come back -- I have a list of questions provided by Commissioner Gaw that we will do with Mr. Roff. See, I'm afraid that they'll take longer than the amount of time we have and we'll be back here tomorrow anyway. And I don't know whether there are other Commissioners who may have questions for either of you two, so that's my plan and I'm sticking to it.

MR. WILLIAMS: What time will we restart tomorrow?

JUDGE THOMPSON: I guess 8:30. Miss Reporter, 8:30. So without further adieu, we'll be in recess until tomorrow morning.

WHEREUPON, the recorded portion of the hearing was concluded until 8:30 a.m. on December 16, 2004.

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