

Exhibit No.:
Issues: *Bad Debt Expense;*
Infrastructure Rule Expense;
State Income Tax Flow-
Through
Witness: *Paul R. Harrison*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Surrebuttal Testimony*
Case No.: *ER-2010-0130*
Date Testimony Prepared: *April 23, 2010*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

PAUL R. HARRISON

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2010-0130

Jefferson City, Missouri
April 2010

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1 The first witness, Ms. Long, on page 2 and 3 of her rebuttal testimony, recommends
2 that bad debt expense be factored-up by applying the Staff's bad debt expense ratio to the
3 revenue requirement increase resulting from this rate case. The second witness, Ms. Walters,
4 recommends on page 4 of her rebuttal testimony that Empire's alleged remediation costs
5 associated with compliance with the Commission's infrastructure inspection rules either be
6 included in a tracker mechanism that was created as a result of Empire's last rate case or
7 reflected in a separate annualization adjustment to expense in this case. Finally, Mr. Williams
8 recommends on page 6 of his rebuttal testimony that Empire be allowed to recover deferred
9 state income taxes associated with alleged flow-through rate treatment afforded to accelerated
10 depreciation tax timing differences prior to 1994. He requests that the Company recover
11 \$130,431 per year of deferred taxes over 18 years through an amortization to expense.

12 My surrebuttal testimony will explain in detail the Staff's recommendations
13 concerning each one of these issues.

14 **BAD DEBT EXPENSE**

15 Q. Ms. Long states at page 3 of her rebuttal testimony that the calculation of the
16 bad debt write-off factor should be applied to the increase in rate revenue resulting from this
17 case. Does Staff agree with Ms. Long?

18 A. No. In principle, Staff agrees that it is possible that bad debts may increase to
19 some extent as a result of an increase in Empire's revenue levels. However, Staff does not
20 subscribe to the position that any increase in the Company's revenue requirement necessarily
21 causes bad debt expense also to increase proportionately, or on a dollar-for-dollar basis. Staff
22 has simply seen no evidence of this direct correlation in this or other rate cases. In fact,

1 historical experience shows that there have been several years where different utilities
2 operating within Missouri have experienced increases in actual revenues while actual bad
3 debts have declined in total.

4 Q. What does the term bad debt “factor-up” or “gross-up” mean and what is the
5 rationale behind its use?

6 A. The bad debts factor-up adjustment is calculated by applying the ratio of
7 adjusted bad debt expense to adjusted test year revenues to the actual increase in rates ordered
8 by the Commission in a rate proceeding. The usual justification for use of the bad debt
9 factor-up is that it is necessary to properly match the level of bad debt expense established in
10 a rate case with the amount of revenue requirement increase that will be determined by the
11 Commission in that case. This additional amount of bad debt expense, if the factor-up is
12 granted, will be calculated and added to the annualized and normalized level of bad debt
13 expense found reasonable for inclusion in the utility’s revenue requirement.

14 Empire’s proposed use of a bad debt factor-up is based on the assumption that any
15 amount of increased revenues resulting from this rate case will cause bad debt expense to
16 increase proportionately as well. In other words, the Company believes it is reasonable to
17 assume that if some ratepayers are not able to pay their current utility bills when they are due,
18 chances are that some of these same customers would not be able to pay their bills when the
19 utility bills go up as a result of a rate increase. While this view may seem reasonable in
20 theory, it does not always hold true in reality because it assumes bad debt increases are a
21 certainty with each rate increase. This is not a realistic view. In order for Empire to justify
22 using a bad debt factor-up, a substantial amount of analysis must be done to demonstrate a
23 direct correlation between revenue levels and bad debt.

1 Q. Has the Company performed an analysis that would support its position that a
2 direct correlation exists between increases in bad debt and increases in rate levels?

3 A. Not to Staff's knowledge.

4 Q. Has Staff performed an analysis that would support its position that no direct
5 correlation exists between increases in bad debt and increases in rate levels for Empire?

6 A. Yes. Staff performed an historical analysis of the Company's bad debts and
7 retail revenue levels for Empire for the past five calendar years (2005 through 2009). The
8 Staff compared the proportionate percentage increase/decrease of bad debt to the
9 proportionate percentage increase/decrease of revenues. During calendar years 2005, 2006,
10 2007, 2008 and 2009, Empire's revenue levels increased/decreased by 19.31%, 6.57%,
11 11.14%, -6.93% and 5.31% respectively. During the same time periods Empire's bad debt
12 levels increased/decreased by 30.05%, 29.69%, 75.84% -35.23% and 3.13%, respectively. As
13 can be seen by this analysis, when comparing Empire's bad debt levels to Empire's revenue
14 levels, bad debt and revenue levels increase and decrease from period to period, but there is
15 no direct correlation or equal movement between one another. None of the Staff's analysis
16 produced any substantive evidence to support the direct relationship that must exist between
17 bad debt and revenues to justify inclusion of a full bad debt gross-up in this case.

18 Q. How is "proportionate" defined and how does it relate to bad debt
19 factor-up and increased revenues resulting from a rate case?

20 A. The Encarta Dictionary defines "proportionate" as "in proportion",
21 comparable, equal or equivalent to one another. "In proportion" is defined as having the
22 correct relationship of size, quantity, or degree to something else, or remaining in the same
23 relationship when things change. While Staff believes there may be some relationship

1 between bad debt expense and increased revenues resulting from a rate case, when it has
2 examined this relationship in rate cases for other utilities, Staff has generally found that rate
3 increases do not always cause a proportionate increase in bad debt expense

4 Q. Does the bad debt factor-up proposed by Empire work in the same way as an
5 income tax factor-up, as suggested by Ms. Long on page 3 of her rebuttal testimony?

6 A. Yes. The income tax factor assumes that for every increase in earnings to a
7 utility resulting from a rate case there will be a direct and absolute proportionate increase in
8 income taxes. This is a well-known and established relationship, and in this case both
9 Company and Staff have applied an income tax factor-up to the additional revenue
10 requirement calculation to determine the proper level of income taxes in this case. If the
11 Commission authorizes a rate increase in this proceeding, then a corresponding income tax
12 amount will have to be added to the additional revenue requirement amount or the Company
13 will not be able to recover the authorized amount of increase in its revenue requirement.
14 However, the relationship between bad debt expense and increased rates is not the same as the
15 relationship between income tax expense and increased rates. It is clear from the analysis
16 conducted by Staff that a direct relationship does not exist between increased rates and
17 increased bad debt expense.

18 Q. Did Staff include an adjustment in this case for the bad debt factor-up
19 associated with the revenue requirement to be determined in this rate case?

20 A. No. Staff's position is based on its current analysis of actual Empire data that
21 shows no direct correlation exists between the revenue increases and increases in bad debt
22 expense. The Staff's analysis does not support the position that an increase in revenue will
23 result in proportionate increase in bad debt expense.

1 **INFRASTRUCTURE RULE EXPENSE (REMEDIAION COSTS)**

2 Q. What are the costs Empire refers to as “remediation costs?”

3 A. It is the Staff’s understanding that these costs are related to maintenance and
4 repair costs associated with Empire’s facilities that allegedly will be incurred at a higher level
5 due to the inspections required per the Infrastructure Inspection Rule (“Infrastructure Rule”),
6 as discussed in Ms. Walters’ rebuttal testimony at pages 3-4. When maintenance needs are
7 discovered in the course of the mandated inspections, either Empire or an outside contractor
8 performs preventive maintenance to remediate problems with the infrastructure. Empire
9 included these costs incurred prior to the end of the test year update period
10 (December 31, 2009) in its Commission Rules Tracker (tracker) balance filed in this case.
11 This tracker mechanism was ordered by the Commission for Empire’s compliance costs
12 related to the Vegetation Management Rule and Infrastructure Rule in the Company’s last rate
13 proceeding, Case No. ER-2008-0093.

14 Q. How did the Staff treat these costs in it direct filing for this case?

15 A. The Staff removed \$611,234 related to minor maintenance and repair costs
16 from the tracker balance and made an adjustment to include this cost in
17 Transmission and Distribution maintenance expense. The Staff removed these remediation
18 costs from the tracker balance to be consistent with the treatment ordered in the
19 Report and Order in Case No. ER-2008-0318, an AmerenUE rate request case. After the Staff
20 filed its Cost of Service Report in this proceeding, the Company provided the Staff data
21 showing that the actual level of remediation costs included in the tracker was \$172,827. The
22 Staff made this correction to its cost of service recommendation.

1 Q. How did the Commission treat remediation costs associated with the
2 Infrastructure Rule in the AmerenUE rate request, Case No. ER-2008-0318?

3 A. At page 43 of its Report and Order, the Commission addressed this issue in
4 part as follows:

5The Commission finds that AmerenUE's rates already allow for
6 recovery of the expenditures required to repair its electric system. The
7 fact those repairs may occur following an inspection does not mean the
8 repairs would not eventually have been made anyway and there is no
9 reason to believe the repairs would be more costly simply because they
10 were made after an inspection. Thus, to allow recovery under this
11 provision as an increased cost of complying with the rule could result
12 in a double recovery of those costs.
13

14 Q. At what date did Empire begin making inspections under the
15 Infrastructure Rule?

16 A. According to Ms. Walters's testimony at page 4, lines 11 and 12, "the actual
17 inspection process did not commence until the middle of 2009, and the remediation efforts
18 related to these inspections did not begin until late 2009. As a result, the test year does not
19 reflect a full year of the remediation costs that are directly related to the Commission rule".

20 Q. Does the Company or the Staff know what level of remediation costs Empire
21 will incur as a result of the Commission Rules?

22 A. No. Ms. Walters cites budgeted 2010 data for remediation costs in her rebuttal
23 testimony at page 4, lines 13-16, but she also states that Empire only began incurring these
24 costs late in 2009 as they allegedly relate to Empire's infrastructure inspection activities.
25 Thus, there had only been very limited historical experience regarding these costs as of the
26 test year update period in this case.

1 Q. What is the Staff's recommendation concerning the level of Empire's
2 remediation costs for this case?

3 A. The Staff recommends that these costs are reviewed and updated as part of
4 true-up for this case. At that point, there will be more data available to determine whether
5 further adjustment to Empire's test year costs are appropriate related to remediation and
6 repair efforts.

7 **DEFERRED STATE INCOME TAXES FLOW-THROUGH**

8 Q. What is Empire's request related to the alleged flow-through in rates of state
9 income tax deferrals prior to 1994?

10 A. The Company is seeking rate recovery of a regulatory asset, estimated by
11 Empire at a value of \$2,347,760, which relates to deferred state income taxes for which the
12 tax benefits were allegedly flowed through to Empire customers in the past. The Company's
13 proposed amortization of these regulatory assets necessarily assumes that flow through
14 treatment of the tax timing differences were actually granted by the Commission in rates, and
15 that flow-through treatment resulted in a past benefit to customer (i.e., that regulatory state
16 income tax expense charged to customers was lower due to the flow-through treatment).
17 Empire has not provided any evidence to substantiate either assumption; nor has Staff been
18 able to discern any evidence supporting the Company's request to date in its own
19 investigation of this matter.

20 Q. Mr. Williams stated on page 2, lines 11 through 15 of his rebuttal testimony
21 that "from January 1, 1954 to August 15, 1994, Empire flowed through the state income tax
22 benefits of accelerated depreciation to ratepayers. Deferred income tax expense included in

1 the Company's cost of service included only the deferred federal income tax computed at the
2 statutory rates in effect during that period. As a result, ratepayers gained the benefit of the
3 state deferred income tax expense". Do you agree with Mr. Williams, that the Company
4 flowed through the state income taxes between 1954 and 1994?

5 A. To date, Empire has provided no documentation or other evidence to
6 substantiate this position.

7 Q. Do Commission Orders concerning Empire's rate requests during this time
8 period provide support for Empire's characterization of past Missouri rate treatment of state
9 income tax expense?

10 A. Apparently not. By Empire witness Williams' own admission in his rebuttal
11 testimony at page 4, lines 7 through 10, "with respect to this issue, all the rate cases that the
12 Company was involved in from 1973 to 1994 were negotiated settlements".

13 Negotiated settlements can be entered into by the parties with stipulations of particular
14 issues, or through a "black box" settlement. Either method involves extensive negotiations,
15 and if a "black box" settlement is used to settle the issues in a rate case, there is no way of
16 knowing what issue valuation, if any, was used in the settlement.

17 Additionally, Staff submitted Data Request No. 0340 to Empire on April 5, 2010
18 requesting that the Company provide the following information:

19 In Mr. William's rebuttal testimony, page 2, he stated that from 1/1/1954
20 through 8/15/1994, it was the Company's practice to flow through to
21 ratepayers, income tax benefit that was required to be normalized.
22 Please provide the following documents to support this position: 1) any
23 document that required the Company to flow through to ratepayers,
24 income tax benefits that were required to be normalized. 2) Each and
25 every MoPSC Report & Order, MoPSC Accounting Schedule or any
26 other document for every rate case filed with the Commission between
27 1954 and 1994 supporting the Company's position that state tax was

1 flowed through to ratepayers prior to 1994. 3) The 1956 & 1970
2 Accounting Order cited in Mr. Williams testimony. 4) The 12/17/70
3 letter cited in Mr. Williams' testimony. 5) The 1969 Tax Reform Act
4 provisions that disallowed the normalization of state income tax referred
5 to in Mr. William's testimony. 6.) Any and all documents to support
6 Mr. Williams claim that compliance with Commission orders specifying
7 the recording of deferred federal income taxes and the IRS requirement
8 that only federal income taxes be normalized; state deferred income
9 taxes were not included in Empire's rates.

10 Empire objected to this data request in a letter dated April 6, 2010. The letter stated in
11 pertinent part:

12 I am writing to object to Staff data requests 0340 served on The Empire
13 District Electric Company on April 5, 2010. Empire objects to request
14 0340 on the basis that it is overbroad and unduly burdensome and seeks
15 information which is not legally relevant. Subject to these objections
16 and without waiving the same, Empire will make a good faith effort to
17 respond to these data requests in full.

18 At this time, response to this data request has not been provided. If, and when the
19 Company responds to this request, the Staff may be able to make a more accurate
20 determination as to whether Empire actually flowed through the state income tax benefits of
21 accelerated depreciation to ratepayers until 1994.

22 Q. Is the Staff aware of any other major Missouri utility that has claimed that its
23 state accelerated depreciation tax timing differences was given flow-through treatment for rate
24 purposes prior to 1994 in Missouri?

25 A. No. In fact, it was the Staff policy, going back at least as far as the early 1980s
26 to provide normalization treatment to accelerated depreciation tax timing differences for both
27 federal and state income taxes for major utilities.

28 Q. Does this conclude your surrebuttal testimony?

29 A. Yes it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric)
Company for Authority to File Tariffs Increasing) Case No. ER-2010-0130
Rates for Electric Service Provided to Customers)
in the Missouri Service Area of the Company)

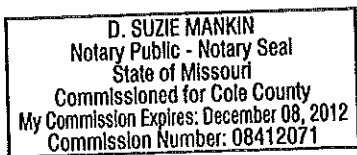
AFFIDAVIT OF PAUL R. HARRISON

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Paul R. Harrison, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 10 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Paul R. Harrison
Paul R. Harrison

Subscribed and sworn to before me this 22nd day of April, 2010.



Suzie Mankin
Notary Public