

Exhibit No.:

Issue: Cost allocation, Off-system sales and
Fuel and Energy costs and Amortization

Witness: W. Scott Keith

Type of Exhibit: True-up Testimony

Sponsoring Party: Empire District

Case No. ER-2006-0315

Before the Public Service Commission

of the State of Missouri

True-up Testimony

of

W. Scott Keith

September 2006

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

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TRUE-UP TESTIMONY
OF
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THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2006-0315

1 **INTRODUCTION**

2 **Q. STATE YOUR NAME AND ADDRESS PLEASE.**

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

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

6 A. I am presently employed by The Empire District Electric Co. ("Empire" or "the
7 Company") as the Director of Planning and Regulatory. I have held this position
8 since August 1, 2005. Prior to joining Empire I was Director of Electric
9 Regulatory Matters in Kansas and Colorado for Aquila, Inc. from 1995 to July
10 2005.

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

15 A. Yes.

16 **Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?**

17 A. In its Order Concerning Test Year and True-Up and Adopting Procedural
18 Schedule, the Commission ordered a true-up of fuel expense and other significant

1 revenue requirement elements for the three-month period ending June 30, 2006.

2 The purpose of this testimony is to present Empire's revenue deficiency trued-up
3 as to the items specified in the Commission's order thru June 30, 2006, and to
4 discuss Staff's recommended adjustment for the allocation of administrative and
5 general expenses and general plant investment due to the acquisition of the gas
6 property previously owned by Aquila, Inc.

7 **Q. PLEASE DESCRIBE EMPIRE'S TRUE-UP DEFICIENCY THRU JUNE**
8 **30, 2006.**

9 A. Presented as Schedule WSK-1 is a schedule that displays the calculation of
10 Empire's revenue deficiency of \$26,231,680, if the IEC is terminated as Empire
11 has requested. This deficiency has decreased from the reconciliation as filed by
12 Staff on August 25, 2006, at which time it was \$26,799,437.

13 **Q. HAVE ANY NEW ISSUES DEVELOPED AS A RESULT OF THE TRUE-**
14 **UP POSITIONS?**

15 A. Yes. There are at least three differences between the relative positions of Empire
16 and Staff. These differences concern fuel and purchased power expense, off-
17 system sales and a new item – allocation of common costs and common property
18 due to the recent, June 1, 2006, acquisition of the Aquila, Inc. gas operations in
19 Missouri. The parties' relative positions as to the gain on the unwinding of the
20 hedging transaction, management incentive and customer demand programs have
21 not changed from the quantification of those positions presented prior to the
22 hearings held from September 5, 2006 to September 14, 2006. The rate of return

1 on rate base also changed as a result of the update in the capital structure through
2 June 30, 2006.
3

4 **CORPORATE ALLOCATIONS**

5 **Q. PLEASE EXPLAIN THE DIFFERENCES BETWEEN STAFF AND**
6 **EMPIRE AS TO THE ALLOCATION OF COMMON EXPENSES TO THE**
7 **COMPANY'S NEWLY ACQUIRED GAS OPERATIONS IN MISSOURI.**

8 A. On June 1, 2006, The Empire District Electric Company acquired the Missouri
9 natural gas distribution operations of Aquila, Inc. As a result of this acquisition,
10 Empire expects to realize synergies in excess of increased costs related to the
11 common costs associated with the combined operations of the electric and gas
12 companies. The Stipulation and Agreement in Case No. GO-2006-0205 (the case
13 in which the acquisition was approved), directed Empire to complete an updated
14 cost allocation manual by December 1, 2006. This cost allocation manual has not
15 been completed at this time. There is only thirty days of historical data available
16 and no updated cost allocation manual to indicate how the common cost
17 allocations will be performed in the future. Accordingly, Empire and Staff are
18 left to forecast future cost allocations in the true-up and have used different
19 methodologies to do so.

20 **Q. DOES EMPIRE DISPUTE THE LIKELY CREATION OF SOME**
21 **SYNERGIES?**

22 A. No. Empire acknowledges that the newly acquired gas operations should enable
23 the Company to spread its common costs over a larger customer base, and Empire

1 has used known and measurable costs to recognize the impact of this cost benefit
2 in this update to the electric rate case. On the other hand, the Staff's approach to
3 this same issue does not use a known and measurable approach to quantify these
4 future benefits, and in doing so has inaccurately, and, I believe, overstated the
5 benefits or synergies forthcoming from Empire's combined electric and gas
6 operation.

7 **Q. HOW DOES EMPIRE PROPOSE TO ANNUALIZE THE FUTURE COST**
8 **ALLOCATIONS IN THIS RATE CASE TRUE-UP?**

9 A. Empire's actual allocation of common expenses to its Missouri gas operations in
10 June was \$32,631. This cost assignment was based on Empire's existing cost
11 allocation manual that has been previously provided to, and reviewed by, the Staff
12 of the Missouri Public Service Commission. It reflects the same methodology
13 Empire has historically used to allocate common cost to its non-regulated
14 businesses. This methodology uses a quantity of items such as purchase orders
15 and vouchers to allocate costs such as purchasing and accounts payable. This cost
16 assignment assumes that as the level of common expenses increase in total, the
17 volume of activity also increases as the various operating functions move to
18 Empire from Aquila during the transition period.

19 **Q. DOES EMPIRE HAVE ANY ADDITIONAL INFORMATION THAT**
20 **WOULD SUPPORT THE AMOUNT EMPIRE WOULD PROPOSE TO**
21 **ALLOCATE TO ITS MISSOURI GAS OPERATIONS?**

22 A. Yes. The common cost assignment in June 2006 is consistent with the common
23 cost assignments made in July and August of 2006, representing the entire period

1 of actual operating history. As a result, Empire proposes that the June 2006 cost
2 assignment to the Missouri gas operations be annualized for purposes of this true-
3 up. This results in an adjustment of \$391,572 to Empire's total operations and an
4 adjustment of \$324,572 to the Company's Missouri jurisdictional electric
5 operations.

6 **Q. WHAT ADJUSTMENT DID STAFF MAKE FOR THIS SAME**
7 **ALLOCATION?**

8 A. Staff chose to allocate selected general and administrative expenses based on a
9 Massachusetts formula provided by Empire. This resulted in a Staff adjustment
10 of \$728,584 to the Company's Missouri jurisdictional operations.

11 **Q. WHAT HAS CAUSED THE LARGE DISCREPANCY BETWEEN THE**
12 **TWO METHODS OF COMMON COST ALLOCATION USED BY**
13 **EMPIRE AND THE STAFF?**

14 A. The Company has used the actual common expense assignment to the Missouri
15 operations in June of 2006 to forecast the annual cost allocation. Staff has
16 projected the future allocation based on a projected percentage of overall expense
17 at June 30, 2006, without taking into consideration additional costs that the
18 Company has incurred to take over the gas operations since June 30 or that it has
19 forecasted to increase as the transition process related to the gas operation
20 progresses. As a result, Staff's method fails to recognize that the level of
21 common cost will increase for Empire's combined gas and electric operations.
22 For example, Empire has added employees since the end of June to handle the
23 increase in workload as the duties associated with the gas operation have

1 transitioned from Aquila. These new positions and the associated increase in cost
2 are not captured or accounted for in the Staff's recommendation. Empire
3 anticipates its overall base payroll, excluding related benefits, to increase
4 approximately \$375,000 due to the gas acquisition. The overall level of office
5 supplies and other miscellaneous costs related to the gas acquisition will increase
6 as well. In addition, the Staff methodology does not appropriately classify
7 administrative and general costs into common and direct categories. This will
8 overstate the level of assignment to the gas operations and understate the ongoing
9 level of administrative and general expenses that are directly related to the electric
10 operations.

11 **Q. CAN YOU GIVE THE COMMISSION AN EXAMPLE OF HOW THE**
12 **STAFF'S FAILURE TO PROPERLY CATEGORIZE COSTS WILL LEAD**
13 **TO AN UNDERSTATEMENT OF COSTS FOR EMPIRE'S ELECTRIC**
14 **OPERATIONS?**

15 A. Yes. The Staff's broad brush methodology results in an allocation of outside
16 service expenses to the gas operations that are directly related to the electric
17 operation. The most clear cut example of this is related to the Integrated
18 Resource Planning process in Missouri. The cost of this activity during the 12-
19 months ended June 30, 2006 is directly related to the electric operation and none
20 of it should be assigned to the gas operation. There are undoubtedly other
21 examples of this sort of problem in the update data and the Staff proposed
22 methodology.

1 **Q. WHY DO YOU THINK STAFF HAS NOT TAKEN THESE ADDITIONAL**
2 **EXPENSES INTO ACCOUNT?**

3 A. The Staff does not take into account the additional expenses that will occur as a
4 result of the acquisition of the gas company due to the fact that some of these cost
5 increases were not incurred during the month of June 2006. This reasoning does
6 not mesh with the allocation factor the Staff used to assign projected allocated
7 costs. For example, the Staff used an allocation factor that assumed a higher level
8 of expenses, beyond June 30, 2006, and applied it to the twelve months ended
9 June 30, 2006 expense level, which only included one month of data for the gas
10 operations. As a result, the Staff's proposed adjustment is inconsistent and to
11 some extent has used an "apples to oranges" comparison to arrive at the allocation
12 of costs.

13 **Q. IS THIS THE ONLY TRUE-UP ADJUSTMENT THE STAFF HAS MADE**
14 **FOR THE NEWLY ACQUIRED GAS OPERATIONS?**

15 A. No. The Staff has allocated a portion of Empire's general plant, accumulated
16 depreciation, and depreciation expense to the newly acquired gas operations. This
17 allocation of general plant investment has reduced the Staff's Missouri
18 jurisdictional revenue requirement by \$509,045.

19 **Q. DID EMPIRE MAKE A SIMILAR TRUE-UP ADJUSTMENT?**

20 A. No. Empire does not believe that there is sufficient information at this time to
21 make this adjustment, and that the Staff proposal is fraught with inconsistencies
22 that make it highly inaccurate. For example, included in Empire's general plant
23 investment are office furniture, computers and other items used at the Empire

1 generating plants and electric line departments. The investment in this property
2 can be separated by location and function. Much of the investment in general
3 plant is not common property and should not be allocated to the gas operations.
4 The approach used by the Staff does not take this into account, and as a result
5 overstates the assignment to the gas operations. Empire is working to separate
6 these types of items for the cost allocation manual to be completed by December
7 1, 2006. Until that process is complete and the cost allocation manual is updated,
8 an allocation of common general plant cannot be accurately determined.

9 **Q. IF AN ASSIGNMENT OF COMMON GENERAL PLANT IS MADE FOR**
10 **PURPOSES OF THIS TRUE-UP, DO YOU AGREE WITH STAFF'S**
11 **METHODOLOGY?**

12 A. No. As I mentioned earlier, until the common general plant balances are
13 developed as part of the revised cost allocation manual, an accurate assignment
14 cannot be determined as part of this true-up. This Staff cost assignment of
15 general facilities does not take into account the investment that directly supports
16 Empire's electric operations, and overstates the level of general plant investment
17 that is used by the gas operations and should be rejected by the Commission.

18 **Q. DO YOU HAVE ANY COMMENTS REGARDING THE STATUS OF THE**
19 **CORPORATE COST ALLOCATIONS ISSUE?**

20 A. Yes. Because this is an issue that arises as a result of the true-up, Staff and the
21 Company continue to discuss and exchange information related to the appropriate
22 level of corporate allocations.

23

1 **OFF SYSTEM MARGIN NORMALIZATION**

2 **Q. PLEASE DESCRIBE THE EMPIRE TRUE-UP TO THE OFF-SYSTEM**
3 **MARGIN NORMALIZATION.**

4 A. Essentially, the same methodology used for the direct case was used for the true-
5 up period. Empire used a five year average after the exclusion of an unusual
6 transaction that took place with AEP, the same position that has been taken earlier
7 in the rate case. In addition to reflecting the five-year average adjusted for the
8 AEP transaction, Empire's update in this area reflected the refund that has been
9 ordered by the Federal Energy Regulatory Commission ("FERC") in ER99-1757-
10 008, et al. This analysis resulted in an increase to Missouri jurisdictional revenue
11 of \$819,916. Staff used the twelve months ended June 30, 2006 margin to
12 normalize the level of off-system sales. This Staff approach is consistent with the
13 position taken earlier in this rate case by the Staff. The difference between the
14 two approaches is \$1,006,463 on a Missouri jurisdictional basis.

15
16 **FUEL AND PURCHASED POWER EXPENSE**

17 **Q. PLEASE DESCRIBE THE TRUE-UP TO THE FUEL AND PURCHASED**
18 **POWER EXPENSES.**

19 A. Empire updated the customer load for growth to the June 30, 2006 level. This
20 resulted in \$137,839,369 of Missouri jurisdictional fuel and purchased power
21 expense. Staff's recommended update to fuel and purchased power expense
22 results in approximately \$135 million of Missouri jurisdictional expense or a
23 difference between Empire and Staff of approximately \$3 million in Missouri

1 jurisdictional fuel and purchased power expenses. This difference excludes the
2 difference in positions in fuel expense due to the unwinding of a future hedge
3 position. The unwinding issue is the same issue that has been addressed in earlier
4 testimony in this rate case.

5

6 **AMORTIZATION**

7 **Q. IS THE COMPANY ADDRESSING AMORTIZATION IN THIS UPDATE**
8 **FILING?**

9 A. Not at this time. The Company continues to work with the parties in the case to
10 determine the appropriate method to calculate the amortization called for in case
11 EO-2005-0263 and may need to file supplemental testimony on this subject. Just
12 as before, the level of amortization, if any, is dependent upon other factors in the
13 rate case -- with one of the most important factors being the overall return on
14 equity authorized by the Commission.

15 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

16 A. Yes, it does.