Missouri Public Service Commission

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August 30, 2001

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: Case No. ER-2001-299

Dear Mr. Roberts:

Enclosed for filing in the above-captioned case are an original and eight (8) conformed copies of a **TRUE-UP INITIAL BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION.**

This filing has been mailed or hand-delivered this date to all counsel of record.

Thank you for your attention to this matter.

Sincerely yours,

Dennis L. Frey

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DLF:ccl
Enclosure
cc: Counsel of Record

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

FILED[3]
AUG 3 0 2001
Missouri Public Service Commission

In the Matter of the Empire District Electric Company's Tariff Sheets Designed to Implement a General Rate Increase for Retail Electric Service Provided to Customers in the Missouri Service Area of the Company	))))))	Case No. ER-2001-299

TRUE-UP INITIAL BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION

COMES NOW the Staff ("Staff") of the Missouri Public Service Commission ("Commission") and for its True-Up Initial Brief states:

I. INTRODUCTION

On August 23, 2001, the true-up hearing in this case was held. At that time only two issue areas were contested; namely: (1) property taxes and (2) capital structure/cost of capital, and in particular, the embedded cost of Trust-Originated Preferred Securities ("TOPrS"). This brief presents the Staff's positions and arguments on these two issue areas in that order.

II. PROPERTY TAXES

The dispute between Staff and the Company on this issue relates to the level of property tax expense that should be included in rates in this proceeding.

Staff developed property taxes in this case by applying an appropriate property tax rate to December 31, 2000, balances of electric property. Staff's property tax rate was developed by dividing the amount of property taxes paid in 2000 by the total balance of Empire's electric property at January 1, 2000. (Boltz Direct, Ex. 39, p. 5.)

In contrast, Empire went beyond year-end 2000 property balances in determining its property tax expense allowance by adding the balance of new plant in service added to its system through the end of the true-up period to the property on which its property tax calculation was based. Almost all of this new plant is associated with the new State Line Combined Cycle (SLCC) Unit. (Gibson True-Up Rebuttal, Ex. 120, p. 4.) Both Staff and the Company have recommended that the balance of the new SLCC unit be included in rate base as of June 30, 2001, the end of the true-up period, reflecting invoices approved through July 31, 2001.

Empire's complaint that Staff has not included property taxes associated with the new SLCC unit in its case may seem plausible on a superficial basis. At first glance, it does not seem logical that the new unit should be included in the Staff's rate base, while not also reflecting any additional property tax expense associated with the unit in the case. However, a closer examination of the evidence underlying the issue shows Staff has appropriately reflected property taxes associated with the new SLCC unit in its revenue requirement, and that Empire's position on this matter is inconsistent with past Commission precedent on property taxes issues, specifically, and on test year/true-up policy in general.

First, it is necessary to understand how property taxes are actually assessed on utility (and non-utility) property to appreciate Staff's position on this issue. Taxing authorities only assess property for taxing purposes once a year, based upon the plant and other assets held by utilities on January 1 of each year (or December 31 of the previous year). (Boltz True-Up Surrebuttal, Ex. 123, p. 2.) Staff's property tax expense allowance is based upon the property balances as of that assessment date. The balance of a utility's plant in service account on January 2 of any year is of absolutely no concern to property tax authorities. (Boltz True-Up Surrebuttal, Ex. 123, p. 2.) Nor would be Empire's plant in service balance on June 25, 2001 (the SLCC unit's in-service date) or at July 31, 2001, (the cut-off date for SLCC unit invoices to be reflected in plant in service). (Tr. 1148.) The next relevant date for assessing the SLCC unit for property tax purposes will be January 1, 2002, some months from now and several months beyond the operation-of-law date for this rate proceeding. (Tr. 1148.) The way property taxes are assessed makes this expense a unique item for ratemaking purposes. (Boltz True-Up Surrebuttal, Ex. 123, p. 3.)

It is also important to recognize that Staff is not leaving a "hole" in Empire's property tax expense by not increasing expense in this case for SLCC property taxes. Empire's property was last assessed based upon its value on January 1, 2001. This assessment included the new SLCC unit - more specifically, its Construction Work in Progress balance associated with that unit as of that date. (Tr. 1143, 1178.) But property taxes on construction are capitalized for rate purposes, and included in the eventual plant in service balance for the asset in question. Such capitalized property tax amounts are then recovered over the life of the asset by the utility through annual accruals of depreciation expense, with any unrecovered portion included in rate base. (Boltz True-Up Surrebuttal, Ex. 123, pp. 7-8.) Staff in this manner has fully accounted for all property taxes assessed on SLCC unit amounts as of January 1, 2001; Empire has been made "whole" for these property taxes for rate purposes.

However, once a plant item is completed and placed in service, all subsequent property taxes on that item are expensed on the utility's books and for ratemaking purposes. Expensing of property taxes associated with a particular plant item does not begin concurrently with the asset's in-service date; rather, accrual of those property taxes will not begin until the next assessment date for the utility's assets (i.e., January of the following year). (Tr. 1146.) Even though the new SLCC unit is now in-service, the Staff has not attempted to speculate on what level of property tax expense will be reflected on Empire's books in 2002 associated with the new unit. This is appropriate because neither Staff nor Empire knows what the assessed value of the new SLCC unit or Empire's other assets will be at January 1, 2002, what property tax rate will be applied to those assessed values, or, ultimately, what the Company's property tax payments will be late in 2002. (Tr. 1149.) For all of these reasons, Empire's 2002 property tax expense cannot be considered by any reasonable standard to meet the Commission's traditional "known and measurable" standard for inclusion of cost of service items in rates. (Boltz True-Up Surrebuttal, Ex. 123, p. 6.) At the very minimum, the assessment date for a utility's plant in service should have occurred and be within the test year, update period or true-up period before any consideration is given to inclusion of property tax expense for those assets in rates. (Tr. 1173.)

Not only would Empire's approach to property taxes in this case violate the Commission's "known and measurable" standard, it would also lead to an improper "matching" of rate base, expense and revenue items in cost of service. (Boltz True-Up Surrebuttal, Ex. 123, pp. 4-5.) Empire's position on this issue would require the Commission to overlay a 2002 level of property taxes in the Company's revenue requirement, when every other element of the case is subject to a strict cut-off as of the end of the true-up period in this case. Empire's requested treatment of property taxes implicitly assumes that any additional property taxes associated with the new SLCC unit based upon its assessed value at January 1, 2002, will not be totally or partially offset by revenue increases (either from new customers or additional usage by existing customers), expense decreases (such as from employee reductions) or by decreases in rate base (such as typically occurs when a major plant addition is brought into service and the ongoing depreciation accruals begin reducing the rate base). (Tr. 1196-97.) In fact, the record reflects that property tax expense itself has decreased from year to year several times in the last five years. (Tr. 1197.) The table in Empire's True-Up Rebuttal Testimony shows an approximate decrease of $500,000 in Empire's property tax from 1999 to 2000. (Gibson True-Up Rebuttal, Ex. 120, p. 3.) This demonstrates that property tax expense on Empire's existing plant in service at January 1, 2001, may decline in 2002 and future years, offsetting at least in part any additional property taxes due in those years related to the new SLCC unit.

Concerning the above point, the Commission should decline to give any credence to Empire's speculation that failure to recover property tax expense in this case will force it to file for new rates next year. (Tr. 1155.) First, Empire's valuation of this issue is approximately $1 million on a Missouri jurisdictional basis, compared to its requested rate relief in this case of approximately $41 million. (Tr. 1198.) More importantly, again Empire's claim implicitly assumes that future increases in revenues and decreases in other expenses and in rate base will not offset all or in part its speculated increase in SLCC property taxes. The claim by Empire that it will not have opportunity to recover property taxes from its customers if those costs are not included in this case is without merit. Just as with other expense items or plant additions that would typically increase revenue requirement that may occur outside the operation-of-law date of any given case, there are always other elements to the revenue requirement that could partially or completely offset any such revenue requirement increases for property taxes. To the extent that Empire earns a reasonable return in any given period, it is assumed that the Company is recovering its costs, including property taxes associated with new plant additions, in rates. There is certainly no evidence in the record to justify the Commission's reliance on an assumption that all other elements of the Company's cost of service will remain static while its property taxes increase by over a million dollars. The Commission should not violate its long-established matching and test year/true-up policies date in this case based upon such an unreasonable assumption.

In addition, regardless of all the parties' inability to quantify calendar year 2002 property tax expense, this issue is well beyond the appropriate time frame of this case and well beyond the operation-of-law date for this case. The Commission has traditionally rejected going outside the operation-of-law date for any event including payroll increases for contractual union agreements that are "known" to occur but cannot be quantified. The Commission has never gone outside the operation-of-law date to reflect in revenue requirement an expense item such as property taxes in the manner that Empire is suggesting. (Tr. 1179.) The property taxes at issue in this proceeding won't be actually paid until December, 2002 and won't even be assessed until January 1, 2002, almost three months past the operation-of-law date and a full six months past any other revenue requirement item subject to true-up as of June 30, 2001. To put this proposal by Empire into perspective, if the Company had a contractual union wage increase that was scheduled to go into effect December 31, 2001, based upon past precedent, the Commission would not include this increase in payroll in rates since the event would occur outside the test year update and true-up dates used to determine the revenue requirement, as well as, outside the operation-of-law date of the case.

In fact, Empire will actually over-collect property taxes in rates under its proposal, as discussed with Staff's witness by Empire's own counsel during the evidentiary hearing. Empire, through its counsel appeared to suggest that if there was an over-collection of property taxes by Empire, it would only be two months and Staff could use present value techniques to solve this problem. (Tr. 1195.) However, Empire did not provide any evidence to make such a present value calculation. Further, such an approach would not in any way resolve Staff's concerns regarding the inappropriateness of "matching" calendar year 2002 property tax expense for rate purposes with June 30, 2001, levels of rate base, revenues and other expense items.

Finally, the Company's approach to this issue flies in the face of well-established Commission precedent. In Case No. GR-96-285, a case involving Missouri Gas Energy, that utility sought inclusion of property tax expense in its case based upon the level of plant in service included in rate base. (Boltz True-Up Surrebuttal, Ex. 123, p. 9.) More recently, in Case No. WR-2000-844, St. Louis County Water Company sought the exact same treatment for its property tax expense (i.e., to base the amount on the plant in service balance in its rate base). (Boltz True-Up Surrebuttal, Ex. 123, pp. 9-10.) In both cases, the Commission rejected these utilities' approach, and properly recognized that the timing differences between when companies add plant to their systems, and when taxing authorities assess such plant and when utilities actually pay the property taxes related to plant additions, does not support automatically increasing property taxes for additions to plant in rate base.

In its recent May 3, 2001, Report and Order in the St. Louis County Water case, at page 22, the Commission found that adopting that company's proposal would violate known and measurable concepts:

> The Company's projected property tax increases are neither known nor measurable. While it is probable that the Company will experience an increase in property tax expense at the end of the year, it is by no means certain. Even more damaging to the Company's proposal is the fact that its best estimate of the amount of any increase is based on an assumption that finds no support in the record. Company's proposed property tax calculation assumes that the tax rates for 2000 will be the same as the tax rates for 1999.

In this proceeding, yet again a utility comes before the Commission and seeks property tax expense based upon the level of plant in service included in its rate base. The Commission should be consistent with these prior decisions, and refuse Empire's invitation for it to speculate on future and out-of-period level of property taxes for inclusion in rates.

For all of the above reasons, the Commission should adopt Staff's position on property taxes in this proceeding.

III. CAPITAL STRUCTURE/COST OF CAPITAL

Capital Structure

Selection of Date for Determining Capital Structure

On January 4, 2001, the Commission issued its Order Setting Test Year, Setting True-Up Hearing and Adopting Procedural Schedule. In that order, the Commission stated: "The parties are agreed that the proper test year is the twelve-month period ending December 31, 2000, updated for *known and measurable changes* through June 30, 2001, for ...capital structure and cost of capital ..." (Emphasis supplied). In that same order, the Commission adopted those test year and true-up recommendations of the parties.

The Company did not file any direct true-up testimony on the issue of capital structure. Although Company witness David W. Gibson did file true-up rebuttal testimony and true-up surrebuttal testimony, neither he nor any other Company witness made any attempt to true up the Company's capital structure. Instead, Mr. Gibson merely renewed his argument that the Commission should adopt the hypothetical capital structure that he had proposed in his testimony in the main part of the case. That testimony is not properly a part of the true-up process, and the Commission should reject it.

As noted above, the stated purpose of the true-up is to update for "known and measurable changes." Mr. Gibson's testimony about a hypothetical capital structure has no place in the true-up process, because he did not testify about any *changes* after the end of the test year. Furthermore, the hypothetical capital structure that he testified about is *neither known nor measurable*, but is merely a reargument about what the Company's capital structure has normally been in the past or may be in the future, if it ever gets around to issuing some new common equity.

For reasons that have been adequately explained in the Staff's Initial Brief and Reply Brief herein, the Commission should reject the Company's proposal to use a hypothetical capital structure, and should instead use the Company's actual capital structure as of June 30, 2001, the true-up date.

Company's Capital Structure as of June 30, 2001

Staff witness Roberta A. McKiddy testified that the Company's capitalization as of June 30, 2001 consisted of the following:

Common stock equity	$231,960,394
Preferred stock	48,442,500
Long-term debt	334,006,533
Short-term debt	0
Total capitalization	$614,490,427

(McKiddy True-Up Direct, Ex. 124, Sch. 1). OPC witness Mark Burdette's testimony on this matter was substantially identical to Ms. McKiddy's. (Burdette True-Up Direct, Ex. 126, Sch. MB-1T). Ms. McKiddy testified that the common stock equity represented 37.76% of total capital, preferred stock represented 7.88%, and long-term debt represented 54.36%. (McKiddy True-Up Direct, Ex. 124, Sch. 1). Two of Mr. Burdette's figures varied from Ms. McKiddy's by a mere 0.01%. Use of a calculator reveals that the percentages in Ms. McKiddy's testimony are the correct ones.

As noted above, Mr. Gibson did not file any true-up testimony regarding the Company's actual capital structure. He did, however, confirm that the Company's common equity as of June 30, 2001, was $231,960,394. (Gibson True-Up Rebuttal, Ex. 120, p. 6, lines 15-16). And he did not dispute Ms. McKiddy's statement that the actual common equity percentage of total capital, as of June 30, 2001, was 37.76%.

The Commission should therefore find that the Company's capital structure consists of 37.76% common equity, 7.88% preferred stock, and 54.36% long-term debt.

Cost of Capital

Method of Determining Weighted Cost of Capital

Weighted cost of capital is determined, as shown in Schedule 5 to Ms. McKiddy's True-Up Direct Testimony, by: multiplying the common equity percentage by return on equity ("ROE"); multiplying the preferred stock percentage by its embedded cost; multiplying the long-term debt percentage by its embedded cost; and then adding the products. The cost of capital thus depends upon six variables. There was no dispute on the values of four of these six variables as of June 30, 2001.

There was a dispute regarding the proper ROE, but ROE is not subject to true-up. For the reasons explained in the Staff's Initial and Reply Briefs, the Commission should establish the ROE within the range of 8.50% to 9.50%.

Ms. McKiddy testified that the embedded cost of the Company's long-term debt is 7.87%, whereas Mr. Burdette calculated it to be just slightly more, at 7.88%. Mr. Gibson did not file true-up testimony on the embedded cost of long-term debt. The Commission should find that the embedded cost of long-term debt is 7.87%.

The Embedded Cost of Trust Preferred Stock

The only variable on which there was substantial dispute at the true-up hearing was the embedded cost of trust preferred stock. The Staff and the Company both contend that the embedded cost should be calculated in the same way that the embedded cost of debt is calculated. The OPC, on the other hand, contends that it should be calculated in the same way that the embedded cost of equity is calculated.

The Company's preferred stock consists of Trust-Originated Preferred Securities, known as "TOPrS." These securities were issued in the following manner. The Company created a subsidiary trust, known as Empire District Electric Trust I. This trust sold preferred stock to investors. (Tr. 1202, lines 9-22). The trust used the proceeds from this sale to lend money to the Company for a term of 30 years. (Tr. 1202, line 23 -- Tr. 1203, line 11; Tr. 1203, lines 3-7). Whenever the Company pays the trust interest on this debt, the trust must pay dividends to the holders of the preferred stock. The Company is obliged to repay its debt to the trust in full on March 1, 2031, and the trust must then redeem the preferred stock. The investors thus hold preferred stock that is backed by long-term debt. (Tr. 1203, lines 9-11).

All three of the witnesses on this subject testified that the TOPrS are more like debt than they are like equity. Mr. Gibson stated that TOPrS "has more characteristics of debt than it does common equity." (Tr. 1209, line 10 – Tr. 1210, line 2). Ms. McKiddy said: "I'm taking the position that this particular instrument that I'm looking at does have characteristics that are more like debt than like equity, and, in this particular case, they need to look at the TOPrS as a debt." (Tr. 1218, line 24 – Tr. 1219, line 3).

Even OPC witness Burdette stated that "absent a ruling from this Commission that they are equity, I believe TOPrS are debt." (Tr. 1225, lines 21-23). Mr. Burdette also testified that the TOPrS have a definite redemption date (Tr. 1229, lines 20-24) and that he did not believe the TOPrS would have indentures with covenants (Tr. 1229, lines 9-14), and he acknowledged that Empire backs up the dividend payments with unsecured debt (Tr. 1230, lines 6-10). Although Mr. Burdette said that TOPrS have characteristics of both debt and equity, the only equity characteristic he could think of was that they pay "what is called a dividend." He then added: "I answered already that I consider TOPrS essentially to be debt." (Tr. 1229, lines 3-8).

Clearly, the only basis for Mr. Burdette's conclusion that TOPrS are equity was the "ruling from this Commission" in Case No. GR-96-285, a rate case filed by MGE. The Commission's Report and Order in that MGE case did recognize TOPrS as equity, but only for the purpose of meeting financial benchmarks, according to Staff witness McKiddy. (Tr. 1216, lines 6-11; Tr. 1217, lines 5-10). As Ms. McKiddy pointed out, the Commission regarded TOPrS as equity only in order to determine that MGE met the criteria it had to meet in order to file a rate case; but the Commission did not declare that TOPrS were equity for the purpose of calculating costs associated with it. (Tr. 1219, line 13 – Tr. 1220, line 2). Mr. Burdette also conceded that the basic issue that the Commission determined in the MGE case was that for purposes of meeting the benchmark, TOPrS would be considered as equity. (Tr. 1234, line 25 – Tr. 1235, line 4).

TOPrS are a hybrid, neither clearly debt nor clearly equity. But because all three witnesses testified that they are more like debt than equity, and there is no evidence that the Commission treated them as equity when calculating the embedded cost of the TOPrS in the

MGE case, the Commission should calculate the embedded cost of the TOPrS in the same way it calculates the embedded cost of debt.

OPC witness Burdette testified that the proper method of calculating the embedded cost of long-term debt is to deduct the unamortized debt issuance expense from the amount outstanding and then include a yearly amortization expense. (Tr. 1227, line 23 – Tr. 1228, line 8). That is the method Ms. McKiddy used to calculate the embedded cost of the TOPrS.

The Commission should find that the embedded cost of the TOPrS is 8.88% and the weighted cost of capital is within a range of 8.19% to 8.57%, as shown in Schedule 5 of Ms. McKiddy's True-Up Direct Testimony (Ex. 124).

IV. CONCLUSION

WHEREFORE, for the above-stated reasons, the Staff requests that the Commission adopt the Staff position on the true-up issues presented in this case.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 30th day of August 2001.

Dennis L. Frey

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