LAW OFFICES
BRYDON, SWEARENGEN & ENGLAND
PROFESSIONAL CORPORATION
312 EAST CAPITOL AVENUE
P. O. BOX 456
JEFFERSON CITY, MISSOURI 65102-0456
TELEPHONE (573) 635-7166
FACSIMILE (573) 635-3847
E-MAIL: DUFFY@BRYDONLAW.COM

DAVID V.G. BRYDON
JAMES C. SWEARENGEN
WILLIAM R. ENGLAND, III
JOHNNY K. RICHARDSON
GARY W. DUFFY
PAUL A. BOUDREAU
SONDRA B. MORGAN
CHARLES E. SMARR

DEAN L. COOPER
MARK G. ANDERSON
TIMOTHY T. STEWART
GREGORY C. MITCHELL
BRIAN T. MCCARTNEY
DALE T. SMITH
BRIAN K. BOGARD

OF COUNSEL
RICHARD T. CIOTTONE

August 30, 2001

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

Mr. Dale Hardy Roberts
Executive Secretary
Missouri Public Service Commission
Governor Office Building
Jefferson City, Missouri

HAND DELIVERED

RE: Case No. ER-2001-299
The Empire District Electric Company

Dear Mr. Roberts:

Enclosed for filing in the above-referenced proceeding please find an original and eight copies of the Initial Brief of The Empire District Electric Company on True-up Issues.

Both a hard copy and an electronic copy has been sent to all counsel and an electronic copy has been sent to Judge Ruth per her request.

If you have any questions, please give me a call.

Sincerely yours,

Gary W Duffy

Gary W. Duffy

Enclosures
cc w/encl: Office of Public Counsel
Office of the General Counsel
Stuart W. Conrad

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

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

FILED[3]

AUG 3 0 2001

Missouri Public Service Commission

INITIAL BRIEF OF

THE EMPIRE DISTRICT ELECTRIC COMPANY

ON TRUE-UP ISSUES

James C. Swearengen MoBE# 21510
Gary W. Duffy MoBE# 24905
Brydon, Swearengen & England, P.C.
312 East Capitol Avenue
Jefferson City, Missouri 65101

Attorneys for
The Empire District Electric Company

August 30, 2001

110

TABLE OF CONTENTS

I. INTRODUCTION AND SUMMARY

This initial brief addresses the "true-up" issues which were heard by the Commission in the hearing held on August 23, 2001. The Commission should rule that revenue requirement should be increased by $884,042 (which is the total company number of approximately $1,027,000 multiplied by .8604 which is the Missouri jurisdictional allocator) to account for property taxes on the increased plant in service recognized by the true-up audit. It should also rule that the issuance cost for the trust originated preferred securities issued by Empire in March 2001 should, in accordance with Generally Accepted Accounting Principles ("GAAP"), be recovered over the 30 year life of those securities. The Commission should also rule that Empire's capital structure for purposes of this rate case should be 45% common equity, 7.9 % trust preferred, and 47.1% long term debt and its authorized return on common equity should be 11.5 to 12 percent.

In considering these true-up issues, the Commission should also keep in mind the status of the remainder of the issues in this case. The parties have worked hard to reach agreement on a number of very complex and thorny issues. The parties are expecting the Commission to approve those agreements as a resolution of those respective issues. One of those issues subject to a pending settlement -- fuel and purchased power -- has a large but unique monetary impact on this case. That settlement provides that $19,643,484 of revenue requirement from this case is interim and subject to refund, depending upon actual fuel and purchased power costs. It will not be known until actual costs are experienced and audited how much, if any, of that $19,643,484 Empire will be allowed to keep. Therefore, the Commission needs to remember that of the overall revenue increase it authorizes in this case, up to $19,643,484 on an annual basis, plus interest, may be returned to ratepayers depending on actually experienced fuel and purchased power conditions.

II. PROPERTY TAXES ON NEW PLANT

Should the Commission increase the total company revenue requirement by approximately $1,027,000 ($884,042 Missouri jurisdictional) to account for property taxes on the $122,479,047 in additional plant in service recognized by the Staff in the true-up?

Summary

While the Staff has agreed that Empire's plant in service is $122,479,047 *greater* as a result of the true-up audit, the Staff has failed to recognize the Missouri property taxes that are directly associated with that increased plant. Empire will have to pay approximately $884,042 Missouri jurisdictional (approximately $1,027,000 total company) in annual property taxes on just those plant additions, but there are no dollars in Staff's proposed revenue requirement for that unavoidable legal obligation of Empire. The Staff has arbitrarily decided to cut off recognition of property taxes related to Empire's plant as of December 31, 2000, even though "property taxes" was an item specifically listed as a part of the true-up audit.

Facts

One result of the true-up audit performed by Staff was an increase of $122,479,047 in the amount of "plant in service" which the Staff recognizes as appropriate. (Tr. 1165). That $122,479,047 increase is the difference between the Staff's plant in service amount of

$909,895,340[1] as of December 31, 2000, and the plant in service amount of $1,032,374,387[2] as of June 30, 2001; just six months later. (Tr. 1165). That big jump in the amount of plant in service is mostly attributable to the completion of Empire's State Line Combined Cycle ("SLCC") power plant in late June of this year. (Tr. 1165). Empire's witness estimated that it accounted for about $98,000,000 of that total. (Ex. 120, p. 1). The remainder is simply other plant additions that Empire makes in the normal course of business.

Property taxes are an unavoidable legal obligation of Empire. The Staff witness conceded that Empire will have to pay property taxes on those plant amounts. (Tr. 1163). He admitted that there is no likely scenario under which Empire could escape paying these property taxes. (Tr. 1163-1164). He agreed that if Empire doesn't pay its property taxes, the government can sell Empire's property to the highest bidder in order to collect the taxes. (Tr. 1159).

Empire will be officially assessed by the state on this increased plant on or about January 1, 2002. (Tr. 1178). Empire will be required to pay the property taxes on this increased plant on or before December 31, 2002. (Tr. 1163). If the $884,042 (Missouri jurisdictional; $1,027,000 total company) Empire has requested in increased revenue to cover this legal obligation is built into its rates in this case as it requests, Empire will presumably collect that amount by October 1, 2002, just before it is required to turn around and make a payment for that amount to the various property taxing authorities. (Tr. 1193). If the $884,042 is ***not*** built into the rates established in this case, Empire's shareholders will have to pay for the property taxes on plant which is in

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[1] See Accounting Schedule 3-4 in Exhibit 32 (Staff Accounting Schedules, April 3, 2001)

[2] See Accounting Schedule 3-4 in Exhibit 128 (Staff Accounting Schedules, August 7, 2001)

service and serving the ratepayers. (Tr. 1155). There has been no allegation by the Staff that these property taxes are imprudent expenditures which should not be borne by the ratepayers.

Property taxes were specifically listed for consideration in this true-up. The "Order Setting Test Year, Setting True-Up Hearing and Adopting Procedural Schedule" issued January 4, 2001, explicitly provided on page 3 that "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 utility plant in service, accumulated depreciation, deferred taxes, fuel prices, cash working capital, capital structure and cost of capital, customer growth revenues, payroll, fuel and purchased power expense, depreciation expense, system loads, rate case expense, property insurance, income and **property taxes**, purchased power demand charges, and allocation factors." (Emphasis supplied).

The property tax amounts which the Staff has recognized in this case are the result of estimates made by the Staff, rather than exact amounts paid. (Tr. 1163). The property tax calculation by the Staff, as it stands at this time, only recognizes Empire's plant in service at December 31, 2000.

Argument

The essence of the Staff's position appears to be that because Empire will not actually make the property tax payments to the taxing authorities on this $122,479,047 until December 2002, it is (1) an estimate and (2) the payment is too far out into the future to qualify as a known and measurable item for Commission consideration. This Staff position belies some basic and simple facts and deprives Empire of sufficient revenue to meet lawful and unavoidable expenses.

First, it should not be a material concern that the number used for property taxes is an "estimate." The number the Staff has for property taxes in the case *right now* is an estimate.

According to Mr. Boltz, the Staff utilized a figure made up of current property tax levies to which Empire is subject, and applied it to the plant in service figure as of December 31, 2000, to reach a number. (Tr. 1167). Mr. Boltz conceded that was an "estimate." (Tr. 1162-1163).

Empire has done essentially the same thing. To quantify this issue, Mr. Gibson testified that Empire took the property tax rates in effect at the end of 1999 and simply applied that to this $122,479,047 in new plant the Staff has recognized. (Tr. 1150).

The use of an estimate is not prohibited. There are other estimates in the Staff's true-up case, such as the revenue amount assumed for "customer growth." (Tr. 1154). The use of reasonable estimates in rate-making is not something that is either unusual or inappropriate.

Mr. Boltz conceded that the property tax rates in the various taxing jurisdictions are not likely to fluctuate wildly from what it is right now. He termed it "minor variations." (Tr. 1161-1162).

Property taxes certainly qualify as "known" and "measurable" items in this situation. They are "known" because they are inescapable legal obligations. They are "measurable" in this case because the exact same method the Staff used to estimate an amount for them at December 31, 2000 can be applied to estimate them at June 30, 2001; just six months later. That is what Empire has done. The only difference in the equation is to change the amount of plant to which the ratio is applied. The amount of plant used is the amount the Staff recognized in the true-up.

Second, it should also be of little concern to the Commission that the property tax payment related to this increase in plant will not be paid until December 2002. That payment date for the taxes is not going to change. Empire cannot escape making the payment. As noted above, if the amount requested by Empire is built into rates in this case, it will be about October 2002 before Empire collects enough in revenue to pay the tax bill attributable to that new plant added between January 1, 2001 and June 30, 2001. That, of course, assumes that the estimates built into this case for customer usage are correct. If they are not, it could take Empire either a longer or a shorter period of time to collect the $884,042. If the estimates are reasonably correct, though, Empire would not collect the full amount until a year after the new rates go into effect. That is only about 90 days before it will have to write a check to the various taxing authorities for these property taxes. Therefore, Empire will not have some "windfall" recovery on this expense item.

If the Commission wishes to attempt to be even more exact on this, it could certainly perform an adjustment to ensure there is no over-collection. It could reduce the $884,042 amount by an assumed discount rate to reflect that Empire might collect the amount 90 days before it was due. This would likely be a small adjustment.[3]

If the Commission includes the $884,042 amount requested, Empire will be fortunate to collect just enough to pay the tax bills for this particular property. Of course, even if the Commission includes the full $884,042, it still will not be enough to pay the tax bill for <u>all</u> of the property on which Empire will be assessed on January 1, 2002. Even with this true-up, Empire will still be adding plant during the rest of 2001 after the cut-off of the up-date period at June 30. Empire can never "catch up" and have a level of property taxes in rates that corresponds to its plant balance as long as historical plant balances are used for rate-making purposes. That fact, in and of itself, is reason for the Commission not to attempt to reduce the $884,042 figure for the

[3] As a simple example, assume Empire collects the $884,042 as of October 1, 2002 in rates and then deposits it with a bank and earns interest on it at 5 percent for three months before it has to pay the taxing authorities. It might earn about $11,050 in interest in three months under the assumptions. Even if you double the assumed interest rate to10 percent (a rate that may be very difficult to find) it is still a relatively small amount compared to the amount that Empire will have to pay.

time value of the money in this instance.

III. CAPITAL STRUCTURE/RATE OF RETURN

A. What capital structure is appropriate for Empire?

Empire has presented competent and substantial evidence which demonstrates that its proposed capital structure of 45% common equity, 7.9% trust preferred ("TOPrS") and 47.1% long term debt should be utilized by the Commission for purposes of this case. Although this is neither Empire's actual test year or updated test year capital structure, nonetheless it should be adopted by the Commission for the reasons stated by Empire through its evidence and briefs. That is because it represents a "normal" capital structure for the Company.

As a result of the true-up, the Commission Staff and Public Counsel now argue that the Commission should adopt Empire's capital structure as of June 30, 2001. However, as with the test year capital structure, this updated capital structure does not represent a "normal" capital structure for Empire. (Ex. 120, p. 5). Stated another way, Empire's updated test year capital structure is inappropriate to use for rate-making purposes because it is not representative of Empire's historical capital structure, nor is it representative of the capital structure which Empire will have in place in the future when the rates established in this case will be in effect. (Ex. 16, p. 25). Both Empire's test year and updated June 30, 2001 capital structures are anomalies and neither should be used for rate-making purposes. The evidence demonstrates that since 1992 and prior to Empire's failed merger with UtiliCorp United Inc., Empire's common equity ratio ranged between 45% and 50%. A 45% plus equity ratio is where Empire has been in the recent past and that is the direction where it is headed in the future. (Tr. 404).

The effect of using an abnormal capital structure, as proposed by the Staff and Public

Counsel, coupled with an abnormally low authorized return on common equity, will result in an unfair and unreasonable overall rate of return for Empire. (Ex.120, p. 5).

Of particular interest is a proper consideration of the evidence which the Staff now uses in support of its 37.76% common equity ratio. The Staff argues that because the average common equity ratio for a group of electric utilities is 38%, this mandates a similar result for Empire. This comparison, however, really underscores the point which Empire is attempting to make. The facts are that the <u>authorized</u> returns for those electric utilities cited by the Staff average 11.91% and the actual return on equity <u>earned</u> by those same utilities averages 13.2% (Ex. 120, p. 5). It is inconsistent and inappropriate for the Staff to argue the average equity ratio for a group of utilities authorized to earn nearly 12% justifies a 38% common equity ratio for Empire <u>when the corresponding return on equity suggested by the Staff for Empire is a meager 8.5% to 9.5%</u>!

The appropriate capital structure for Empire for purposes of this case is 45% common equity, 7.9% trust preferred and 47.1% long term debt. This capital structure, coupled with a reasonable return on common equity, is absolutely essential to produce a fair overall return as well as just and reasonable rates for Empire in this case.

B. Should the issuance costs associated with Empire's TOPrS be included as part of the imbedded cost of debt?

The Public Counsel seeks a ruling in this case that Empire's trust preferred securities or "TOPrS" are either debt or equity for all regulatory purposes. This, however, is not the issue before the Commission. It would be unwise for the Commission to make such a broad policy determination in any event because TOPrS, as a hybrid security, have characteristics of both debt and equity. The Commission needs to remain flexible and decide TOPrS related issues on a case-by-case basis as dictated by the particular facts in each instance.

The facts in this case are as follows: Empire issued TOPrS in March of 2001 and incurred issuance expenses in the amount of approximately $1.6 million. (Ex. 121, p. 2). The issuance costs will be amortized over their 30 year life as required by GAAP. (Ex.121, p. 2). The proceeds from TOPrS were used to fund the general operations of the Company. There is no allegation that these proceeds and the related issuance costs did not benefit customers. (Ex. 121, p. 3; Tr. 1227). In fact, the opposite is true. In connection with the issuance of its TOPrS, Empire created a trust which makes payments to the holders of the TOPrS. Empire has issued $50 million in unsecured debt to this trust which guarantees the TOPrS dividend payments. (Ex.121, p. 2; Tr. 1203). The TOPrS dividend rate is 8.5%. (Tr. 1232). Both the TOPrS and the unsecured debt will be retired in 2031. (Tr. 1204; 1229).

TOPrS have characteristics of both debt and equity. For example, TOPrS are issued for a definite term and are treated as debt by the Internal Revenue Service. This feature results in a benefit for Empire's customers. (Tr. 1207; 1211). TOPrS costs or payments, however, are referred to as "dividends" and the instruments receive equity treatment by Standard and Poor's up to approximately 10 percent of total capitalization. (Ex. 121, p. 1; Tr. 1205).

In this case, there is no argument that Empire has experienced costs associated with issuing the TOPrS. As indicated, according to GAAP, these issuance costs are required to be amortized over the life of the asset. (Ex. 121, p. 2).

Both the Company and the Staff believe that these issuance costs should be included in the calculation of the imbedded cost of the TOPrS for capital structure purposes in this case. This is the manner in which the embedded cost of long term debt is calculated for rate-making purposes. (Tr. 1227; 1228). The Public Counsel, on the other hand, claims that the TOPrS issuance costs should be excluded. As a result of this dispute, Public Counsel says the imbedded cost of Empire's TOPrS is 8.77%, while Empire and the Staff believe that the imbedded cost is 8.88%. This difference translates into approximately $52,000 in revenue requirement. (Tr. 1224-1225).

The sole basis for the Public Counsel's position appears to be a prior decision of this Commission in a case involving Missouri Gas Energy. That case can be easily distinguished. The MGE case, Case No. GR-96-285, reported at 5 Mo. P.S.C. 3d, 437, concerned the issue as to whether or not MGE could implement a general increase in non-gas rates. At the time it acquired its Missouri properties in Case No. GM-94-40, Southern Union agreed that it would not implement a general increase for non-gas rates until its total debt to total capital ratio did not exceed a certain Standard and Poor's benchmark. The issue arose in the subsequent rate case, GR-96-285, as to whether or not the TOPrS issued by Southern Union should be considered debt or equity for the purposes of this contractual condition. The Commission found that Southern Union's TOPrS did constitute the creation of equity insofar as compliance with the contractual condition in Case No. GM-94-40 was concerned, and therefore, Southern Union was entitled to implement a general rate increase. In that same proceeding, however, even though the Commission declared TOPrS to be equity for those purposes, the issuance costs related to the Southern Union's TOPrS were treated as debt and included as a part of the embedded cost for capital structure purposes. (Tr. 1216; 1218; 1220; 1240). This is the same treatment Empire seeks in this case; that is, treat TOPrS as debt for purposes of determining the embedded cost of capital.

Clearly, the fact that Empire has incurred costs in issuing the TOPrS; the fact that the TOPrS have a definite redemption date; the fact that the issue costs associated with the TOPrS are amortized by Empire over the life of the securities as required by GAAP; and further given that in the past this Commission has included TOPrS issuance costs as a portion of the imbedded cost of that security, are all reasons why Empire and the Staff should prevail on this issue.

C. What return on common equity is appropriate for Empire?

The appropriate rate of return on common equity for Empire in this case is in a range from 11.5% to 12%. The Public Counsel continues to support a range of 10% to 10.25%. The Staff continues to argue for a range of 8.5% to 9.5% (Tr. 1231, 1232), the topside of which is only marginally above the 8.5% dividend rate of Empire's TOPrS -- a rate which is essentially "guaranteed." (Tr. 1232). Empire is hopeful that in its Initial True-Up Brief, the Staff will finally concede that its DCF calculation is flawed and will make an appropriate upward adjustment in its recommended rate of return.

IV. CONCLUSION

The Commission should rule in accordance with the positions advocated by Empire herein.

Respectfully submitted,

James C. Swearengen MoBE# 21510
Gary W. Duffy MoBE# 24905
Brydon, Swearengen & England, P.C.
312 East Capitol Avenue
Jefferson City, Missouri 65101
Email: Duffy@Brydonlaw.com

Attorneys for
The Empire District Electric Company

Certificate of Service

The undersigned certifies that a true and correct copy of the foregoing document was either hand delivered or placed with the U.S. Postal Service, first class postage prepaid, this 30th day of August, 2001, to the Office of the General Counsel, Office of the Public Counsel, and Stuart W. Conrad.

Gary W. Duffy

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