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July 20, 2001

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Service Commission

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 **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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cc: Counsel of Record

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

INITIAL BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION

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July 20, 2001

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INITIAL BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION

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

I. INTRODUCTION

On November 3, 2000, The Empire District Electric Company ("Empire" or "Company") submitted to the Missouri Public Service Commission ("Commission") proposed tariff sheets that would increase rates for electric service provided to its Missouri customers, along with testimony supporting the proposed rate increases. The proposed tariff sheets bear an effective date of December 3, 2000 and were designed to produce an annual increase of $41,467,926.00 (approximately 19.3%) in Empire's electric revenues.

Staff's Initial Brief is organized in accordance with the issues in this case, as set forth in the Revised List Of Issues, List Of Witnesses And Order Of Cross-Examination, filed on June 4, 2001, with the exception that Item No. 8 ("True-Up Issues") in said List of Issues does not appear, since these issues have been deferred to the true-up phase of this proceeding.

During the course of the proceeding, several major issues were settled among the parties via stipulation and agreement, including fuel and purchased power expense, class cost of service and rate design, the appropriate in-service criteria for the new State Line Combined Cycle plant ("SLCC"), and the capital costs for the SLCC to be included in rate base (in the event that the SLCC is placed in service in this case). Since these issues are not contested among the parties, no arguments regarding them are presented herein. Several issues remain contested, however, including such major ones as depreciation and capital structure/rate of return. Presented below are the Staff's arguments regarding the contested issues.

II. ARGUMENT

A. Depreciation

Empire is entitled to the opportunity to recover its depreciation expense in rates. This Commission has broad discretion in determining depreciation. See *State ex rel. Capital city Water Co. v. Public Service Commission of Missouri*, 298 Mo. 524, 252 S.W. 446, 451-452 (Mo. banc 1922). Depreciation is the lessening of price or value.[1] (Adam Rebuttal, Ex. 34, p. 3, l. 5 to p. 4, l. 4). The Missouri Supreme Court at least twice has quoted with approval the explanation for depreciation stated by the U.S. Supreme Court in *Lindheimer v. Illinois Bell Telephone Co.*, 292 U.S. 151, 54 S.Ct. 658 (1934) that follows:

> 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.

[1] Webster's Third New International Dictionary Unabridged, published by C. & G. Merriam Company of Springfield, Massachusetts, copyright 1976, has the following definitions for depreciate: 1. to lessen in price or estimated value; lower the worth of 2. to represent as of little value or claim to esteem.

It has the following definition for depreciation accounting: a branch of accounting that deals with systematically distributing or allocating the cost or other basic value of a fixed asset over its estimated useful life by periodic charges to expense or against revenue.

> 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 in the service rendered.

(*State ex. Rel Martigney Creek Sewer Co. v. Public Service Commission*, 537 S.W.2d 388, 397 (Mo. banc 1976); *State ex rel City of St. Louis v. Public Service* Commission, 341 Mo. 920, 110 S.W.2d 749, 767-768 (banc 1937)). For example, if an electric turbine-generator can be maintained for 50 years to generate electricity before it is retired and it had an original value of $50 million, then it depreciated $50 million over 50 years or, on average, $1 million per year. However, because the actual retirement date is not known at the time the plant is put into service, it is necessary to estimate the service life of each piece of plant. In the testimony of Staff witness Paul W. Adam this estimate is called the "average service life" ("ASL").

Amounts In Dispute

As shown in the Revised Reconciliation of Parties' Positions on the Revenue Requirement Issues prepared by the Staff (Ex. 119), exclusive of the State Line Combined Cycle unit, it is Empire's position that, based on calendar year 2000, it has Missouri jurisdictional depreciation expense of $28,445,716 per year. In contrast, the Staff, based on the same calendar year and exclusive of the State Line Combined Cycle unit, has determined Empire's Missouri jurisdictional depreciation expense to be $18,249,834 per year (Ex. 119; Ex. 32, Sch. 5-4). The difference between these positions is $10,195,882. Of this difference $2,832,250 is attributable to net salvage, $1,699,350 is attributable to differences in amortizing net salvage and $5,664,500 is attributable to differences in plant average service lives. (Ex. 119). Thus, before true-up and exclusive of the State Line Combined Cycle unit, for the depreciation issue, Empire seeks inclusion of $10,195,882 in its annual revenue requirement over that which the Staff recommends, and an associated additional increase in rates.

The Staff estimates that the annual depreciation expense for the State Line Combined Cycle unit, when it is in service, will be $4.02 million without Missouri jurisdictional adjustment. (Adam Direct, Ex. 33, p. 26, l. 30). When the allocation factor of 0.8013 developed by the Staff for State Line units is applied to this annual depreciation expense (See Ex. 32, Sch. 3-3, ll. 51-57) the Missouri jurisdictional depreciation expense that the Staff would recommend for the State Line Combined Cycle unit is $3.219 million.

Issues

In its statement of positions filed in this case on May 15, 2001, the Staff stated its positions on the issues the parties agreed are before the Commission. The Staff's positions on the issues relating to depreciation are presented below together with Staff's argument in support of those positions.

1. **Should Empire's test year depreciation expense be adjusted [(issue 1.(A) of the issues list)]?**

   <u>Staff's Position</u>: The Staff is proposing new depreciation rates, to be used on a going-forward basis.

The Staff proposes to use historical information and engineering knowledge of the plant as the bases for establishing the depreciation expense to be used for setting rates for Empire in this case. The Staff's approach is to "determine depreciation rates that allow the Company to collect from customers the original cost of the plant over the average service life (ASL) of the plant." (Adam Direct, Ex. 33, p. 18, ll. 21-23). To permit the recovery of the net salvage cost of life span plant in the event of the retirement and removal of that plant, the Staff proposes to sponsor an amortization that will permit the company to recover an appropriate amount from customers related to the retirement and removal beginning at the time the plant is retired and removed. (Adam Direct, Ex. 33, p. 19, ll. 2-6).

The Staff also proposes to consider the net salvage cost of interim retirements of life span plant and final retirements of mass property independently of depreciation, i.e., not to include this net salvage cost in any fashion when setting depreciation rates. Instead, the Staff proposes to treat this net salvage cost as a separate expense item where the amount of this net salvage cost is based on the actual net salvage cost that the company has incurred in the recent past. (Adam Direct, Ex. 33, p. 3, ll. 4-6). Like its approach to setting depreciation expense, this approach is also based on actual cost data and is not an estimate.

2. **What are the appropriate average service lives for plant in service other than at State Line Power Plant [(issue 1.(A)(1) of the issues list)]?**

Staff's Position: The average service lives appearing in the direct testimony of Staff witness Paul Adam, which reflect information obtained in meetings with key Empire personnel, are appropriate.

3. **What are the appropriate average service lives for plant investments [at the State Line Power Plant (issue 1.(B)(2) of the issues list)]?**

Staff's Position: The Staff believes that the average service life previously established for State Line No. 1 remains appropriate. For the Combined Cycle unit, the design life of 35 years is currently appropriate for the determination of the depreciation rate.

The specific average service lives that the Staff proposes are set forth in schedule 1-1 to 1-4 under the column labeled "LIFE" under the header "STAFF'S PROPOSAL" (Adam Direct, Ex. 33, Sch. 1-1 to 1-4).

Where possible, the Staff used mortality data from Empire to determine the average service lives of Empire's plant. This data was available for some plant because Empire, in part, complied with this Commission's rule that requires companies such as Empire to maintain records of different types of plant in different accounts designated by the Federal Energy Regulatory Commission, and plant mortality data is one of those types of records that Empire is required to keep. (Adam Direct, Ex. 33, p. 19, ll. 7-19.) Staff engineers toured Empire's major power plant facilities and met with Empire's engineers to verify the integrity of Empire's mortality data. Where the plant recorded in a particular account was a large number of similar units (mass property), for example transmission poles, and Empire provided mortality data—the date each unit was placed in service and the date it was removed from service—for the account, the Staff used that mortality data to determine the average service life of that plant. To do so, the Staff graphed the mortality data (percent dollars surviving vs. age), thereby creating survivor curves. In accounts where none of the oldest plant is 100% retired these survivor curves do not allow a direct calculation of average service life by integrating the area under them. However, with the use of engineering judgment, the Staff compared the survivor curve it generated for each account to type curves with known characteristics ("Iowa curves") and, thus, was able to derive an average service life for the plant in that account. (Adam Direct, Ex. 33, p. 20, ll. 6-13; Adam Surrebuttal, Ex. 35, p. 2, l. 17 to p. 3, l. 2; Tr. 219, l. 15 to Tr. 220, l. 18; Tr. 256, l. 19 to Tr. 258, l. 17).

Where Empire failed to provide to the Staff the historical mortality data it is required to maintain by Commission Rule, the Staff determined average service lives based on information it gleaned during tours of Empire's major power plant facilities and the results of the Staff's depreciation study made for Case No. ER-94-174. The Staff concluded that the average service lives found in that depreciation study are still appropriate. (Adam Direct, Ex. 33, p. 20, l. 14 to p. 21, l. 2).

For Empire's State Line Combined Cycle Unit which was not in service, due to the lack of any better means of determining an average service life, the Staff relied on the design engineer's stated design life of 35 years for the average service life of that new plant. (Adam Direct, Ex. 33, p. 21, l.3 to p. 23, l. 12; Tr. 256, l. 19 to Tr. 257, l. 12). This is the same service life that Empire relied on for that unit. (Loos Direct, Ex. 11, Sch. LWL-1, p. 4-4, Table 4-2, fn. (b); Loos Direct, Ex. 11, Sch. LWL-1, p. 6-2).

For its transmission, distribution and general plant, Empire used the same average service life approach as the Staff. (Loos Direct, Ex. 11, Sch. LWL-1, pp. 5-1 to 5-4).

Where it was available the Staff relied on mortality data to determine average service lives of all of Empire's plant, including Empire's generating units. Although the Staff made inquiry, no Empire employees would submit to the Staff final retirement dates for any of Empire's generating plant. (Adam Rebuttal, Ex. 34, p. 4, ll. 16-19; Adam Rebuttal, Ex. 34, p. 5, ll. 4-9; Adam Rebuttal, Ex. 34, p. 7, ll. 1-10; Tr. 259, l. 13 to Tr. 260, l. 4). Unlike the Staff's approach, Empire, through its witness L.W. Loos, employs a fixed retirement date for each generating unit. This generates life spans for plant at that generating unit that Empire then uses in lieu of average service lives in determining depreciation expense. In this case, with the exception of its Riverton units 7, 8 and 9 (Tr. 136, l. 10 to Tr. 137, l. 9) , Empire relies solely on the judgment and experience of L.W. Loos of Black & Veatch Corporation for those final retirement dates and resulting life spans. (Tr. 134, l.17 to Tr.137, l. 9; Tr. 156, l. 10 to Tr. 160, l. 21; Loos Surrebuttal, Ex. 31, p. 7, ll. 10-17). For Riverton units 7, 8 and 9, Empire's employees agree with L.W. Loos that, due to federal environmental regulation and the age and condition of the units, it anticipates the units will be retired about 2008. (Tr. 158, l. 6 to Tr. 159, l. 18).

Apparently recognizing the weakness in relying solely upon the judgment of L.W. Loos, for its life spans, Empire through the surrebuttal testimony of its witness L.W. Loos, presents depreciation rates based on plant life spans five years longer than those it used in deriving the depreciation rates that it recommends to this Commission. (Loos Surrebuttal, Ex. 31, p.15, ll. 1-20 ; Sch. LWL-5).

While Empire proposes plant life spans by each generating unit using a fixed date for retirement of all plant at each such unit (Loos Direct, Ex. 11, Sch. LWL-1), the Staff proposes average service lives for each type of plant based upon the FERC account into which it falls and the nature of the energy source that is converted into electricity (Adam Direct, Ex. 33, Schs. 1-1 to 1-4). Under the Staff's approach plant remains in service until it is retired; therefore, there is no fixed retirement date for the plant. Empire's approach of using life spans—an estimated retirement date for each particular generating unit—has the effect of truncating the survivor curves that the Staff employed to determine average service lives and, thus, Empire proposes shorter lives than the Staff. (Tr. 257, l. 15 to Tr. 259, l. 6). Further, this difference in approach, and the data presented by Empire in testimony, makes a direct comparison of proposed service lives impracticable for much of Empire's generation plant; however, where it is practicable, Staff witness Adam has made such a comparison in the column headed "life" under the three columns headed "company's proposal" and in the column headed "life" under the two columns headed "Staff's proposal" in schedule 1-1 to 1-4 attached to his direct testimony. (Adam Direct, Ex. 33, Sch. 1-1 to 1-4). As can be seen from that schedule, generally the Staff and Empire do not differ greatly on the average service lives they propose for plant where such a comparison can be made. Therefore, the above $5,664,500 difference in depreciation expense between the Staff and Empire relating to differences between the Staff and Empire in plant lives are attributable to the retirement dates estimated by Empire witness L.W. Loos that are unsupported by Empire's employees.

Empire's witness L.W. Loos projects remaining services lives of eight years for Units 7, 8 & 9 at Riverton; 17 years for Units 10 & 11 at Riverton; 14 years for Units 1 & 2 at Asbury; 14 years for Unit 1 at Iatan; 22 years for Units 1, 2, 3 & 4 at Ozark Beach; 12 years for Unit 1 and 15 years for Unit 2 at Energy Center; and 29 years for Unit 1 and 35 years for Unit 2 at State Line (projected retirement date less year 2000). (Loos Direct, Ex. 11, Sch. SWL-1, Table 4-2). These projected retirement dates fly in the face of current conditions.

Empire's Units 7, 8 and 9 at Riverton represent 105.8 MW of Empire's base load capacity and nearly 15% (105.8MW / 715.8MW) of Empire's total capacity (excluding the State Line Combined Cycle unit). (Adam Rebuttal, Ex. 34, p. 4, ll. 16-18; Loos Direct, Ex. 11, Sch. LWL-1, p. 4-4, Table 4-2). Empire is earning clean air credits from these low cost electricity generators, in meetings with the Staff Empire's personnel would not support the retirement date of 2008 and Empire has no plans to replace the loss of the 105.8 MW these units can produce. (Adam Rebuttal, Ex. 34, p. 4, ll. 18-21).

Empire's Units 1 and 2 at Asbury represent 211 MW of Empire's generating capacity or nearly 30% (211MW / 715.8MW) of Empire's total generating capacity (excluding the State Line Combined Cycle unit). (Adam Rebuttal, Ex. 34, p. 5, ll. 4-9; Loos Direct, Ex. 11, Sch. LWL-1, p. 4-4, Table 4-2). Empire is earning clean air credits from these units that generate electricity at a relatively low production cost, Empire's personnel also would not support the 2014 retirement date presented by Empire witness Loos, and Empire's "personnel clearly stated that they have no plans to replace Asbury's 211 MW of low cost power." (Adam Rebuttal, Ex. 34, p. 5, ll. 6-9). In direct conflict with Empire's witness L.W. Loos' retirement date of 2014, Empire is committed to spend in late 2001, $10 million to replace cyclone burners, install a new computer-based control system and inspect the large turbine at these units. (Adam Rebuttal, Ex. 34, p. 5, ll. 9-12).

Empire owns 12% of the Iatan Power plant operated by Kansas City Power & Light. Through its witness L.W. Loos, Empire projects that this coal-fired generation plant that has a capacity of 667 MW will be totally shut down in 2014. Shutting down these low cost Riverton, Asbury and Iatan units that generate clean air credits would remove 993.8 MW of electric energy generation capacity from Missouri by 2014. Empire has presented nothing to show how this generational capacity will be replace if these units are retired as Empire predicts. (Adam Rebuttal, Ex. 34, p. 6, ll. 14-22).

The prediction of Empire's witness L.W. Loos that Empire will retire its hydroelectric generation capacity at Ozark Beach in 2022 is contradicted by representations of Empire employees to the Staff that Empire plans to replace the water wheels on all four existing hydro units in the next two to four years which will increase efficiency and power output, and that it is also considering adding three more power generation units. (Adam Rebuttal, Ex. 34, p. 7, ll. 1-10).

Empire's 1997 and 1998 load forecasts predicted that Empire would experience a capacity shortage beginning in 2001 of about 90 MW and increasing to about 135 MW by 2003. (Beecher Direct adopted from Brill, Ex. 5, p. 3, ll. 2-6). In response Empire ultimately decided to expand its generation capacity by building its State Line Combined Cycle unit. (Beecher Direct adopted from Brill, Ex. 5, p. 2, l. 7 to p. 10, l. 4). Empire's own current projections of load demand for the next 3-5 years show more demand than it is currently capable of producing, and, as with the State Line Combined Cycle unit, it is planning to add plant to meet that demand.

(Tr. 259, l. 18 to. Tr. 260, l. 25). Further, due to present demand and backlog, orders for combustion turbines must be placed with GE or Seimens Westinghouse five years before they are to be installed. (Tr. 261, l. 7 to 17).

While Empire does have plans to obtain a combustion turbine from an alternative supplier to meet the 3-5 years anticipated shortfall of its current plant, including the State Line combined cycle unit, it presently does not have plans to replace with another source any of the electricity generated by its existing power generating units that its witness L.W. Loos predicts will be retired. (Tr. 261, l. 18 to Tr. 262, l. 3). Further, Empire projects the load demand to increase more beyond five years into the future. (Tr. 262, ll. 6-10). Because Empire reasonably anticipates demand in the next 3-5 years that exceeds its current generation capacity but has not made plans to replace any of its current generating capacity in addition to adding plant to meet that additional load, this Commission should reject Empire's projected retirement dates and life span approach.

Additionally, it is worth noting that while Empire projects service lives of 35 years for its combustion and conventional steam turbines located at State Line, Energy Center and Iatan, it has three convention steam or combustion turbines at Riverton that presently are providing service that were placed in service in 1950, 1954 and 1964 and for which Empire, through its witness L.W. Loos, has projected a retirement date of 2008. (Loos Direct, Ex. 11, Sch. LWL-1, Table 4-2). These projected retirement dates yield life spans of 59, 55 and 45 years, respectively, far longer than the 35 years Empire proposes for similar type generating units at its other locations. Further, Empire, through its witness L.W. Loos, proposes a retirement date of 2022 for its hydroelectric generating units which it placed in service in 1931, based solely on the expiration of its current operating license. (Loos Direct, Ex. 11, Sch. LWL-1, Table 4-2). This retirement date conflicts with Empire's plans to replace the water wheels on all four of its hydroelectric generating units, possibly upgrading them. It also conflicts with Empire's consideration of adding three more hydroelectric generating units. (Adam Rebuttal, Ex. 34, p. 7, ll. 1-10).

In light of the willingness of Empire's witness L.W. Loos to rely on plant retirement dates that are unsupported by Empire's employees and to ignore Empire's projections that it will need additional capacity in the near future but has no plans to do more than add that needed capacity, i.e., it has no plans to replace existing capacity as well, the Staff has demonstrated the peril of relying on the recommendations of Empire's witness L.W. Loos in developing rates for Empire. The plant retirement dates upon which Empire's witness L.W. Loos relies would have the impact of increasing Empire's annual depreciation expense by $5.66 million over that which the Staff recommends. (Ex.119). Similarly, Empire's recommendation for annual net salvage cost is $4.53 million over that which the Staff recommends. (Ex. 119).

4. **How shall the net salvage component be treated [for plant other than at the State Line Combined Cycle unit (issue 1.(A)(2) of the issues list)]?**

Staff's Position: The Staff believes that only current net salvage costs should be considered and that they should be expensed.

5. **How shall the net salvage component be treated [for plant at the State Line Combined Cycle unit (issue 1.(B)(3) of the issues list]?**

Staff's Position: The Staff believes that only current net salvage costs should be considered and that they should be expensed.

Based on the average service life of the property in each account, the Staff determined the appropriate depreciation rate for that account to permit recovery of the original cost evenly (straight line) over the average service life, i.e., the Staff applied the following formula: 100% /

average service life = depreciation rate (% per annum). (See Adam Direct, Ex. 33, Sch. 1, p. 1-1). Depending upon the account, and thus the type of property, the Staff determined depreciation rates that range from 1.05% per annum (Adam Direct, Ex. 33, Sch. 1, p. 1-1, account no. 311.00, structures and improvements) to as high as 14.29% per annum (Adam Direct, Ex. 33, Sch. 1, p. 1-3, account no. 391.20, computer equipment). In the aggregate, the Staff recommends that, exclusive of the State Line Combined Cycle plant, $18,249,834 be included in Empire's annual revenue requirement for depreciation expense.[2] (Ex. 119). The Staff estimates that the annual depreciation expense for the State Line Combined Cycle unit, when it is in service, will be $4.02 million without Missouri jurisdictional adjustment. (Adam Direct, Ex. 33, p. 26, l. 30). When the allocation factor of 0.8013 developed by the Staff for State Line units is applied to this annual depreciation expense (See Ex. 32, Sch. 3-3, ll. 51-57) the Missouri jurisdictional depreciation expense that the Staff would recommend for the State Line Combined Cycle unit is $3.219 million.

In the past this Commission has included the net residual value of plant at the end of its service life as an adjustment to the original cost of the plant when determining depreciation rates. (Tr. 210, l. 16 to Tr. 211, l. 18). Rather than continuing to determine net salvage cost adjusted depreciation rates, in this case the Staff kept the determinations of net salvage cost and depreciation independent. (Adam Direct, Ex. 33, p. 18, ll. 20-23; p. 17, ll. 4-11; Featherstone Direct, Ex. 46, p. 17, ll. 8-16). This approach highlights the impact of net salvage cost by listing it as a separate expense item rather than burying its impact by including it as a component of the depreciation rate used to establish the annual depreciation expense.

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[2] Staff originally, based on calendar year 1999 recommended depreciation expense of $19,638,073. (Adam Direct, Ex. 33, p. 27, ll. 4-6; Adam Direct, Ex. 33, Sch. 1, pp. 1-1 to 1-3). The Staff's recommendation is now based on calendar year 2000; thus, the revised amount.

Net salvage cost is made up of two components. The first component is the gross salvage value of the plant. This component typically acts as an offset to the second component, the cost of removing the plant. For all accounts net salvage cost is viewed as an expense. (Featherstone Direct, Ex. 46, p. 16, ll. 4-13). Both of the components are based on future events that take place no earlier than the date that specific plant is retired and, in many cases, a considerable time thereafter.

A company may delay removing retired plant until long after it is retired, or it may not remove it at all. (Tr. 213, ll. 6-10; Tr. 263, ll. 20-24). Empire's own expert witness testified that generating plant typically remains in place for some time after retirement; i.e., neither salvage nor removal costs are realized at the time the plant is retired. Further, he testified that this is the case for Unit 6 of Empire's Riverton Plant which has neither been salvaged nor removed although it is retired. (Tr. 161, ll. 6-18). This ability of a company to chose the date it actually realizes a gross salvage value and/or cost of removal creates an opportunity for the company to manipulate the date it realizes net salvage cost, if it in fact realizes any net salvage cost, to reap more benefit than that predicted when net salvage value was set for rate purposes. This ability to manipulate the date net salvage cost is actually realized could easily lead to the over-recovery of net salvage cost from present ratepayers if Empire's approach is adopted.

In addition to this ability to manipulate the realization of net salvage cost, due to the long service lives of most plant, predicting the net salvage cost of plant at the end of its service life is fraught with uncertainty. (Tr. 272, ll. 19-21). For example, Empire has a hydroelectric power generating plant that it put in service in 1931 and coal-fired power generating units that it put in service in the 1950's. (Loos Direct, Ex. 11, Sch. LWL-1, p. 4-4). Within the past 50 years laws and regulations pertaining to environmental clean-up have dramatically impacted net salvage cost, often causing it to appear as an increase, rather than an offset, to overall company expense. (Adam Direct, Ex. 33, p. 17, ll. 11-23). Further, there is no guarantee that the utility now owning the plant will actually incur any of these environmental clean-up costs—it may transfer the contaminated site without first cleaning it up. (Tr. 197, l. 5-11). Moreover, numerous other assumptions must be made in predicting removal and clean-up costs. Among these assumptions are inflation rates and labor costs. (Adam Direct, Ex. 33, p. 17, ll. 16-19; Tr. 207, ll. 13-25; Tr. 207, ll. 13-25).

Due to these factors, the Staff elected to review the residual value of the plant that Empire has actually retired and use that as the basis for predicting the net salvage cost of the plant that is still in service. (Adam Direct, Ex. 33, p. 18., ll. 21-23; Featherstone Direct, Ex. 46, p. 16, l. 4 to p. 17, l. 22; Tr. 272, l. 13 to Tr. 273, l. 1). The Staff accomplished this by taking a five-year average of the plant that Empire has actually retired. It then included this five-year average as an expense for the appropriate recovery of net salvage cost by Empire in its authorized rate of return. (Featherstone Direct, Ex. 46, p. 16, l. 4 to p. 17, l. 22). With this approach the Staff avoids the need to predict when the plant will be salvaged; the need to predict when the plant will be removed, if at all; the need to estimate the salvage value at the predicted salvage date; and the need to estimate the removal cost at the predicted removal date. (Tr. 263, ll. 9-24). Further, since it is less speculative than Empire's approach, the Staff's approach is less likely to lead to over-recovery of net salvage cost from ratepayers.

Unlike the Staff, Empire seeks to have this Commission treat net salvage as part of the value of the plant to be depreciated and, thus, treat it as a factor to be included when setting the depreciation rate. Therefore, for a plant with an original value of $50 million, a 50-year useful life, an estimated salvage value of $2 million at the end of its useful life and an estimated removal cost at the end of its useful life of $12 million, Empire would seek depreciation of $60 million over the useful life of the plant or, on average, $1.2 million per year (($50 million - $2 million + $12 million) / 50 years).

While the Staff has amortized net salvage over the useful life of plant in the past and included net salvage when determining depreciation rates, the Staff does not consider net salvage to be a component of depreciation itself. (Adam Rebuttal, Ex. 34, p. 1, l. 13 to p. 4, l. 4). By the very nature of its proposal, unlike the Staff's approach which is based on removal costs and salvage values actually incurred, Empire seeks to have the Commission assume, for purposes of determining net salvage value, that the plant will be salvaged and removed on the date the plant's useful life is over. Included in the foregoing removal costs are the costs of removing hazardous materials such as asbestos. (Loos Direct, Ex. 11, Sch. LWL-1, p. 4-5; Tr. 272, l. 13 to Tr. 273, l. 1). As the Staff has indicated above, there is no assurance that Empire will necessarily incur the costs to remove retired plant, or when it will incur such costs. By its treatment of net salvage, the Staff is supporting that Empire recover net salvage cost at the rate it incurs the expense and recognizing that net salvage cost is independent of depreciation expense.

Using the Staff's approach, Empire will recover net salvage expense at the rate it recently has realized such expense; i.e., aside from the depreciation issue of plant life, Empire proposes to recover more in net salvage expense on an annual basis than it has realized in the recent past. This is seen by adding the amounts that Empire proposes over those proposed by the Staff on a Missouri jurisdictional basis as shown on the rows labeled "Difference associated with Net Salvage" and "Difference associated with Amortization of Net Salvage" on Exhibit 119 as follows: $2,832,250 + $1,699,350 = $4,531,600. Since the Staff's determination of Missouri jurisdictional net salvage expense of $1,065,342 (Ex. 32, Sch. 9-3, l. 98) is based on actual net salvage cost that Empire has incurred, and can be expected to incur in the near future, this $4.5 million difference represents the annual recovery of net salvage expense over that which it is realizing that Empire seeks.

6. **Should future additional plant investments be recognized [at Empire's State Line Power Plant (issue 1.(B)(1) of the list of issues)?**

Staff's Position: The Staff believes that proposed future plant investments should not be recognized because they are not known and measurable.

The Staff make no distinction in the appropriate treatment of future plant for Empire. Empire's State Line Combined Cycle unit is no different than its other plant except that as of the date of the hearing in this case it was not yet in service and due to the lack of historical data, the Staff used design life in lieu of average service life for purposes of determining an estimated depreciation expense for that plant. (Adam Direct, Ex. 32, p. 23, ll. 7-12). Because the Staff's approach is simply to "determine depreciation rates that allow the Company to collect from customers the original cost of the plant over the average service life (ASL) of the plant." (Adam Direct, Ex. 33, p. 18, ll. 21-23; Adam Surrebuttal, Ex. 35, p. 3, ll. 19-20), it would be inappropriate to recognize estimated future plant investments until the investments are actually made, i.e., the Staff would only recognize future expenditures after they are incurred. This approach parallels the statutory requirement that newly constructed plant to be "fully operational and used for service" before it can be considered in setting rates. §393.135, RSMo 2000.

During the evidentiary hearing in this case, Commissioner Murray posed to Staff witness Adam in the context of depreciation, and not net salvage value, the question following: "There is not necessarily any harm done by having fully depreciated a particular generating plant before it's retired?" Staff witness Adam responded with a qualified answer as follows: "As far as the customers are concerned, I believe your statement is reasonably correct, given that there are rate cases held on a reasonable frequency." In elaboration of that response the Staff, through the following example suggests that customer harm is a possibility. If depreciation expense for ratemaking purposes is based on a service life 30 years and the plant is actually in service for 50 years, then those customers during that first 30-year period will have paid in rates a portion of the depreciation expense that in theory should have been paid by customers during the subsequent 20-year period. If all customers are the same during the full 50 years then the total amount they pay is unchanged; however, timing issues arise. If the customers during the 30-year period differ from those in the later 20-year period, then the customers during the 30-year period have paid through rates all of the original cost of the plant and the customers during later 20-year period will pay no part of the original cost of the plant. Because rate cases allow for adjustments of depreciation rates to all accounts, erroneous predictions of service lives can be adjusted as the rates cases are ruled on and, therefore, the impact on customer rates due to erroneous predictions of service lives is unlikely.

Depreciation Recommendations

The Staff recommends the following:

1) That the Commission treat depreciation expense and net salvage value expense independently when determining rates in this case;

2) That the Commission base rates, exclusive of the State Line Combined Cycle unit, on Empire having Missouri jurisdictional depreciation expense of $18,249,834 per year;

3) That the Commission base Empire's rates on Empire having Missouri jurisdictional net salvage value expense of $1,065,3342 per year;

4) That the Commission, if the State Line Combined Cycle unit is in service before the conclusion of this case, base Empire's rates on Empire having Missouri jurisdictional depreciation expense of $3.219 million for that unit; and

5) That the Commission order Empire to submit to Commission Staff in Gannet-Fleming format the data for all of the FERC accounts it is to maintain as required by Commission rule 4 CSR 240-40.030.

B. Bad Debt

A certain level of bad debts, or uncollectibles, is typically built into utility revenue requirements as an expense. In this case, there is no disagreement concerning the amount of normalized bad debt expense to include in this case between the parties. Instead, Staff and Empire only disagree concerning whether the amount of uncollectibles should be automatically increased to take into account any overall revenue increase that may be ordered by the Commission in this case. Staff strongly disagrees that any kind of automatic factor-up of bad debts is appropriate.

Empire Witness William L. Gipson testified that "bad debt expense should be correlated with revenues and treated consistently in the context of this case." (Gipson Rebuttal, Ex. 21, p. 2, lines 7-8.) However, as Staff witness Roy M. Boltz, Jr. testified, "Staff does not believe there is any correlation between increased revenues and increased bad debts for Empire at this time." (Boltz Surrebuttal, Ex. 40, p. 1, lines 19-20.) Boltz further testified that "there is no direct correlation between revenues and bad debt expense," (Boltz Surrebuttal, Ex. 40, p. 2, line 5), as "there is no correlation between number of customers, revenues, and bad debts." (Boltz Surrebuttal, Ex. 40, p. 2, lines 3-4.) Mr. Boltz's assertions are fully supported by the information contained within Schedules 1 and 2 to his Surrebuttal Testimony. Empire witness Gipson himself testified that the Company's uncollectibles decreased in two of the last five years, even while revenues were increasing each year. (Gipson Surrebuttal, Ex. 28, p. 2, lines 3-5.) Therefore, revenues and customers may increase but bad debt expense (and actual write-offs) may decrease in any given year. (Boltz Surrebuttal, Ex. 40, p. 1, lines 22-23.)

In essence, what Empire is seeking in this case is for bad debts to be treated similarly to income taxes in the context of a rate increase ordered by the Commission. (Income tax expense is automatically factored up, and the associated increased in income taxes is automatically included in a utility's revenue requirement, in the event the Commission orders a rate increase for a utility.) However, the distinction between income tax expense and bad debt expense in this circumstance is crucial. When a utility orders a rate increase for a company, the fact that the utility will have to pay increased income taxes on a proportional basis as a result of the increased revenues is a known and certain fact. By contrast, whether uncollectibles will increase at all as a result of a rate increase and, if so, how much, can only be a matter of speculation by the parties to a rate proceeding and, ultimately, the Commission. Unlike the situation with bad debts expense, "[t]here is a direct relationship between income tax expense and revenue requirement levels….." (Boltz Surrebuttal, Ex. 40, p. 3, lines 5-6.)

So, should the Commission grant Empire an increase in revenues, it does not necessarily follow that bad debts will increase. (Boltz Surrebuttal, Ex. 40, p. 2, lines 5-8.) Other factors, such as weather or the Company's collection policies and efforts, could influence the outcome of bad debts. There is simply no way to predict whether bad debts will increase by a certain set factor. To attempt to do so would be mere speculation. Indeed, at the evidentiary hearing in this matter, Mr. Gipson was forced to concede that the relationship between revenues and bad debt write-offs in the last five years has varied greatly. (Tr., p. 309, line 21 through p. 310, line 22.) As for Mr. Gipson's contention that the Year 1999 and Year 2000 relationships between bad debts and revenues were affected by unusual situations (Tr., p. 307, lines 15-16), this hardly begins to explain the fluctuating relationship between the write-offs and revenues in previous years.

For these reasons, Staff encourages the Commission to rule in Staff's favor on the issue of a bad debt factor-up.

C. Payroll – Incentive Pay

The Staff recommends that the $323,000 of test year incentive awards should not be recovered in cost of service by Empire. (Ex. 113, Fischer Supp. Sur., p.1). There has been a considerable amount of confusion regarding this issue. At the evidentiary hearing the confusion started with the opening statement of counsel for Empire when he stated regarding Empire's position on this issue, "We believe this is also an approach that the Commission approved in a prior rate case, the one in 1997." (Vol. 5, Tr. 88). Empire's prior rate case was Case No. ER-97-81 which was a settled case except for the issues of whether State Line Combustion Turbine No. 2 was "fully operational and used for service" on June 21, 1997, which had been extended from a deadline of May 31, 1997, and whether the Commission should adopt a Competitive Market Research Project and Pilot Open Access Program proposed by ICI Explosives USA, Inc. and Praxair, Inc. and agreed to by Empire. The Unanimous Stipulation And Agreement filed on April 4, 1997 contained language that none of the parties to the Unanimous Stipulation And Agreement should be deemed to have approved or acquiesced in any ratemaking principle or any method of cost determination or cost allocation. *Re Empire District Electric Company,* Case No. ER-97-81, Report And Order (not including Unanimous Stipulation And Agreement or First Amendment To Unanimous Stipulation And Agreement) 6 Mo.P.S.C.3d 406 (1997).

Empire witness Myron W. McKinney testified that "the Incentive Awards were included in the Company's 1997 case and, while that case resulted in a stipulated settlement, Staff work papers in that case indicate the inclusion of incentive Payroll, so the Incentive Awards should not have been a new item to the Staff." (Ex.114, McKinney Supp. Sur., p. 4). The Unanimous Stipulation And Agreement provides that "[t]he Staff will submit to the Commission a memorandum explaining its rationale for entering into Paragraphs 1-7 of the Stipulation and

Agreement." On April 16, 1997, the Staff filed a Memorandum In Support Of Stipulation And Agreement. "Payroll/Incentive Compensation" is shown on page 6 as a stipulated item valued at $220,000. On page 9 appears the following entry:

5. Payroll/Incentive Compensation

Empire: During prehearing, sought inclusion of an incentive compensation payment made in February 1997.

Staff: Did not include this payment as it was outside the test year.

Staff Settlement Basis: Included payment in settlement of revenue requirement.

Adjustment to Staff Revenue Requirement:	$220
Value of Initial Difference Between Empire and Staff:	No initial difference; was not reflected in either Empire's or Staff's direct filing.
Related Stipulation & Agreement Paragraph:	None

(Vol. 9, Tr. 791-94).

Moreover, Mr. McKinney testified that the incentive awards at issue in this proceeding involve an incentive awards program that did not exist until 1997 and the first awards were made in February 1998 for calendar year 1997:

> [Mr. McKinney] Actually in -- there were incentive Awards made in 1996, in October of 1996. Those were not for the program that's in question here today that included the stretch goals and the base goals. That was on an older program that the company had. The first payments that were actually made that were based on the system that we're using today were made in February of '98, I believe, for calendar year '97.

(Vol. 9, Tr. 795). Staff witness Janis E. Fischer testified that although there were incentive awards related to 1996, the current incentive awards program was not effective until goals were set for the year 1997. (Vol. 9, Tr. 873).

Empire's response to Staff Data Request No. 318 adds to the confusion involving the incentive awards issue. (Ex. 115HC). Part of Empire's response to Staff Data Request No. 318 is pages from a document entitled "The Empire District Electric Company – Employee's Handbook: Performance, Compensation and Career Development Approach." Mr. McKinney identified the pages submitted in response to Staff Data Request No. 318 as containing Empire's incentive awards program. (Vol. 9, Tr. 801). On pages 1.5 and 1.2, respectively, of the pages provided by Empire appears, in part, the following information:

> Rewards fall into two categories:
>
> A) The **"Merit Increase" (adjustment to base salary) can adjust your pay based on the job value for your position and the contribution you have made to the business**. You must meet two criteria to be eligible for consideration for this award:
>
> 1) Must meet base objectives, and
> 2) The base salary must be less than job value
>
> . . . .
>
> B) The **"Incentive Award" (lump sum) can reward you for meeting or exceeding your Incentive Objectives defined in Part II**. To qualify for incentive awards, you must have been employed by the Company the entire performance year.
>
> Incentive Awards reward results that go beyond those normally associated with a position. These results tend to be fleeting; a project that results in a one-time contribution to the Company's bottom line or a team that successfully develops a process beneficial to the Company and then disbands. Results such as these are more appropriately rewarded on a one-time, lump-sum basis.

(Emphasis supplied).

. . . .

> ***Part II – Incentive Objectives***
>
> . . . **Incentive Objectives describe results which go beyond those normally associated with your position that, when accomplished, add significant financial, strategic or cultural value to the Company. An Incentive Objective should never be written simply as a means of**

> **giving an employee more money.** These objectives may be prioritized at the beginning of the performance year and re-evaluated periodically to determine if their order of importance has changed or the objective itself needs adjusted. It is important for you to know which incentives are strategically more important. Incentive Objectives should be viewed as the projects, process improvements, team assignments, etc. that continuously pull the Company into the future.

(Ex. 115HC; Emphasis in original text).

The Staff identified approximately $300,000 of Merit Awards and included that employee compensation in the Staff's test year payroll annualization because it represented permanent adjustments to employee' base salaries/wages rather than incentive awards. (Ex. 54, Fischer Sur., p. 8).

Questions from Staff Data Request No. 318 and Empire's responses follow. Empire's response to question 3 is particularly relevant:

> Question 1:
> 1. Please provide a list of employees that received bonuses, discretionary awards, etc. other than Lightning Bolts or money from the $300,000 pool provided in response to DR #271 in addition to their 12/31/00 wage/salary level during January-March 2001.
>
> Answer 1:
> 1. See attached
>
> Question 2:
> 2 List the dollar amount received for each of the employees listed in 1. above and when it was received.
>
> Answer 2:
> 2. See attached.
>
> Question 3:
> 3. Designate if the amount received was a lump sum or will be paid throughout the year 2001. Please explain in detail.
>
> Answer 3:
> 3. All Merit Awards (referred to as Incentive Awards in the employee handbook) are lump sum amounts received on the date indicated each year.
>
> Question 4:
> 4. What was the reason for each employee's bonus, award, etc.? Please explain in detail.

Answer 4:

4. See the employee handbook for reasons for the awards. Payroll maintains the individual authorizations from the managers on the amount of each person's award.

Question 5:

5. Does the money represent a permanent wage increase for each employee? Please explain in detail.

Answer 5:

5. These are not permanent wage increases. They [sic] one time lump sum awards.

Question 6:

6. Who determined the amount each employee received? Please explain in detail.

Answer 6:

6. See the employee handbook for who determines the amount of the awards.

Question 7:

7. Does Empire provide this pay increase bonus, award, etc. annually? If so, please provide the same information in questions 1-6 for the last five years. If not, please explain why the bonus, award, etc., was paid out to employees in 2000.

Answer 7:

7. The awards are paid annually after the performance evaluations have been completed for the year. The information regarding the awards for the last 5 years is attached.

(Ex. 115HC).

He related that as each year starts the officers decide how much money will be accrued on a monthly basis over the year, usually 2.0 – 2.5% of the payroll that is paid, for the lump sum incentive awards that are made in late February of the following year. (*Id.* at 813-14; Ex. 27, McKinney Sur., p. 2). Mr. McKinney explained that "the managers have a pretty wide discretion in the application of those monies" (Vol.9, Tr. 811):

> . . . Each manager is provided with an amount of money that he is to spread throughout his work force. If he felt that one individual in that group played such a major role to the exclusion of all others, all that money could go to one individual. That has never happened, of course, but the discretion is [sic] how to distribute that money within the work group is left to the managers.

> And just to take that one step further, the way that determination is made, the payroll or the incentive amounts that is to [sic] distributed is spread basically between the vice president [sic] as a percentage of payroll, they then spread it within their organizations. And they have discretion as how it is spread to their managers within the organization.

(*Id.* at 812-13).

The approach followed by the Staff is that compensation recovered from ratepayers should reward employees for performance that is both exceptional and beneficial to ratepayers, i.e., incentive compensation for the performance of normal job duties, or incentive compensation for exceptional performance that is not beneficial to ratepayers, should not be recovered from ratepayers. Incentive compensation for activity that is required or expected as part of the normal job duties is duplicative compensation and should not be recovered from ratepayers. Incentive compensation for the performance of job duties that directly enhance shareholder value rather than benefiting ratepayers through increased safe and reliable service should not be recovered from ratepayers. (Ex. 53, Fischer Reb., p. 10; Ex. 54, Fischer Sur., p. 10). Thus, the Staff would be opposed to recovery from ratepayers of incentive awards related to Empire attaining a specified return on equity and/or earnings goals, as well as performance of merger projects related to UtiliCorp's aborted merger with Empire, all of which items are of principal benefit to Empire's shareholders, not Empire's ratepayers. The Staff did not remove from its cost of service calculation Empire's Management Incentive Plan (MIP) relating to meeting electric Operations and Maintenance (O&M) expense and fuel and purchase power goals because those goals were of principal benefit to ratepayers. (Ex. 54, Fischer Sur., p. 10).

Staff witness Fischer testified that the Staff applied the criteria established by the Commission in a 1987 Staff excess earnings complaint case against Union Electric Company, Case No. EC-87-114 et al. where the Commission held that "[a]t a minimum, an acceptable management performance plan should contain goals that improve existing performance, and the benefits of the plan should be ascertainable and reasonably related to the incentive plan." (Ex. 113, Fischer Supp. Sur., p. 6; Ex. 54, Fischer Sur., p. 11; *Staff of the Missouri Public Service Commission v. Union Electric Company*, Report And Order, 29 Mo.P.S.C.(N.S.) 313, 325 (1987). There were seven goals in the plan. For each goal achieved, management employees were to receive a bonus of .3% over their base salary. The Staff opposed the management incentive plan on the basis that (1) UE had not determined the savings resulting from the plan and had made no offset to the cost of the plan by such savings, (2) there was no guarantee that UE would incur the costs associated with the plan, and (3) only four of the seven goals called for improvement over 1986 performance. The seven goals were as follows:

1. Reduce preventable motor vehicle accidents by 10 percent, and achieve a specific level of on-the-job accidents.
2. Achieve a five percent reduction in sick leave.
3. Limit O&M expenses to the budgeted level.
4. Limit construction expenditures to a specified level.
5. Achieve a five percent reduction in customer outage time.
6. Achieve a five percent reduction in the level of non-Callaway materials and supplies inventory.
7. Achieve an overall major power plant equivalent availability rate of 73 percent.

29 Mo.P.S.C.(N.S.) at 325.

Empire witness McKinney argued that to measure the Empire incentive awards plan against the management incentive plan referenced in Case No. EC-87-114 et al. "is not appropriate" because the UE plan "dealt with <u>corporate</u> goals and objectives and applied to <u>management</u> employees," while "Empire's plan, on the other hand, concerns <u>individual</u> goals and objectives and is not available to employees at the officer level." (Ex. 114, McKinney Supp. Sur., pp. 8-9; Emphasis in original text). Mr. McKinney contradicted himself in attempting to explain the incentive awards process. He testified that the goal setting process is a top-down approach that involves taking specific company goals and formulating them for individual departments and individual employees, all building back to the company goals. (Vol. 9, Tr. 824). Furthermore, there is a match up of some of the goals in the UE management incentive plan addressed in Case No. EC-87-114 et al. and the goals for certain Empire employees under the Empire incentive awards program being reviewed in this proceeding:

EC-87-114 Union Electric Management Incentive Plan Goals	**ER-2001-299 Empire Individual Employee's Incentive Objectives**
1. Limit O&M expenses to the budgeted level	1. Help maintain O&M budget at its approved level
2. Achieve a 5% reduction in sick leave	2. Never late logging in
3. Limit construction expenditures to a specified level	3. Hold capital expenditures to no more than budgeted amount for the year
4. Achieve a 5% reduction in customer outage time	4. Complete the Asbury Plant spring maintenance outage in the scheduled 31 day period

29 Mo.P.S.C.(N.S.) at 325; Ex. 112HC, p. 9; Ex. 116HC.

Confronted with Ms. Fischer's analysis in her supplemental surrebuttal testimony, Mr. McKinney admitted that due to the pending merger with UtiliCorp, Empire did not comply with the criteria of its own program in making incentive awards for the year 2000:

> . . . the normal process of setting base and stretch goals was, for the most part, not achieved. Simply stated, it became more important to keep the lights on and render timely, accurate bills than to go through the process of establishing goals. In effect, the organization stretched to achieve just that, keeping the lights on. As a consequence, during 2000 the Company did not perform well in establishing and documenting the goals and stretch goals that normally determine the Incentive Awards.

(Ex. 114, McKinney, Supp. Sur., p. 5).

In explaining the analysis that she performed, Ms. Fischer related that given the limitations of the remaining time before the filing of surrebuttal testimony and the evidentiary hearing, she selected the names of twelve Empire employees from various departments, job locations and salary ranges, in an attempt to capture diverse aspects of a wide-range of employees. She requested the base objectives and the incentive or "stretch" objectives used to determine the granting of incentive awards for the years over which this particular program has been in existence for these employees. (Ex. 113, Fischer Supp. Sur., pp. 4-5). She testified that Empire provided the forms used to process the incentive awards program for the employees requested and Empire's response to the Staff's Data Request also included the following statement:

> Copies of the base and incentive objectives were partially or wholly unavailable for [three] employees . . . In addition, copies of base and incentive objectives were unavailable for most of the employees listed for the year 2000. Due to the pending merger close with UtiliCorp, managers and supervisors were not required to formulate base and incentive objectives. However, some managers and supervisors did complete the process, as in the case of [four] employees . . .
>
> In place of incentive objectives, managers were instructed to use discretion in awarding incentives to those employees who played a role in maintaining the organization through the merger process, whether or not that was accomplished through the formal goal setting process.

Id. at 5; Ex. 116HC (Empire response to Staff Data Request No. 331). Mr. McKinney stated that he believed that it was in February 2001 that Empire managers were instructed to use discretion in awarding incentives for the year 2000 to those employees who played a role in maintaining the organization through the merger process. (Vol. 9, Tr. 810).

Mr. McKinney explained that in addition to the foregoing the incentive award criteria was not adhered to for the test year in that certain ineligible employees had received incentive awards:

> Officers of the company are ineligible and the bargaining unit employees are ineligible, part-time employees are ineligible, employees who have been with the company less than a year at the time the Incentive Awards are made are ineligible. Now, I think in this year we probably have accidentally [sic] paid some people that hadn't been there for the full time. So we're in error a little bit with the application this year.

(Vol. 9, Tr. 825).

Ms. Fischer testified that the incentive awards should be disallowed for the following reasons:

> (1) The fact that Empire did not require managers nor supervisors to complete objectives for employees for the test year 2000, yet ultimately issued the Incentive Awards to virtually all eligible employees, demonstrates that Empire did not adhere to its own Incentive Award Plan as outlined in the Employee Handbook, and also did not meet the Commission's criteria for allowing rate recovery of incentive compensation amounts.

(Ex. 113, Fischer Supp. Sur., pp. 5-6).

> (2) The absence of goals/objectives for the individual Empire employees does not meet the Commission's criteria of improved performance because, without pre-set goals, performances cannot reasonably be judged to have improved. In addition, if goals are not known in advance by the employees, any improvement in Empire's performance that may have occurred cannot be identified as related to the incentive plan. More generally, the Staff believes that incentive compensation costs are not appropriate from a ratemaking perspective if utility employees are not even aware of the criteria on which compensation will be ultimately based, which was largely true of Empire during the test year.

(*Id.* at 7.)

> (3) Conferring incentive awards for maintaining the status quo during the merger process is not in the Staff's view an example of improved job performance. Improved job performance would be demonstrated by exceeding the results achieved in prior years.

(*Id.* at 7.)

> (4) The proposed UtiliCorp – Empire merger was entered into voluntarily by the directors and shareholders of Empire. The burdens thrust upon Empire because of that decision were not unforeseeable, but accepted as a consequence of the merger. The shareholders of Empire would have

benefited from the merger as a result of the merger premium offered by UtiliCorp for the Empire common stock. It is not known whether benefits to ratepayers would have resulted if the UtiliCorp – Empire merger had been completed. The Staff views monies paid by Empire related to the merger, including the Incentive Awards paid in February, 2001, were more related to meeting shareholder interests than ratepayer interests. As expressed in the Staff's testimony filed in Case No. EM-2000-369, UtiliCorp's and Empire's Joint Application for Commission authorization of their proposed merger, any costs associated with the merger of Empire and UtiliCorp should not be included in the cost of service to Missouri ratepayers, but should be borne by shareholders and recorded below-the-line by Empire.

(*Id.* at 7-8).

(5) The employee incentive goals in the twelve employee sample selected by the Staff respecting the Empire incentive awards program do not meet the Commission's rate recovery criteria for incentive compensation. Incentive Award goals are repeated from one year to the next for individual employees without any requirement to demonstrate an improvement from the prior year. Many incentive award goals are not quantifiable, such as "help improve Company morale with renewed positive attitude," so it is difficult to objectively determine whether improvement in performance has occurred. Some of the incentive award goals appear to mirror "base goals" that are derived from the basic job requirements, such as "never late logging in" and "renewed positive attitude." Incentive goals that are similar to basic job requirements do not truly "stretch" employee performance. Finally, some employees received incentive awards when the incentive goals were not met and certain employees received incentive awards for the year 2000 even though Empire had not employed them for a full year. The Employee Handbook indicates that workers employed by Empire for less than a full year are not eligible to receive incentive awards.

(*Id.* at 9-10).

In *Re Missouri Gas Energy*, Case No. GR-96-285, Report And Order, 5 Mo.P.S.C.3d 437, 458 (1997), the Commission stated as follows:

MGE recommends that the Commission adopt the adjustment proposed by Staff which reflects a four-year average of incentive compensation paid. [Citation to exhibit omitted.] OPC believes that the Southern Union incentive compensation plan should be excluded from cost of service. OPC contends that the incentive compensation plan relates primarily to shareholder-related goals such as increasing profits or net-income. [Citation to exhibits omitted.]

OPC witness Effron testified at pages 13 and 14 of his rebuttal testimony as follows:

> **Q. . . . To the extent that the incentive compensation program relates to controlling costs, which is arguably a ratepayer oriented goal, should the incentive compensation be included in cost of service?**
>
> A. As a general rule, I would agree that if the incentive compensation is related to customer oriented goals, then it should not be excluded from the cost of service. But, and this is a big but, if one of the nominally consumer oriented goals of the incentive compensation program is reducing expenses, then that incentive compensation should be included in the cost of service only to the extent that the cost containment can be achieved without compromising customer service. . . . Unless the Company can demonstrate that cost reductions pursuant to which incentive compensation has been awarded were achieved while maintaining the quality of service, then the incentive compensation should be excluded from the cost of service. . . . (Emphasis added).

The Commission finds that the quality of service is [sic] provided by MGE has declined precipitously during the last three years. [Citation to exhibit omitted}. Nevertheless, MGE is requesting the Commission to have ratepayers pay for an incentive compensation program that ratepayers may have already paid for in terms of a reduction in the quality of service that ratepayers receive.

The Commission finds that the costs of MGE's incentive compensation program should not be included in MGE's revenue requirement because the incentive compensation program is driven at least primarily, if not solely, by the goal of shareholder wealth maximization, and it is not significantly driven by the interests of ratepayers. [Citation to transcript omitted].

D. Class Cost of Service/Rate Design

This issue was settled among all of the parties. A unanimous stipulation and agreement, covering this issue along with Fuel and Purchased Power Expense, was filed on June 4, 2001. The Staff filed suggestions in support of this unanimous stipulation and agreement on June 5, 2001.

E. Capital Structure/Rate of Return

1. What Capital Structure Is Appropriate for Empire?

The Commission should determine Empire's revenue requirement upon the basis of the Company's actual capital structure as of the June 30, 2001 true-up date, rather than upon a hypothetical capital structure that does not now exist and may never exist.

The Company claims that its capital structure has historically consisted of about 45% to 47.5% common equity, and that this percentage was driven down during 1999 and 2000, because the Company incurred substantial costs for construction of the new State Line Combined Cycle Plant, but that it was prohibited, by the terms of its merger agreement with UtiliCorp, from issuing new common stock. Thus it had to issue new long-term debt, which drove the Company's common equity percentage down.

Empire contends that the current equity percentage is unusually low, and is an anomaly, and that the Commission should disregard it and base the Company's rate of return on a hypothetical capital structure of 45% common equity and 55% debt. This claim should be rejected. The actual capital structure included less than 40% common equity and shows no signs of significantly increasing in the foreseeable future.

Empire's actual capital structure, as of December 31, 2000, included 39.80% equity, according to Staff witness Roberta A. McKiddy. (McKiddy Direct, Ex. 61, Schedule 10; McKiddy Direct, Ex. 61, p. 19, lines 14-19; McKiddy Rebuttal, Ex. 62, p. 2, lines 17-21). The figures provided by other parties differed slightly, but all were near 40%.[3]

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[3] OPC witness Burdette testified that the common equity percentage was 41.86%. (Burdette Direct, Ex. 86, Sch. MB-2; Burdette Direct, Ex. 86, p. 4, lines 11-14). Company witness Murry estimated that it would be 40.0% in 2000. (Murry Direct, Ex. 13, Sch. DAM-3). Company witness Fancher testified that the "actual capital structure for the test year" was 38.9% common equity. (Fancher Direct, Ex. 4, p. 3, lines 14-16.)

Empire witness Dr. Donald A. Murry said that the Company's "pro forma" capital structure, as of December 31, 2000, would include 47.5% equity. Although he was given an opportunity to do so, he never clearly explained what he meant by a "pro forma" capital structure. It appears that, when he used the term "pro forma," he may have meant what "the company was estimating … at that time." (Tr. 423, line 19 – Tr. 425, line 2). In any event, it is clear that the Company did not come close to achieving Dr. Murry's "pro forma" capital structure. As noted above, the actual capital structure as of December 31, 2000, included less than 40% common equity.

Company witness David W. Gibson testified that the capital structure as of December 31, 2000, was "not a normal capital structure for Empire," because the merger had caused the Company to miss its target. (Gibson Rebuttal, Ex. 14, p. 1, line 15 – p. 2, line 9). He and other Company witnesses testified that this would change in the future. For example, Company witness Robert B. Fancher testified that "if the [proposed] merger [with UtiliCorp] doesn't close … Empire will need to issue common equity early in 2001." (Fancher Direct, Ex. 4, p. 4, lines 2-4).

The change in the Company's capital structure that Mr. Fancher and other Company witnesses foresaw has never materialized. Mr. Gibson testified that the common equity percentage was only 37.31% at the end of March 2001. (Gibson Rebuttal, Ex. 14, p. 4, lines 8-9; Gibson Surrebuttal, Ex. 29, p. 3, lines 11-13). And he said that it would decline further in the second quarter of 2001. (Gibson Surrebuttal, Ex. 29, p. 2, line 20 – p. 3, line 4). Mr. Gibson explained that the Company elected not to issue common stock after the merger failed, because it "would not be prudent at that time since it would dilute earnings for the current year," but that it might do so "during the fourth quarter of this year." (Gibson Rebuttal, Ex. 14, p. 3, lines 14-18 and lines 23-25).

Although Dr. Murry stated, in his rebuttal testimony, that Empire "plans to issue additional common equity this spring to raise its common equity ratio" (Murry Rebuttal, Ex. 16, p. 26, lines 4-6), he acknowledged, on cross-examination, that he does not know whether Empire has obligated itself in any way to actually increase the equity percentage. (Tr. 425, lines 16-22). The best he could offer, on cross-examination, was that he "hopes" the Company "increases its equity ratio from where it is currently." (Tr. 425, line 23 – Tr. 426, line 1).

Mr. Gibson, the Company's director of financial services, was not much more specific. He said the Company intends to reinstate its Dividend Reinvestment Plan ("DRIP Plan"), and that the Company was looking toward a financing of common equity later in the year. (Tr. 451, line 5 – Tr. 452, line 1). But implementation of the DRIP Plan, alone, would have little effect on the common equity percentage. And although Mr. Gibson said the Company is "looking towards a financing of common equity in the latter part of this year (Tr. 451, line 23 – Tr. 452, line 1), it apparently has not made any commitment to issue new equity, and it does not even have any firm plans to do so.

Although Company witnesses testified that the current equity percentage is an "anomaly" (Tr. 403, line 13 – Tr. 404, line 6; Tr. 420, line 20 – Tr. 421, line 4), that the capital structures chosen by Staff witness McKiddy and OPC witness Mark Burdette (which were based on data as of December 31, 2000) were "unrepresentative" (Murry Direct, Ex. 16, p. 25, lines 1-6), and that the Commission should normalize the Company's capital structure at its historical level (Tr. 444, lines 2-15),[4] there is no guarantee that this will be achieved anytime soon. The Company's actions speak louder than its words, and it has failed to take action to increase its common equity percentage.

OPC witness Burdette testified that the Commission should use the actual capital structure as of the true-up date (June 30, 2001). (Tr. 599, lines 12-23). And Staff witness McKiddy testified that there was a tentative agreement among the Staff, the Company and OPC to use the capital structure as of the true-up date. (McKiddy Rebuttal, Ex. 62, p. 2, lines 2-8). But Company witness Gibson testified that there was no such agreement. (Gibson Surrebuttal, Ex. 29, p. 2, lines 16-19). The Company is apparently unwilling to agree to any capital structure, other than a hypothetical one that, in all probability, will not be achieved in the near future.

The Company maintains that the actual capital structure should not be used, because it is not typical of *this company.* (Gibson Rebuttal, Ex. 14, p. 1, line 15 – p. 2, line 9). That is, it contends the Commission should not look at the *current* capital structure, but should instead rely upon a *historical* capital structure, because that is, supposedly, more representative of how the Company usually operates. It would appear that this is inconsistent with the Company's position, discussed below at pages 40-43, that when applying the DCF Method for determining the appropriate return on equity, the Company should rely solely upon the *current* price of the Company's stock, and that any stock trades that occurred before January 3, 2001, should be disregarded, because they are not representative.

In fact, if the common equity percentage increases to 45%, as the Company asks the Commission to assume that it will, it is reasonable to assume that shareholders would consider

[4] It should be noted that, although Mr. Gibson testified that the capital structure should be normalized at "some historical level" (Tr. 444, lines 10-13), Dr. Murry testified that he didn't think the capital structure recommendation was based on past historical information, but rather "it represents what the company's intentions are" (Tr. 421, lines 5-13). The Staff makes no attempt to reconcile this apparent contradiction.

the Company's stock less risky, and would bid up the price of the Company's common stock[5], thus driving the yield down, and also driving down the return on equity as determined by the DCF Method. It is for this reason that it is inappropriate to use a hypothetical capital structure that the Company "hopes" to achieve, but to insist upon using only the actual current stock price.

Finally, the Staff submits that a hypothetical capital structure should only be used when the actual capital structure is anomalous to the industry average. (Tr. 564, lines 13-22). That situation does not exist in this case. In fact, Empire's current capital structure is *typical* of the industry, according to OPC witness Burdette. (Burdette Direct, Ex. 86, p. 5, lines 8-16). Staff witness McKiddy agreed. She noted that the average common equity percentage for the electric utility industry is about 38% -- very close to Empire's actual common equity percentage at the present time. (McKiddy Surrebuttal, Ex. 63, p. 2, lines 6-11).

Although Empire's common equity percentage is lower than it has been at other times in recent years, it is not abnormally low for the electric utility industry, and there is no reason for the Commission to believe that it will increase substantially in the near future. Empire had the ability to decide when to file its rate case, and it chose to file at a time when its common equity percentage was relatively low. The Commission should use the capital structure that existed as of the true-up date, June 30, 2001.

2. What Return On Common Equity Is Appropriate For Empire?

The Discounted Cash Flow Method

The Commission has consistently used the Discounted Cash Flow (DCF) method to determine

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[5] But see the testimony of Dr. Murry who stated, inexplicably, that if investors expect the financial risk of the Company to be lessened, "the market price will move downward accordingly, all things being equal." (Murry Rebuttal, Ex. 16, p. 26, lines 4-8).

the appropriate return on equity (ROE) in the past. It should continue to follow that practice in this case.

The three principal witnesses on the ROE issue – Roberta A. McKiddy for the Staff, Dr. Donald A. Murry for the Company, and Mark Burdette for the Office of the Public Counsel – all state they relied primarily on the DCF method in this case.

However these three witnesses came up with different recommendations on the proper ROE in this case. Their recommendations are as follows:

Ms. McKiddy	8.50% - 9.50%	(McKiddy Direct, Ex. 61, p. 24)
Dr. Murry	11.5% - 12.0%	(Murry Direct, Ex. 13, p. 19)
Mr. Burdette	10.06%	(Burdette Direct, Ex. 86, p. 17)

The DCF formula for determining the appropriate ROE is deceptively simple. It may be stated, in words, as follows: Return on equity equals dividend yield plus growth. Since yield = dividends / stock price, this equation may be stated algebraically as follows:

$$k = D_1 / P_0 + g,$$

where k is the cost of common stock equity, D_1 is the expected dividend, P_0 is the present stock price, and g is the growth rate. (McKiddy Direct, Ex. 61, p. 20, line 11 – p. 21, line 20).

There are only three variables in this equation: dividends (D_1), stock price (P_0), and growth rate (g).

Overview of the DCF Method

The number to use for dividends is easily determined. The Company has paid dividends of $1.28 per share for over eight years. There was no evidence that this dividend will change in the near future. In fact, Dr. Murry testified that it will not. (Tr. 406, lines 5-8).

There was considerable disagreement as to the other issues, however. Although there was extensive testimony and disagreement over the stock price, the testimony revealed that the more critical issue was the selection of an appropriate growth rate.

Ms. McKiddy utilized the same principles that the Staff has consistently used in recent cases, leavening the results to account for the circumstances that are peculiar to Empire's situation. She first utilized the DCF method, to estimate the required ROE at 8.50% - 9.50%. She then tested this result for reasonableness by utilizing both the Capital Asset Pricing Model (CAPM) and the Risk Premium method, and she also compared the result of her DCF analysis of Empire with the results of DCF analyses of comparable companies. Finally, she analyzed the adequacy of the selected ROE to meet the Company's bond indenture requirements. Her approach was thorough, complete and reasonable in all respects, and was consistent with well-recognized principles of financial analysis.

Company witness Murry, on the other hand, purported to use the DCF method, but he used it very selectively, and with significant modification. He did not merely apply the principles of the DCF method and then accept the result of this analysis. Instead, he discarded the elements of the method that did not lead him to the desired conclusion, and he retained the elements that supported the high ROE that his client desired. This was most evident in his selection of a growth rate that relied heavily on earnings, to the near exclusion of dividends, and relied on projections of future performance, instead of past performance, because Empire's historical growth rate was not sufficient to suit him.

The Commission should adopt the ROE recommendation of Staff witness McKiddy, and should establish the ROE somewhere within the range of 8.50% to 9.50%.

Stock Price (P_0)

The issue of what stock price to use in the DCF formula was hotly contested in this case. This was because the Company's common stock generally traded at about $27 per share during the last three months of 2000 and on January 2, 2001, before plunging to below $20 per share on January 3, 2001, after UtiliCorp's announcement that it would not consummate the merger with Empire. The stock generally traded between $19 and $21 per share in the three months following the termination of the merger. (McKiddy Direct, Ex. 61, Sch. 14). Because the Company's dividends remained constant at $1.28 per share, this caused the yield on common stock to rise from about 5%, during the last quarter of 2000, to over 6% during the first quarter of 2001. Staff witness McKiddy chose to use data from both the fourth quarter of 2000 and the first quarter of 2001, whereas the Company contends that only "current" stock prices, from the period following the termination of the merger, should be used.

In spite of this sharp disagreement, Ms. McKiddy and Dr. Murry selected remarkably similar figures for the yield portion of the DCF equation. Ms. McKiddy established the dividend yield at 5.50% (McKiddy Direct, Ex. 61, Sch. 14 and Ex. 61, p. 24, lines 14-22; Tr. 473, lines 11-20), whereas Dr. Murry established the dividend yield between a low of 4.72% and a high of 6.77% (Murry Direct, Ex. 13, Sch. DAM-8, DAM-9 and DAM-10). Dr. Murry made his recommendation and filed his direct testimony before the end of 2000 and before the termination of the UtiliCorp merger, but he never changed this recommendation; instead he sought to discredit Ms. McKiddy's approach of using stock price data from both before and after the termination of the merger.[6]

[6] It should be noted, however, that Dr. Murry suggested, in his rebuttal testimony, that the correct yield figure is 6.20%, because he "corrected" Ms. McKiddy's work and altered her assumptions and calculations in his Schedule DAM-27. This analysis utilized only stock prices subsequent to termination of the merger, and completely ignored all stock prices prior to January 3, 2001.

Dr. Murry's calculation of the Company's dividend yield is illustrated in Schedules DAM-8 through DAM-13, attached to his direct testimony. On all six of these schedules, he used a dividend of $1.28 per share, which is shown in the third numerical column from the left of each of those six schedules.

On Schedules DAM-8, DAM-9 and DAM-10, Dr. Murry showed the Company's high and low stock prices for the year 2000. (Murry Direct, Ex. 13, p. 12, line 20 – p. 13, line 4). In each of these three schedules, the high price was $27.10 and the low price was $18.90.[7] As a result, each of these three schedules showed a high dividend yield of $1.28 / $18.90 = 6.77%, and each of these three schedules showed a low dividend yield of $1.28 / $27.10 = 4.72%.[8]

On Schedules DAM-11, DAM-12 and DAM-13, Dr. Murry showed "the current prices from a recent two-week period." (Murry Direct, Ex. 13, p. 12, line 20 – p. 13, line 4). In each of these three schedules, the high price was $26.44 and the low price was $25.92.[9] As a result, each of these three schedules showed a high dividend yield of $1.28 / $25.92 = 4.94%, and each of these three schedules showed a low dividend yield of $1.28 / $26.44 = 4.84%.[10]

On Schedule DAM-14, Dr. Murry presents a summary of his DCF analysis of Empire. Dr. Murry purports to base this schedule on Schedules DAM-7 through DAM-13. In fact, however, Schedule DAM-14 pays no heed, whatsoever, to Schedules DAM-11 through DAM-13. Those are the three schedules that are based on "current" stock prices. Although Dr. Murry did not explicitly say so, what Dr. Murry has done is to use the high and low stock prices for the

[7] This information is shown in the top row of the first and second numerical columns of Schedules DAM-8, AM-9 and DAM-10.
[8] This information is shown in the top row of the fourth and fifth numerical columns of Schedules DAM-11, DAM-12 and DAM-13.
[9] This information is shown in the top row of the first and second numerical columns of Schedules DAM-11, DAM-12, and DAM-13.
[10] This information is shown in the top row of the fourth and fifth numerical columns of Schedules DAM-11, DAM-12, and DAM-13.

entire year 2000; he has ignored the "current" stock prices. He did not explain why he found the prices for all of 2000 to be a more relevant or more accurate measure of the Company's stock price for purposes of DCF analysis than the "current" prices were, so one can only speculate. In each case (that is, when comparing Sch. DAM-8 with Sch. DAM-11, when comparing Sch. DAM-9 with Sch. DAM-12, and when comparing Sch. DAM-10 with Sch. DAM-13), Dr. Murry chose the schedule that produced the *highest* ROE.

Dr. Murry criticized Ms. McKiddy for using stock price data from 2000, when she had available to her more recent stock price data from 2001. He contended that she should have used the "current" stock prices. And yet, when he had the opportunity to use either "current" data or data from all of 2000, he chose to discard the "current" data in favor of the older data. One can only assume that this was because the older data produced a result that was more favorable to his client, because he offered no other explanation of why the older data should be considered more reliable.

When Ms. McKiddy began her analysis, she planned to use stock price data for the period ending at the end of 2000, in accordance with the Staff's standard procedure. But this produced an extremely low result for the DCF, according to Ms. McKiddy. (Tr. 495, lines 5-17). The Staff seeks, in all cases, to normalize the stock price that it uses in the DCF formula. (Tr. 488, lines 2-10). Ms. McKiddy believed that the Company's stock prices were higher than normal in late 2000, but that the stock price was temporarily driven down in early 2001 due to the effects of termination of the merger. (Tr. 492, line 21 – Tr. 493, line 3). To minimize the effects of the failed merger, Ms. McKiddy decided to utilize market price data for three months before the termination of the merger and for three months following the termination of the merger. The result was an average stock price of about $24 per share. This was close to the $23 average price for Empire's stock that existed during the last six months before the announcement of the proposed merger. (Tr. 469, lines 9-18). Ms. McKiddy testified that this result was reasonable because she believed that, in the absence of the merger announcement, the stock would trade near these levels. (Tr. 506, lines 7-13).

The Staff submits that in applying the DCF method in this case, the Commission should utilize stock prices for the period from October 2000 to March 4, 2001, because that produces a result that is more representative of the price investors are currently willing to pay for the Company's stock, it minimizes the effect of the daily volatility of the stock market, and it minimizes the effect of the terminated merger with UtiliCorp. (McKiddy Direct, Ex. 61, p. 23, lines 19-22; McKiddy Rebuttal, Ex. 62, p. 6, lines 15-22; McKiddy Rebuttal, Ex. 62, p. 8, lines 9-16; McKiddy Surrebuttal, Ex. 63, p. 5, line 17 – p. 6, line 2).

Growth (g)

Theoretical Basis

All parties agree that g, the growth figure in the DCF equation set forth above, represents "growth." It is less clear what growth it is supposed to measure.

OPC witness Burdette stated that g is supposed to measure the expected future growth of dividends. For example, he made the following statement in his direct testimony:

> Therefore, the DCF model, using expected future dividends as the cash flows, is appropriate regardless of how long the investor plans to hold the stock. Determination of a holding period and an associated terminal price is unnecessary.

(Burdette Direct, Ex. 86, p. 8, lines 18-21).

In support of this proposition, he quoted from Brealey and Myers as follows:

> We can, therefore, forget about the terminal price entirely and express today's price as the present value of a perpetual stream of cash dividends. (Principles of Corporate Finance, Fourth Edition, page 52)

(Burdette Direct, Ex. 86, p. 8, lines 26-28).

Mr. Burdette explicitly stated how this growth rate is applied to the above equation, as follows:

> The growth rate variable, g, in the traditional DCF model is the dividend growth rate investors expect to continue into the *indefinite future* (i.e., the sustainable growth rate).

(Burdette Direct, Ex. 86, p. 9, lines 9-10).

In response to a question from Company counsel James Swearengen, Staff witness McKiddy read from a treatise by David C. Parcell entitled *The Cost of Capital: A Practitioner's Guide,* on which she relied in preparing her testimony regarding ROE. That passage reads as follows:

> An almost limitless array of techniques have been used in rate proceedings to estimate the constant growth rate component. *Since the dividend discount model is technically concerned with growth in dividends, many methods are concerned directly with dividend growth.*
>
> On the other hand, other methods examine factors other than dividend growth to estimate [g]. *The objective of each of these methods is to estimate the growth of dividends (cash flow) within the DCF context.* The DCF model is forward-looking in that it is designed to reflect the perceptions of investors as they set the current price of the company's stock.

(Tr. 527, line 19 – Tr. 528, line 5; emphases supplied).

All three of these principal witnesses on the ROE issue testified that the dividends paid by Empire are not expected to increase. Thus, if growth in dividends were the only factor considered, as is suggested by the above passages, the growth factor, g, would be zero, and the applicable ROE would equal the Company's dividend yield.

As Staff witness McKiddy testified, however, the selection of a growth rate in the DCF calculation involves a considerable degree of judgment. (Tr. 519, lines 12-15). Ms. McKiddy also testified, however, that "a key principle of the DCF model is to calculate the cost of capital based on an anticipated stream of earnings or dividends," (Tr. 509, lines 2-5) and that "by growth rate we mean what investors anticipate with respect to the growth of cash flows." (Tr. 519, lines 2-5). Thus, Ms. McKiddy sought to limit the effect of an anticipated 0% growth in dividends by considering other factors, such as the anticipated growth in earnings and book value per share.

Not surprisingly, Company witness Murry chose not to rely solely upon growth in dividends, either – for that would have set the ROE equal to the Company's dividend yield. Thus Dr. Murry stated that "g = rate of growth of dividends, or alternatively, common stock earnings." (Murry Direct, Ex. 13, p. 9, line 19).

Likewise, Ms. McKiddy allowed for the consideration of factors other than the growth of dividends, stating:

> Thus, the cost of common stock equity, k, is equal to the expected dividend yield (D_1/P_0) plus the expected growth in dividends (g) continuously summed into the future. The growth in dividends and implied growth in earnings will be reflected in the current price. Therefore, this model also recognizes the potential of capital gains or losses associated with owning a share of common stock.

(McKiddy Direct, Ex. 61, p. 21, lines 16-20).

The difference between Dr. Murry's approach and Ms. McKiddy's approach is that Dr. Murry discarded the dividend growth rate entirely, and relied *entirely* upon earnings growth – and predominantly upon estimates of future earnings growth – whereas Ms. McKiddy considered not only earnings growth, but also dividend growth and growth in book value per share, and she also gave considerable weight to past performance rather than relying exclusively on projections of future performance. Ms. McKiddy's approach is superior and should be adopted.

Staff's Position

Ms. McKiddy's calculations are shown on Schedule 13 to her direct testimony. She first calculated five separate historical growth rates. One of them calculated growth in dividends per share,[11] two calculated growth in book value per share, and the other two calculated the growth in earnings per share. The average of these five historical growth rates was 2.10%. (McKiddy Direct, Ex. 61, Schedule 13).

Ms. McKiddy then relied upon two outside sources to estimate that the Company could expect a 4.00% annual growth in earnings per share. (McKiddy Direct, Ex. 61, Schedule 13).

Based upon these data, Ms. McKiddy established the Company's expected growth, g, as falling within a range of 3.00% to 4.00%. (McKiddy Direct, Ex. 61, Schedule 13). The lower end of this range is nearly a full percentage point *higher than* the average of the historical growth rates. The upper end of the range is equal to the average of the projected growth rates.

Ms. McKiddy's calculation of the growth rate thus took into account the historical growths in each of three different factors – dividends per share, earnings per share, and book value per share. In addition, the calculation gives equal weight to historical data and to projected future earnings. As Ms. McKiddy stated: "Staff believes it is reasonable to assume that projected growth rates are fairly represented by an average of DPS, EPS and BVPS." (McKiddy Rebuttal, Ex. 62, p. 10, lines 23-24).

Company's Position

Dr. Murry's calculation of the Company's growth rate (g) is illustrated in Schedules DAM-8 through DAM-13, attached to his direct testimony.

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[11] It is interesting to note that even though the Company has not increased its dividend in the last eight years, Ms. McKiddy's calculation showed a positive dividend growth rate, because she used a 10-year history of the Company's dividends, instead of using only a five-year history. It is also interesting to note that the Company complained about the use of a 10-year history.

On Schedules DAM-8 and DAM-11, Dr. Murry calculates the average annual compound growth rate that has occurred and that he expects to occur *in the Company's dividends* between the three-year period from 1994-1996 and the three-year period from 2003-2005.[12] Both Schedule DAM-8 and DAM-11 show a dividend growth rate of 0.00%, because the Company's dividends have not changed in eight years, and there is no reason to suspect that they will change in the near future.

On Schedules DAM-9 and DAM-12, Dr. Murry makes a similar calculation, except that here he calculates the compound growth rate that has occurred and that he expects to occur *in the Company's earnings* during the same period of time.[13] Both DAM-9 and DAM-12 show an earnings growth rate of 5.42%, because Dr. Murry assumes that earnings will average $2.00 per share in 2003-2005, compared to $1.24 per share in 1994-1996.

In calculating the growth rate for these two schedules, Dr. Murry has mixed the actual historical growth for the period from 1994-1996 *(sic)* to the present with a hypothetical projected growth from the present to 2003-2005. As Staff witness McKiddy noted:

> Traditionally, the compound growth rate methodology is used for determining an annual historical growth over a historical period with known values. In this instance, Mr. Murry chose to use a historical and projected value, respectively, as his beginning and ending values. Staff believes this is a mix of apples with oranges and produces results that are fundamentally flawed.

(McKiddy Surrebuttal, Ex. 63, p. 8, line 20 – p. 9, line 1).

The result is an earnings growth rate of 5.42% per year, which is far higher than anything the Company has experienced at any time during the most recent five-year and ten-year

[12] This information is shown in the top row of the sixth, seventh and eighth numerical columns of Schedules DAM-8 and DAM-11.

[13] This information is shown in the top row of the sixth, seventh and eighth numerical columns of Schedules DAM-9 and DAM-12.

periods.[14] Why should Dr. Murry – or the Commission – believe that the Company's earnings will suddenly begin to grow at a far faster rate than they have in the recent past? There is no reason to believe that this will occur, and Dr. Murry's analysis should be rejected.

On Schedules DAM-10 and DAM-13, Dr. Murry makes a similar calculation, except that here he simply *assumes* that in the future the Company's earnings per share will grow at an annual rate of 6.00%, based upon a projection by Value Line.[15] Both DAM-10 and DAM-13 therefore show an earnings growth rate of 6.00%.

As was the case with Schedules DAM-9 and DAM-12, these schedules are also predicated upon an unreasonable assumption regarding the Company's future growth. It is based upon a single projection, by Value Line, that the Company's future earnings will grow 6.00% per year. For the same reasons that are set forth in the second preceding paragraph, there is no reason why Dr. Murry – or the Commission – should assume that the Company's earnings growth will suddenly jump from 2.5% per year (or less) to 6.00% per year. Dr. Murry's growth calculations on Schedules DAM-10 and DAM-13 should therefore be rejected.

Summary of Results of the DCF Analyses

Staff witness McKiddy concluded that Empire's cost of equity is 8.50% to 9.50%, consisting of a dividend yield of 5.50% and a growth rate of 3.00% to 4.00%. (McKiddy Direct, Ex. 61, p. 24, lines 14-22).

OPC witness Burdette concluded that Empire's cost of equity is 10.06%, consisting of a dividend yield of 6.56% and a growth rate of 3.50%. These results are similar to Staff's results, but they include a slightly higher dividend yield, because Mr. Burdette used only stock prices

[14] Staff witness McKiddy testified that the Company's growth in earnings per share for the past 10 years was –0.5%, and for the past five years was only 2.5%.
[15] This information is shown in the top row of the sixth, seventh and eighth numerical columns of Schedules DAM-9 and DAM-12.

from 2001, after the termination of the UtiliCorp merger, when the Company's stock price had fallen.

Dr. Murry's results are summarized on Schedule DAM-14 of his direct testimony. As noted above, Dr. Murry rejected "current" stock prices, and relied instead upon prices for all of 2000, despite the fact that he criticized Ms. McKiddy for not using only "current" stock prices. This analysis left him with three different DCF ranges to ponder:

> One, based on a mix of historical and projected dividend growth, produced a DCF range of 4.72% to 6.77%;
>
> Another, based on a mix of historical and projected earnings growth, produced a DCF range of 10.15% to 12.20%; and
>
> A third, based on Value Line's projections of future earnings growth, produced a DCF range of 10.72% to 12.77%.

(Murry Direct, Ex. 13, Sch. 14).

Dr. Murry concluded from this that the Company's ROE should be established at 11.5% to 12.5%. He did not say how he came to this conclusion; clearly he did not average the results produced by the three different calculations of growth. It would appear that he simply discarded the ROE that he calculated through use of the dividend growth rates (this was the lowest of the three ROEs), and he relied instead upon the two ROEs that he calculated through use of the earnings growth rates. As noted above, these latter two calculations were both heavily dependent upon projections that the Company will suddenly experience an earnings spurt.

The Staff submits that Dr. Murry's analysis is unrealistic and should be rejected.

Reasonableness Checks

CAPM and Risk Premium Method

In accordance with its usual practice, the Staff relied primarily upon the DCF Method as the primary tool to determine the Company's cost of equity in this case. (McKiddy Direct, Ex.

61, p. 20, lines 6-9). The Staff then analyzed Empire's cost of equity using two other models – the Risk Premium analysis and the Capital Asset Pricing Model ("CAPM"). The results of these two analyses were *not* used to establish the proper ROE for the Company, however, but were only used for the purpose of checking to determine whether the result obtained by the DCF Method was reasonable.

Ms. McKiddy's application of the Risk Premium method produced an estimated cost of equity of 9.79%, which "supports the high end of [her] cost of equity range derived using the DCF model." (McKiddy Direct, Ex. 61, p. 25, lines 2-15). Although this result is *slightly higher* than the top of Ms. McKiddy's ROE range, as calculated by the DCF Method, it is *far below* the bottom of Dr. Murry's ROE range (11.5%-12.5%), and is much closer to Ms. McKiddy's recommended range than it is to Dr. Murry's recommended range. This analysis therefore supports Ms. McKiddy's range, but does not support Dr. Murry's range.

Ms. McKiddy then performed a CAPM analysis, which produced an estimated cost of equity range of 9.39% to 9.73%, which also "supports the high end of [her] cost of equity range derived using the DCF model." (McKiddy Direct, Ex. 61, p. 25, line 16 – p. 27, line 7). This result actually straddles the high end of Ms. McKiddy's ROE range, as calculated by the DCF Method, and is, again, far below the bottom of Dr. Murry's ROE range.

OPC witness Burdette's CAPM analysis provides further support for the reasonableness of the result that Ms. McKiddy reached through the DCF Method. According to his CAPM analysis, Empire's cost of common equity is 8.66%. This supports the low end of Ms. McKiddy's recommended range.

Because both the Risk Premium analysis and the CAPM analysis supported Ms. McKiddy's DCF analysis, there was no need to modify the result that she obtained through use of the DCF Method. These analyses confirmed that an ROE of 8.50% to 9.50% is appropriate in this case. (McKiddy Direct, Ex. 61, p. 27, lines 8-11).

Comparable Companies

All three of the principal witnesses on the ROE issue also analyzed companies that they deemed to be comparable to Empire, to help them determine whether the return on equity that they were recommending for Empire was reasonable.

Staff witness McKiddy described exactly how she selected her list of comparable companies. She began with a list of the 48 publicly traded electric utility companies monitored by Value Line. She then applied six separate screens to this list of 48 companies, to identify nine companies that are truly comparable to Empire. (McKiddy Direct, Ex. 61, p. 30, line 18 – p. 31, line 14). Ms. McKiddy's Schedule 20 clearly shows how the nine comparable companies were finally chosen.

It appears that OPC witness Burdette also selected his comparable group of six companies, using a series of eight separate screens, without introducing any subjective judgment on whether to include or exclude a company from his list of "comparables." (Burdette Direct, Ex. 86, Schedule G, p. 30).

It is less clear that Dr. Murry rigidly applied his series of four screens in selecting his six comparable companies. He did not show how many companies he initially considered, how many were eliminated by each of his screens or whether he used any subjective judgment in choosing the final six comparable companies. (Murry Direct, Ex. 13, p. 7, line 9 – p. 8, line 4).

It is worth noting that Dr. Murry did not eliminate utilities with nuclear operations from his list of comparables (Murry Direct, Ex. 13, p. 7, lines 9-21; Tr. 386, lines 9-16); and he did not eliminate utilities with a substantial level of nonregulated activity (Murry Direct, Ex. 13, p. 7, lines 9-21; Tr. 386, line 25 – Tr. 388, line 1; Tr. 408, lines 1-17).

Also, although Empire derives about 99% of its revenue from electricity, Dr. Murry lowered the bar, including companies with more than 50% of their revenues from electricity as comparable to Empire. (Murry Direct, Ex. 13, p. 7, lines 14-15). He acknowledged that companies that derived a larger portion of their revenue from electricity would have been more comparable, stating that he would have used companies that are 90 percent electricity "if they existed." (Tr. 407, lines 17-24). Dr. Murry also eliminated those firms with equity ratios less than 40% (Murry Direct, Ex. 13, p. 7, lines 16-17), even though Empire's equity ratio was less than 40% when he filed his direct testimony. (Fancher Direct, Ex. 4, p. 3, lines 14-16).

Staff witness McKiddy determined that the estimated range for cost of equity for her nine comparable companies was 10.15% to 11.65% using the DCF Method (McKiddy Direct, Ex. 61, p. 32, lines 9-18, and Sch. 25), and it was 9.69% to 10.03% using the CAPM Method (McKiddy Direct, Ex. 61, p. 32, line 19 – p. 33, line 5, and Sch. 26).

It is important to note that the comparable companies analysis is only a check on the results obtained from the Empire-specific DCF analysis that Ms. McKiddy performed. Although the analysis of comparable companies produced higher results, they were near the results for Empire and supported the upper end of Ms. McKiddy's range. As Ms. McKiddy noted, the comparable companies had "a higher result simply because of the fact that it had a higher growth rate." (Tr. 497, line 20 – Tr. 499, line 1).

Effect of the Termination of the Proposed Merger with UtiliCorp

Staff witness McKiddy prepared her direct testimony in March 2001, after the termination of the Company's proposed merger with UtiliCorp. She based her recommendation on the proper ROE for the Company upon application of the DCF Method, utilizing stock price data from October 2000 through March 4, 2001, which included stock prices from both before and after the termination of the merger. On the basis of this data, she determined the Company's dividend yield to be 5.50%.

Company witness Murry prepared his direct testimony in October 2000. In his calculation of ROE under the DCF Method, he utilized stock price data for all of calendar year 2000 until the date he prepared his testimony, which included only stock prices from before the termination of the merger. On the basis of this data, he determined the Company's dividend yield to be within a range from 4.72% to 6.77%.

Dr. Murry did not change his ROE recommendation when he filed his rebuttal and surrebuttal testimonies after the termination of the UtiliCorp merger. But he roundly criticized Ms. McKiddy for failing to use postmerger stock prices in her determination of ROE under the DCF Method, and Company counsel Swearengen cross-examined Ms. McKiddy at length to inquire why she had not used "current" stock prices.

At the time of the hearing, the price of the Company's common stock was about $19.90 per share. The Company suggests that Ms. McKiddy should have used this figure in her DCF calculation of the ROE. This would produce a dividend yield of $1.28 / $19.90, or about 6.42%.[16] Under cross-examination, Ms. McKiddy repeatedly refused to accept the premise that the dividend yield factor in the DCF calculation should be adjusted to use only stock prices from 2001. See, for example, the following response to a question from Mr. Swearengen:

[16] The Company also suggested that Ms. McKiddy should utilize the Company's conclusion that the growth factor should be 5% to 6.5% per year. Although Ms. McKiddy never offered any testimony in support of either such a yield or such a growth factor, the Company insisted on tinkering with Ms. McKiddy's testimony by offering Exhibit 104, which purported to show that the ROE should be in the range of 11.42% to 12.92%. This conclusion is entirely contrary to Ms. McKiddy's testimony and is totally unsupported by Ms. McKiddy. The only conclusion it supports is that if you change the data that you input into a proper formula, the result will also change.

> In my opinion, if you're going to true up one component of the formula, you have to true up all components. And as we all know, the growth rate projections for Empire has dropped since that original testimony was filed.

(Tr. 521, lines 4-8).

Ms. McKiddy testified that, on April 6, 2001, after she had prepared her direct testimony, Value Line lowered its projection on the Company's ROE for 2001from 12% to 9%, and that it had lowered its projection on the growth of the Company's earnings from 6% to 4% per year. If she had known this at the time that she prepared her direct testimony, she would have used a lower growth rate (g), and this would have reduced her ROE calculation.

Dr. Murry acknowledged that he knew that Value Line had lowered its projection of the Company's ROE from 12% to 9% "at least prior to writing surrebuttal testimony." But he said he did not think that he mentioned this revised projection in the testimony he filed in this case. (Tr. 398, line 8 – Tr. 399, line 23). Nor has the Staff found any reference to this revised projection in his testimony.

Dr. Murry also testified that he relied upon Value Line's projection of a 6.00% annual growth in earnings when he prepared his testimony, and that he knew that Value Line had lowered its projection of earnings growth to 4% per year. He said he did take that into account when he estimated the growth factor, but he said there was no reason to update his recommendation regarding ROE, because "the lowering the forecasted growth was more than offset by the decline in price [of the Company's common stock]." (Tr. 399, line 24 – Tr. 401, line 23). In other words, he apparently agreed with Ms. McKiddy that "if you're going to true up one component of the formula, you have to true up all components."

Ms. McKiddy testified that she continues to track the changes in the price of the Company's stock and the change in projections of the growth of the Company's earnings, and as of the time of the hearing, the revised calculation of ROE, using "current" data, would still produce a result within her projected range of 8.50% to 9.50%. This is because the growth rate has declined at the same time as the Company's dividend yield has increased. (Tr. 583, lines 5-20). She testified that, as of the day before she testified, she believed her calculation of ROE using the DCF Method was "in the upper end of [her] range, though, about 9.3 percent." (Tr. 590, line 20 – Tr. 591, line 16).

Although the price of the Company's common stock has declined since the termination of the UtiliCorp merger, causing the Company's dividend yield to increase, this is offset by the decline in projected growth rates. Ms. McKiddy's calculation properly determines the Company's required ROE.

Adequacy of the Chosen Return on Equity

Company witness Murry stated in his rebuttal testimony that Staff witness McKiddy claimed that all the Company must do is meet the "bare" indenture requirements. (Murry Rebuttal, Ex. 16, p. 3, lines 17-20). That statement simply mischaracterizes Ms. McKiddy's direct testimony.

Ms. McKiddy clearly outlined her approach in her direct testimony as follows: She first utilized the DCF Method to determine the cost of equity, tentatively concluding that the appropriate ROE range was from 8.50% to 9.50%. (McKiddy Direct, Ex. 61, pp. 20-24). She next performed various reasonableness tests, including the use of the CAPM Method and the Risk Premium Method, concluding that the selected ROE range was appropriate for Empire. (McKiddy Direct, Ex. 61, pp. 24-27; see esp. p. 27, lines 8-11). Only then, after tentatively choosing an ROE range using the DCF Method and checking its reasonableness with the CAPM Method and the Risk Premium Method, did Ms. McKiddy begin to discuss the minimum interest coverage requirement. She concluded that the chosen ROE range would meet the minimum interest coverage requirement that is specified in the Company's indenture. (McKiddy Direct, Ex. 61, pp. 27-30). This was a *check* only; it was not a method for initially determining the appropriate ROE range. Finally, Ms. McKiddy checked the reasonableness of the selected ROE by analyzing comparable companies. (McKiddy Direct, Ex. 61, pp. 30-34).

The Company raised a number of other objections to the adequacy of Ms. McKiddy's selected ROE range. They included the following claims:

> that Ms. McKiddy's analysis failed to assess the Company's "financial integrity" (Murry Surrebuttal, Ex. 26, p. 2, lines 2-6);
>
> that bond rating companies have downgraded their ratings of the Company's debt (Murry Surrebuttal, Ex. 26, p. 3, lines 1-19);
>
> that the chosen ROE range does not produce the lowest cost of borrowing (Murry Surrebuttal, Ex. 26, p. 3, line 17 – p. 4, line 2);
>
> that if the Company does not get the ROE it desires, it will miss the projections of financial analysts (Gibson Rebuttal, Ex. 14, p. 7, lines 18-22); and
>
> that Ms. McKiddy ignores the fact that the Company will not be able to increase its dividend (Murry Rebuttal, Ex. 16, p. 3, line 25 – p. 4, line 1).

None of these arguments has any merit. A brief discussion of each argument follows.

As Ms. McKiddy noted in her direct testimony, the Company is entitled to a fair and reasonable return for the services it provides. "However, this fair and reasonable rate does not necessarily guarantee revenues or the continued financial integrity of the utility." (McKiddy Direct, Ex. 61, p. 5, line 27 – p. 6, line 26). Although Company witness Murry initially stated on cross-examination that the Commission has some sort of obligation to ensure the financial integrity of the Company (Tr. 390, line 24 – Tr. 391, line 9), even he later conceded that the Commission does not have an absolute obligation to do so (Tr. 391, line 10 – Tr. 392, line 4), and he said that he would "certainly agree" with the statement that the financial integrity also rests on the utility companies and the company has responsibility in maintaining its financial responsibility. (Tr. 393, lines 6-11).

Dr. Murry repeatedly complained that the ROE that Ms. McKiddy recommends fails to meet the tests of financial integrity, because this would compound the Company's problems in maintaining its bond ratings. (Murry Surrebuttal, Ex. 26, p. 3, lines 1-14). On cross-examination, Dr. Murry testified that the term "financial integrity" means the ability to "successfully borrow or raise equity capital in the capital markets to sustain itself in the future." (Tr. 390, lines 10-17).

There is no doubt that all of Empire's securities are "investment grade." Ms. McKiddy so testified. (McKiddy Direct, Ex. 61, p. 16, line 35 – p. 17, line 6). Dr. Murry also testified that even though Moody's has recently downgraded Empire's debt to Baa1, that is still considered "investment grade" debt. He acknowledged that a Standard & Poor's rating of BBB+ would also be considered "investment grade," and that Standard & Poor's rates Empire's debt as A-, which is a higher rating than BBB+ and is also "investment grade." (Tr. 393, line 18 – Tr. 395, line 7). Dr. Murry said that Empire's credit rating is not very unusual for the utility industry (Tr. 395, lines 8-13), and he did not dispute Standard & Poor's statement that 40% of the utilities hold a bond rating of BBB, which is lower than Empire's credit rating. (Tr. 395, line 14 – Tr. 396, line 15). There is clearly no evidence to suggest that Empire is unable to raise capital or that its financial integrity is threatened.

Dr. Murry testified that most analysts believe that companies that have a bond rating of A or AA from Moody's have the "lowest cost of borrowing." (Murry Surrebuttal, Ex. 26, p. 3, lines 17-22). This conclusion misses the point, however. The Commission should be concerned about establishing a return on equity that will provide the Company with an adequate return, at the lowest cost to the ratepayer. The cost of borrowing is only one element of the rate of return, the other element being the return on equity. Ratepayers do not benefit by the cost of borrowing being kept very low, if the ROE is set so high that it increases the total cost to the ratepayer.

It is true that Dr. Murry testified on cross-examination that the "cost of capital" is lowest for companies that have an A or AA bond rating (Tr. 394, lines 10-12; Tr. 433, lines 3-7), but he did not elaborate on this statement or identify the basis for his conclusion. It is unclear whether he meant that the cost of *capital*, overall, would be lowest if the company maintained an A or AA bond rating, or if it is only the cost of *borrowing* that would be reduced thereby.

Company witness Gibson testified that if the Commission adopts Ms. McKiddy's recommendation, the Company might not achieve the 12.00% return on equity that some analysts have projected for the Company. (Gibson Rebuttal, Ex. 14, p. 7, lines 18-24). It should be obvious that if the Commission authorizes an ROE of 8.50%-9.50%, the Company will probably not achieve an ROE of 12.00%. But aside from that, there is no authority for the implied proposition that the Commission has some sort of duty to set the Company's ROE high enough that the Company will meet analysts' expectations. The Commission's obligation is to set the ROE at a level that will result in a just and reasonable rate.

Finally, Dr. Murry testified that Ms. McKiddy ignored the fact that the Company will not be able to increase its dividend. (Murry Rebuttal, Ex. 16, p. 3, line 25 – p. 4, line 3). He cited no authority for the proposition that the Commission should establish an ROE that is sufficient to enable the Company to increase its dividend, and the Staff knows of no such authority.

Capital Structure/Rate of Return Recommendations

The Commission should continue to utilize the DCF Method to determine the appropriate return on equity in this case, as it has consistently done in the past. Staff witness McKiddy's analysis of the Company's stock prices, which utilizes data for the period from October 2000 to March 4, 2001, produces a result that represents the price that investors are currently willing to pay, is reasonable, and should be adopted. The resulting dividend yield of 5.50%, coupled with an achievable growth rate of 3% to 4% per year, results in an ROE range of 8.50% to 9.50%.

Analyses using the CAPM Method, the Risk Premium Method, and data from comparable companies produce results that support the high end of the Staff's recommended range of return and demonstrate that the Staff's recommendation is reasonable.

Although the Company's stock price has declined since the termination of the proposed merger with UtiliCorp, driving the Company's dividend yield up, there have been compensating changes in the projected growth of the Company's earnings, so a DCF calculation based on current data produces a similar result. The Staff's recommended ROE range of 8.50% to 9.50% is adequate for the continuing operations of the Company.

The Commission should approve an ROE in the range of 8.50% to 9.50%.

F. <u>State Line Power Plant and Energy Center</u>

1. What are the appropriate capital costs for inclusion in rate base for the State Line Combined Cycle Unit?

This issue was settled among all of the parties. A unanimous stipulation and agreement, covering this issue was filed on May 25, 2001. The Staff filed suggestions in support of this unanimous stipulation and agreement on June 1, 2001.

2. What are the appropriate expenses for Operation and Maintenance at the State Line Power Plant and the Empire Energy Center?

Staff believes that the Commission should not determine expense levels for the Operation and Maintenance revenue requirement calculation until the "true-up" phase of this case. Postponing this process by using a "true-up" proceeding has been judicially sanctioned. *See*

*State ex rel., Mo. Pub. Serv. Co. v. Charles J. Fraas, et al.,*627 S.W.2d 882, 888 (Mo.App. W.D. 1982). Accordingly, Staff has not made any recommendation (Featherstone Surrebuttal, Ex. 107, p. 29). As more information has become available since the May hearing, Staff has fulfilled its commitment to examine items under a maintenance contract as well as other, noncontractual items in order to recommend the proper revenue requirement to the Commission (Tr. 760). Staff expects that long-term contracts will become available for review. Regardless of the outcome of contractual negotiations, however, Staff intends to allow the Company an amount for maintenance expenses that is greater than the test year data, as the Combined Cycle unit did not exist during that time period (Tr. 757). Staff will base its final recommendation on a combination of historical and estimated future costs (Tr. 770), and will strive to assure that it is supported by all available data.

3. What are the appropriate In-Service Criteria for determining whether the new State Line Combined Cycle Unit should be included in rate base?

This issue was settled among the parties via a stipulation and agreement, which was filed on May 14, 2001, and concerning which the non-signatory party did not request a hearing. The Staff filed suggestions in support of this stipulation and agreement on May 29, 2001.

G. <u>Fuel and Purchased Power</u>

This issue was settled among all of the parties. A unanimous stipulation and agreement, covering this issue along with Class Cost of Service and Rate Design, was filed on June 4, 2001. The Staff filed suggestions in support of this unanimous stipulation and agreement on June 5, 2001.

III. CONCLUSION

WHEREFORE, for the above-stated reasons, the Staff requests that the Commission adopt the Staff position on each and every issue 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 20th day of July 2001.

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