Exhibit No.:	
Issues:	*Payroll; Payroll Taxes; 401(k) Plan, Health Care Costs; Incentive Compensation, Depreciation & Amortization Expense and Income Taxes*
Witness:	*Amanda C. McMellen*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Direct Testimony*
Case No.:	*ER-2006-0315*
Date Testimony Prepared:	*June 23, 2006*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

AMANDA C. MCMELLEN

THE EMPIRE DISTRICT ELELCTRIC COMPANY

CASE NO. ER-2006-0315

Jefferson City, Missouri
June 2006

****Denotes Highly Confidential Information****

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BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of The Empire District Company of Joplin, Missouri for authority to file tariffs increasing rates for electric service provided to customers in Missouri service area of the Company.	))))	Case No. ER-2006-0315

AFFIDAVIT OF AMANDA C. MCMELLEN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Amanda C. McMellen, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Direct Testimony in question and answer form, consisting of 29 pages to be presented in the above case; that the answers in the foregoing Direct Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Amanda C. McMellen

Amanda C. McMellen

Subscribed and sworn to before me this 22nd day of June 2006.

Toni M. Charlton

TONI M. CHARLTON NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

TONI M. CHARLTON
Notary Public - State of Missouri
My Commission Expires December 28, 2008
Cole County
Commission #04474301

TABLE OF CONTENTS

DIRECT TESTIMONY OF

AMANDA C. McMELLEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2006-0315

DIRECT TESTIMONY

OF

AMANDA C. McMELLEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2006-0315

Q. Please state your name and business address.

A. Amanda C. McMellen, 200 Madison Street, Suite 440, Jefferson City, MO 65102.

Q. By whom are you employed and in what capacity?

A. I am a Utility Regulatory Auditor for the Missouri Public Service Commission (Commission).

Q. Please describe your educational and employment background.

A. I graduated from DeVry Institute of Technology in June 1998 with a Bachelor of Science degree in Accounting. Before coming to work at the Commission, I worked as an accounts receivable clerk. I commenced employment with the Commission Staff (Staff) in June 1999.

Q. What has been the nature of your duties while employed by the Commission?

A. I am responsible for assisting in the audits and examinations of the books and records of utility companies operating within the state of Missouri.

Q. Have you previously filed testimony before this Commission?

A. Yes, please refer to Schedule 1, attached to this direct testimony, for a list of the audits on which I have assisted and filed testimony.

Q. Have you made an examination of the books and records of The Empire District Electric Company (Empire or Company) for purposes of this case?

A. Yes, in conjunction with other members of the Staff.

Q. Please describe your areas of responsibility in this case, Case No. ER-2006-0315.

A. I am responsible for the areas of payroll, payroll taxes, payroll related benefits, incentive compensation, depreciation and amortization expense, and income taxes.

Q. Please describe what adjustments you are sponsoring in this case.

A. I am sponsoring the following Income Statement adjustments:

Payroll/Incentive Comp	S-6.3, S-7.2, S-8.2, S-9.2, S-10.2, S-12.4, S-13.4, S-14.4, S-15.4, S-16.4, S-17.1, S-19.1, S-20.1, S-21.1, S-22.1, S-23.1, S-24.1, S-25.1, S-26.1, S-27.1, S-28.1, S-29.1, S-30.2, S-32.1, S-33.1, S-34.2 S-35.1, S-37.1, S-39.2, S-40.2, S-41.2, S-42.1, S-31.1, S-45.1, S-46.1, S-47.4, S-48.2, S-49.3, S-50.1, S-51.1, S-52.1, S-53.1, S-54.1, S-55.1, S-56.2, S-58.2 S-59.1, S-60.2, S-61.2, S-62.1, S-63.1, S-64.1, S-65.1, S-66.1, S-67.1, S-68.1, S-69.2, S-71.1, S-72.1, S-73.2, S-76.1 S-77.2, S-78.1, S-79.2, S-79.4, S-80.3, S-82.2, S-85.6, S-89.3, S-91.2
Payroll Taxes	S-95.1, S-95.2, S-95.3
Payroll Related Benefits	S-85.7, S-85.8, S-85.9
401(k) Plan	S-85.10
Depreciation Expense	S-92.1
Amortization Expense	S-94.1, S-94.2, S-94.3, S-94.4
Current Income Tax	S-96.1
Deferred Income Tax	S-97.1

This testimony will also explain the following line items contained on Accounting Schedule 2, Rate Base:

Deferred Income Taxes

Q. What Accounting Schedules are you sponsoring in this proceeding?

A. I am sponsoring Accounting Schedule 5 - Depreciation Expense and Accounting Schedule 11 – Income Tax.

Q. What test year has the Staff utilized in this case?

A. The Staff has used the Commission-authorized test year ending December 31, 2005, updated through March 31, 2006.

Q. What knowledge, skills, experience, training, and education do you have related to your audit assignments in this case?

A. My college education provided a fundamental knowledge base, which I have utilized in my assigned duties at the Commission. I have attended training courses and reviewed in-house training materials while at the Commission. I have continually received guidance from the Senior Auditors in the Commissions Auditing Department on my assignments. I have reviewed the testimony and workpapers from previously filed cases on the issues to which I am assigned in this case. I reviewed the Company's testimony, workpapers, and data request responses on the issues to which I am assigned in this case. I was assigned to and submitted testimony in a previous Empire case, specifically Case No. ER-2001-299. Finally, my previous work assignments at the Commission have provided a knowledge base upon which I rely to develop my assigned areas in this rate proceeding.

EXECUTIVE SUMMARY

Q. Please provide a brief summary of your testimony.

A. My testimony covers the areas of payroll, payroll-related expenses, and income taxes. I reviewed the Company's payroll/payroll-related expenses and developed adjustments to annualize and normalize these areas. I developed adjustments to reflect updated payroll/payroll related expenses through March 31, 2006.

Q. Please provide a general outline of your discussion of payroll.

A. A utility's test year expenses, like its revenues, must be annualized and normalized in order to develop a cost of service that is representative of the company's ongoing operations. First, I will describe the types of adjustments the Staff is proposing in this case. Second, I will discuss the specific adjustments I am sponsoring. Lastly, I will describe the approach I utilized regarding the determination of payroll/payroll related benefits for purposes of annualizations and normalizations.

Q. Please describe your testimony related to income taxes.

A. There are four (4) components to the total income tax liability for a utility: current income tax; deferred income tax; the amortization of excess deferred income tax; and the amortization of deferred investment tax credit. I calculated the Staff's level for these four components.

AMORTIZATION RESERVE

Q. Please describe the Staff's level for amortization reserve.

A. Accounting Schedule 2, Rate Base, lists Empire's total amortization reserve balance as of the update period ending March 31, 2006 on Line 4.

PAYROLL

Q. What are the different components of the Staff's payroll annualization?

A. The payroll annualization considers six (6) major categories of pay: executive, non-union full-time, non-union part-time, full-time union, part-time union and non-regulated employees. Commissions, overtime, incentive pay, total and permanent disability pay, supplemental executive retirement plan and other miscellaneous pay items are also included in the Staff's payroll annualization.

Q. What are annualizations?

A. Annualizations are made to reflect a full 12-month period of revenues and expenses in the development of the proper revenue requirement. The annualization process is commonly used to adjust expense levels such as payroll increases and lease payments. Anytime an event occurs during the test year or update period that causes revenue and expense levels to go up or down on an ongoing basis, an annualization is necessary. The event could be a change in executive salaries and/or union wages, a change in fuel prices or a change in depreciation levels for new plant additions.

Q. What methodology did you employ to determine annualized payroll?

A. The Staff used the Company's employee levels at March 31, 2006. The wage rate and salary levels are based upon straight time wages/salaries according to the most recent information available to the Staff through March 31, 2006. Hourly wage rates were computed for hourly workers using 2,088 hours, which represents the number of work hours in a year based on the 12-month period ending March 31, 2006. Salary rates are computed on an annual basis as of March 31, 2006.

Q. Why did the Staff use the wage rates/salaries and employee levels at March 31, 2006 to calculate the payroll annualization?

A. Using information as of March 31, 2006, which is the end of the update period ordered in this case, and is consistent with other aspects of this case, uses most recently available information within the test year as updated, and is consistent with the ratemaking principle of maintaining/matching the proper relationship of revenues, expenses and investment at an appropriate point in time.

Q. How did the Staff calculate of the overtime portion of the payroll adjustment?

A. The Staff used a five-year average of overtime hours worked for the years April 2001 through March 2006, multiplied by the most recent hourly overtime rate paid during the 12-months ended March 31, 2006, provided in the Company's updated payroll workpapers.

Q. Please explain how the Staff determined that a five-year average of overtime hours was appropriate.

A. The Staff performed a five-year historical analysis of overtime hours to determine the reasonableness of overtime dollars included in the test year payroll. The historical analysis of overtime hours indicated that hours varied by year with no consistently increasing or decreasing trend. Based upon the Staff's analysis, the Staff determined that the five-year average of overtime hours provided by the Company would be most representative of a normalized level of overtime hours.

Q. What are normalizations?

A. Normalization adjustments are made to ensure that the revenue requirement determination properly reflects "normal" levels of revenues and expenses. Adjustments are made to remove the effects of unique events not expected to recur and to put in place levels that reflect the Company's ongoing operations. Examples of normalization adjustments are those adjustments made for "normal" weather for those classes of customers whose use of electricity is sensitive to winter and summer temperatures. Another example of a normalization adjustment is when revenues or usage is high or low as a result of an unusual event. Maintenance expense may be unusually high because a power plant may be out of service for an unusually long period of time in a test year, requiring a normalization of maintenance costs to reflect an appropriate level of costs in the case.

Q. What miscellaneous items has the Staff included in its payroll annualization?

A. The miscellaneous items the Staff has included are stipends for employees and gross-up pay associated with required physicals.

Q. How did you determine total annualized payroll?

A. The Staff's annualized payroll equals the sum of annualized salaries and wages; the test year level of commissions; the five-year average of overtime; incentive compensation (which will be discussed later in my direct testimony); and the test year levels of total and permanent disability pay, supplemental executive retirement and other miscellaneous pay items.

Q. Did the Staff include all of Empire's total payroll costs to determine the electric utility operation and maintenance (O&M) expense the Staff included in the revenue requirement it developed?

A. No. In addition to its electric operations in Missouri, Empire also has water, telecommunications and gas operation in Missouri and electric operation outside of Missouri;

therefore, the Staff only allocated that portion of Empire's total payroll costs to its Missouri electric operations that are attributable to those operations.

Q. How did the Staff determine what portion of Empire's total payroll costs to allocate to its Missouri electric operations?

A. The electric O&M expense allocation factor was derived from data provided in response to Staff Data Request No. 291. Empire was requested to identify the amounts of O&M costs charged to expense, construction and retirement for the electric, water and non-utility functions for the years 2001 through 2005.

Q. Why has the Staff used a five-year average to develop its electric O&M expense factor for Empire's Missouri electric operations?

A. The Staff performed a five-year historical analysis of electric O&M expense factors to determine the reasonableness of the test year factor. The historical analysis indicated a year-to-year variance with no consistently increasing or decreasing trend. Based upon the Staff's analysis, a five-year average of electric O&M expense factors is most representative of a normal ongoing level. The Staff's electric O&M expense factor is 72.56%. The remaining 27.44% represents charges to construction, retirements, water operations and non-utility functions combined.

Q. How did the Staff determine the portion of annualized total Company payroll to charge to electric O&M expense?

A. The Staff multiplied total annualized payroll by the Staff's five-year average electric O&M expense factor to derive total annualized electric payroll expense. Total annualized payroll was then distributed to expense functions based upon the actual distribution of test year payroll. Staff includes all payroll, including non-regulated payroll, in its payroll annualization. Staff's O&M percentage eliminates the non-regulated portion from each aspect of Staff's payroll annualization.

Q. Has the Staff applied the electric O&M expense factor to other payroll related adjustments?

A. Yes. The Staff also applied the electric O&M expense factor to other payroll-related adjustments such as 401(k), health care costs and other employee benefits, which naturally follow payroll expense.

Q. Which Income Statement adjustments reflect the Staff's annualization and normalization of payroll?

A. The Staff's payroll adjustments are S-6.3, S-7.2, S-8.2, S-9.2, S-10.2, S-12.4, S-13.4, S-14.4, S-15.4, S-16.4, S-17.1, S-19.1, S-20.1, S-21.1, S-22.1, S-23.1, S-24.1, S-25.1, S-26.1, S-27.1, S-28.1, S-29.1, S-30.2, S-32.1, S-33.1, S-34.2, S-35.1, S-37.1, S-39.2, S-40.2, S-41.2, S-42.1, S-31.1, S-45.1, S-46.1, S-47.4, S-48.2, S-49.3, S-50.1, S-51.1, S-52.1, S-53.1, S-54.1, S-55.1, S-56.2, S-58.2, S-59.1, S-60.2, S-61.2, S-62.1,S-63.1, S-64.1, S-65.1, S-66.1, S-67.1, S-68.1, S-69.2, S-71.1, S-72.1, S-73.2, S-76.1, S-77.2, S-78.1, S-79.2, S-80.3, S-82.2, S-85.6, S-89.3 and S-91.2.

INCENTIVE COMPENSATION

Q. Does Empire have employee incentive compensation plans?

A. Yes. Empire has three incentive compensation plans. There is an incentive compensation plan for the officers of the Company called the management incentive compensation plan (MIP), a discretionary compensation incentive award for salaried non-officer employees, and a program that offers certain employees lump-sum payments in the nature of bonuses called "Lightning Bolts."

Q. Please give a brief description of the Company's MIP.

A. The MIP is available to the Company's senior officers: President and Vice Presidents. An MIP award is based on recommendations from an executive compensation study prepared by HayGroup, a consulting company hired by Empire. The MIP considers three main categories of compensation are reviewed in determining a MIP award: base salary, cash incentives and long-term stock incentives.

In early 2006, MIP awards were paid to senior officers for the achievement of goals during the calendar year 2005. Each senior officer had a list of goals pertaining to areas such as expense control, customer service, regulatory performance and financial performance. Each of these goals were given a specific performance measure and a weighting, thus assigning a target cash payout. The amount of the award determination was based upon attainment of a specific performance level by that senior officer:

1. Threshold (50% of target payout),
2. Target (100% target payout), and
3. Maximum (200% of target payout).

If the results for a specific goal were below the threshold, the senior officer did not receive an MIP award related to that specific goal. If the results were at or above the level set for the maximum goal the senior officer received double the target MIP award for that specific goal.

The MIP long-term stock incentive is made up of stock options and performance shares. Stock options are considered part of the senior officer's total compensation and are granted each year to the officers of the Company. The senior officers do not have any extra goals to meet in order to be granted these stock options. The senior officer can exercise the options after a three-year vesting period if the stock price is higher than at the time of the grant and the senior officer is still employed by the Company.

Annually, there is a three-year comparison of total shareholder return between Empire and the companies in a peer group utilized in the HayGoup study. The total number of performance shares to be awarded is based on this comparison.

Q. Please explain the Staff's treatment of the base salary and cash incentive portion of the MIP.

A. The Staff views the base salary considered in MIP to be the same as the base salary of other employees and has included the entire amount in its annualization of payroll. The Staff has applied the same criteria accepted by the Commission for incentive compensation plans for both management and salaried employees. The Staff performed an analysis of the cash incentives issued for the MIP in early 2006. These cash payments were for the achievement of goals during the test year 2005. The Staff eliminated from recovery awards related to attainment of earnings goals. In the Staff's view, since financial goals primarily benefit shareholders, shareholders should bear the cost of these incentives. There is no direct correlation between increased earnings and customer benefits. The Commission has historically not allowed incentive payments for goals related to the financial performance because these goals primarily benefit the shareholder. In its Report And Order in Case No. GR-96-285, Missouri Gas Energy (MGE), 5 Mo.P.S.C.3d 437, 458 (1997), the Commission stated:

> …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.

The Staff also eliminated payment for goals related to non-regulated activities. The criteria utilized by the Commission and applied by the Staff requires that incentive compensation included in cost of service, be the result of employees performing beyond basic job requirements and providing benefits to Empire ratepayers. In the Report And Order in Case Nos. EC-87-114 and EC-87-115, Union Electric Company, 29 Mo.P.S.C.(N.S.) 313, 325 (1987), the Commission stated:

> …At 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 plan…

The Company uses "at budget" and "on schedule" as target levels and commences payouts of 50% of the target level for outcomes that are over budget and past the scheduled completion date. The Staff eliminated the cash incentives paid out relating to goals in which the results were over budget or past the scheduled completion date. The Staff believes that by using these measurements for payout thresholds, the employees are allowed to perform below an appropriate level of expectation and still receive an award. The Staff believes that at a minimum, goals should have a threshold for payouts of "at budget" or "on schedule."

Q. What is the range of amounts paid out to the executives for MIP?

A. ** ______________________________ **

Q. How many Empire executives received MIP awards for 2005?

A. ** ______________________________ **

Q. What was the total cost to Empire for the base salary and cash incentive portions of the MIP awards for 2005?

A. The total cost to Empire for the base salary and cash incentive portions of the MIP awards in 2005 was ** ________ **

Q. Were any Empire executives eligible for a MIP award for 2005 that did not receive one?

A. ** ____ ___________ **

Q. How are the amounts of MIP awards determined?

A. ** ____ _______________ **

Q. How does the Staff treat the long-term stock incentive portion of the MIP?

A. The Staff eliminated all expenses for stock options during the test year in adjustment S-79.4. These options are granted to the officers with no increase in duties or goals and no measurement to determine whether any specific duties or goals that have been met. These options also accumulate dividend equivalents during the three-year vesting period. The dividend equivalents are intended to keep the executives focused on dividend maximization. The Staff views dividend equivalents as focused on stockholder benefits with no direct connection to improvement in operating performance or quality of service to the ratepayer. Therefore, the Staff believes that the stockholders should bear these costs.

The Staff has not included any costs for the performance shares because the goal that triggers the awarding of the shares is total shareholder return. The Company's total shareholder return is compared to that of a peer group, chosen by the HayGroup, from a list of utility companies of comparative size and financial criteria. The companies in the peer group do not do business in the state of Missouri. Since the triggering mechanism is total shareholder return, the Staff believes that the cost of this benefit should be borne by the shareholders. By using the performance of a peer group to determine an incentive award, the

Company has established criteria that are based on the financial performance of employees and factors beyond Empire's control. There is no direct correlation between the financial performance of the peer group of utilities and benefits to Empire's ratepayers.

Q. What are Empire's program for discretionary compensation incentive awards for salaried non-officer employees?

A. It is a discretionary award pool that Empire uses to reward salaried employees who have met all items on a specified list of objectives.

Q. How is the Staff treating the Company's discretionary compensation award pool?

A. The Staff is allowing a portion of this program. In the Company's response to Staff Data Request No. 268, the Company provided a sample of employees who received a discretionary compensation incentive award for the test year and a description of the criteria under which the awards were granted. The Staff reviewed the goals for each individual in the sample. The Staff discovered that in certain instances employees were receiving awards for objectives met that were part of the employees' normal job duties, and some employees were receiving awards for their active involvement with certain charitable contribution campaigns, such as the United Way. Based on the sample provided in response to Staff Data Request No. 268, the Staff calculated a percentage of awards in which the goals were related to normal job duties, involvement in charitable activities and non-cost of service activities, such as meeting with area legislators. The Staff then applied that percentage to the total discretionary pool awarded to employees. The Staff disallowed the amount resulting from this calculation from the cost of service as being unnecessary for the provision of safe and adequate service at just and reasonable rates. There was no direct correlation between these incentive awards and benefits to Empire ratepayers.

Q. What is the range of the awards paid out to the employees for the discretionary award pool for 2005?

A. The amounts paid out by person range from ** ____________________ ** for the discretionary award pool.

Q. How are the amounts of the awards determined?

A. ** ____ ____ **

Q. What is the total amount awarded to employees over the last few years for the discretionary award pool?

A. Employees have been awarded the following amounts: 2003-$339,132; 2004-$358,385; and 2005-$412,445.

Q. How much of the discretionary award pool is the Staff disallowing?

A. For this case, the Staff is disallowing ** _______ ** of the discretionary award pool.

Q. What is Empire's Lighting Bolts incentive compensation program?

A. It is a discretionary award program offered to Empire's non-union salaried employees. Under this program individuals who have delivered results that are beyond those normally associated with their position may receive cash awards.

Q. How has the Staff treated "Lightning Bolts" awards made in the test year?

A. The Staff recommends disallowance of these awards, as they do not meet criteria accepted by the Commission for incentive compensation. Reasons for awarding

"Lightning Bolts" listed in the Company response to Staff Data Request No. 240 include working on the United Way Campaign, working on the Aquila United, Inc. gas property acquisition and performing normal responsibilities. There are no set criteria established or attached to the earning of the "Lightning Bolts" awards. Employees cannot ascertain the level of performance that must be achieved for such an award. These payments are made solely at the discretion of the Company's management.

Q. What is the range of amounts paid out to the employees for the "Lightning Bolt" awards?

A. The amounts paid out by person range from ** ____________________ ** for the "Lightning Bolt" awards.

Q. What is the total amount awarded to employees over the last few years for the "Lightning Bolt" awards?

A. Employees have been awarded the following amounts: ** ____________ ___________________________ **.

PAYROLL TAXES

Q. Please explain adjustment S-95.2.

A. Adjustment S-95.2 annualizes Federal Unemployment Tax Act (FUTA) expense by multiplying that portion of each employee's salary at or under the current $7,000 FUTA limit by the current 2006 rate of .8%. The electric O&M expense factor of 72.56% was applied to the total annualized FUTA amount to derive the electric O&M expense portion. This amount was compared to the test year level to determine the FUTA expense adjustment.

Q. Please explain adjustment S-95.3.

A. Adjustment S-95.3 annualizes State Unemployment Tax ACT (SUTA) expense by multiplying the portion of each employee's salary at or under the respective State's SUTA limit by the respective State's 2006 unemployment tax rate. The dollar limits are: Missouri - $11,000, Kansas - $8,000, Oklahoma - $13,500 and Arkansas - $10,000. The 2006 rates are: Missouri – 0.78%, Kansas - 0.11%, Oklahoma - 0.20% and Arkansas - .90%. The electric O&M expense factor of 72.56% was applied to the total annualized SUTA amount to derive the electric O&M expense portion. This amount was compared to the test year level to determine the SUTA expense adjustment.

Q. Please explain adjustment S-95.1.

A. Adjustment S-95.1 represents the annualization of the Federal Insurance Contributions Act (FICA) tax.

Q. Please explain how the Staff annualized the FICA tax.

A. FICA (Social Security) is comprised of Old Age, Survivors and Disability Insurance (OASDI) taxes and Medicare taxes. The OASDI tax rate of 6.20% is limited in calendar year 2006 to the first $94,200 of gross income per employee. The OASDI tax may also be reduced by the employee's election to set aside a portion of his/her gross salary/wages for healthcare, life insurance, medical expenses and/or dependent care through Empire's Employee Flexible Benefit Plan. The reduction of OASDI tax related to an employee's election to participate in the Employee Flexible Benefit Plan also reduces the applicable OASDI tax. Empire provided the Employee Flex Benefit Plan elections for 2005, updated through March 31, 2006, in response to Staff Data Request No. 60. The Medicare tax of 1.45% applies to the total gross income with no exclusions. The appropriate OASDI and Medicare tax rates were applied to the tax base portion of annualized wages/salaries for each individual employee. The Staff applied the OASDI and Medicare tax rates to fringe benefits, overtime dollars, incentive compensation and miscellaneous items up to OASDI limitations to determine the annualized total Company FICA taxes. The electric O&M expense factor of 72.56% was applied to the total annualized FICA amount to derive the electric O&M expense portion. This amount was compared to the test year level to determine the FICA tax expense adjustment.

PAYROLL RELATED BENEFITS

Q. Please explain adjustment S-85.10.

A. Adjustment S-85.10 reflects the increase in expenses for Empire's Employee 401(k) Retirement Plan based upon the employees' current election. Under the 401(k) Plan, employees have the option of deferring, for receipt in the future, a portion of their salaries or wages. The Company matches 50% of the employee's deferral, up to a maximum of 6% of the employees' salaries/wages. Empire provided the employee 401(k) deferral election percentages for 2005 updated through March 31, 2006 in response to Staff Data Request No. 58. These amounts were applied to the annualized wage/salary levels to determine Empire's annualized 401(k) expense. The total Company expense factor was then applied to the total Company annualized 401(k) employer cost to determine the electric O&M expense portion. This amount was compared to the test year level to determine the adjustment.

Q. Please explain adjustment S-85.7.

A. Adjustment S-85.7 annualizes the health care expense for Empire employees. The Staff performed an analysis of the health care costs included in account 926 from the general ledger, based on Empire's response to Staff Data Request No. 28. The Staff's analysis shows that health care expenses are currently declining at Empire. The Staff annualized the expense of employee health care plans in effect through the update period ending March 31, 2006. This amount was compared to the test year level to determine the adjustment.

Q. Why are healthcare costs declining?

A. During a meeting with the Company on April 26, 2006, Empire disclosed that in January 2006 it had entered into a new healthcare provider contract in January 2006 with lower rates that are locked in for a five-year term. Also, Empire has implemented a new wellness program in April 2005, which was another asserted reason for the decline in healthcare costs.

Q. Please explain adjustment S-85.8.

A. Adjustment S-85.8 annualizes the life insurance expense for Empire employees. The Staff performed an analysis of the life insurance costs included in account 926 from the general ledger, based on Empire's response to Staff Data Request No. 28. The Staff's analysis shows that life insurance expenses are currently declining at Empire. The Staff annualized the expense of employee health care plans in effect through the update period ending March 31, 2006. This amount was compared to the test year level to determine the adjustment.

STATE LINE 1 AND ENERGY CENTER 1 AND 2 MAINTENANCE EXPENSES

Q. Please explain adjustment S-34.3.

A. The Staff made adjustment S-34.3 to amortize costs associated with the Siemens-Westinghouse maintenance contracts for the State Line 1 and Energy Center 1 and 2 combustion turbines, which went into effect on June 29, 2001, and also the costs associated with the maintenance to bring the units into compliance with the specifications of the maintenance contracts.

State Line Unit 1 went into service during 1995 and the Energy Center Units were brought on-line earlier, in 1978 and 1981. Because of the age and the condition of these plants, maintenance was required to bring the units up to certain specifications before Siemens would enter into a contract to provide ongoing maintenance. Adjustment S-34.3 continues the annualization of these up front costs over the seven-year length of the maintenance contracts on the units, as established in the previous rate case.

Adjustment S-34.3 reflects the normalization of the cost associated with the contract for maintenance on the State Line Unit 1 and Energy Center Units 1 and 21. Staff witness Kofi Boateng addresses ongoing maintenance costs of these units in his direct testimony.

<u>DEPRECIATION EXPENSE</u>

Q. Please explain Accounting Schedule 5 and the associated adjustments to depreciation expense.

A. Accounting Schedule 5, Depreciation Expense, lists in “Column C” the adjusted Missouri jurisdictional plant-in-service balances from Accounting Schedule 3, “Column F.” “Column C” lists the Staff’s depreciation rates used in this proceeding. The rates in “Column C” are then applied to the adjusted Missouri jurisdictional plant balances in “Column B” to determine the annualized level of depreciation expense, an Empire Missouri electric operations only basis, that appears in “Column D.” The total depreciation expense, less the amount recorded in the test year, is the basis for Adjustment No. S-92.1, which appears on Accounting Schedule 10, Adjustments to Income Statement.

Q. What depreciation rates is the Staff proposing to use in this case?

A. The Staff is using the same depreciation rates ordered by the Commission in Empire's last rate proceeding, Case No. ER-2004-0570.

Q. Please explain Income Statement Adjustment Nos. S-93.1 and S-93.2.

A. Adjustment Nos. S-93.1 and S-93.2 remove annualized depreciation expense associated with Accounts 315.200, Accessory Electric Equipment (Riverton), and 342.300 Fuel Holders, Producers, & Accessory (Energy Center-CT). These account numbers have plant-in-service balances that have been fully depreciated. Therefore, these adjustments are necessary so that these expenses are not recovered twice.

AMORTIZATION EXPENSE

Q. Please explain Adjustment No. S-94.1.

A. Adjustment No. S-94.1 increases expense to reflect the annualized amortization expense associated with Account 404.000, Amortization–Limited Term Electric Plant.

Q. Please explain adjustment S-94.2.

A. In 2001, 2002, 2003 and 2004, Empire issued 2,012,500 shares of common stock, 2,500,000 shares of common stock, 2,000,000 shares of common stock and 300,000 shares of common stock, respectively. In doing so, the Company incurred costs totaling $6,818,414. It is the Staff's position that these costs be recovered through rates as an above-the-line adjustment to operating expenses. The costs need to be normalized over a five-year period for purposes of this proceeding. As such, I am sponsoring Adjustment No. S-94.2 to reflect this amortization.

Q. Please explain adjustment S-94.3.

A. The Staff made adjustment S-94.3 to reflect the amortization of cost associated with the move of the step-up transformer at Asbury. During a past Asbury outage, the step-up transformer was inspected, and the Company determined it needed to be replaced. However, there was a delay in delivery of the new transformer so the Company moved the transformer for safety reasons. The Staff, therefore, amortized the costs associated with moving the transformer over five years.

Q. Please explain adjustment S-94.4.

A. The Staff made adjustment S-94.4 to reflect the amortization of actual cost incurred associated with the Customer Programs Collaborative in accordance with the Stipulation And Agreement reached in Case No. EO-2005-0263 and the new Demand Side Management and affordability programs in accordance with the Stipulation And Agreement in Case No. ER-2004-0570.

<u>INCOME TAXES</u>

Q. Please explain adjustment S-96.1.

A. Adjustment S-96.1 adjusts current income taxes to a level consistent with the Staff's calculation of Net Operating Income Before Taxes (NOIBT).

Q. Please explain each component of the Company's total income tax liability.

A. There are four components to the total income tax liability. These four components include: 1) current income tax, 2) amortization of deferred investment tax credit (ITC), 3) deferred income tax, and 4) the amortization of deferred income tax. These components are summarized in the income tax calculation on Accounting Schedule 11.

Q. Please describe the current income tax component.

A. The Staff calculated the current income tax component shown on Accounting Schedule 11 by taking the NOIBT amount from Accounting Schedule 9, Income Statement and adjusting it by the additions to and deductions from NOIBT that appear on Accounting Schedule 11. The Staff then multiplied this result by the appropriate federal and state income tax rates to arrive at the adjusted expense level. This calculation is based upon the fact that federal income taxes are 50% deductible for state income tax purposes and that state income taxes are fully deductible for federal income tax purposes. The calculation in this case is based on the use of a 35% federal income tax rate and a 6.25% state income tax rate. This results in an effective overall tax rate of 38.39%

Q. How did the Staff calculate adjustment S-96.1?

A. Adjustment S-96.1 reflects the difference between the annualized current income tax expense, described above, and the Company's test year level of current income taxes. The annualized level of current income tax expense is shown on Accounting Schedule 11, line 39.

Q. Please describe the amortization of deferred ITC component.

A. The amortization of deferred ITC component represents the recovery by the ratepayer of a portion of previously deferred ITC. The amount is based on the level of deferred ITC amortization reflected on the Company's books during the 12 months ended December 31, 2005, which represents the test year.

Q. Please describe the deferred income tax component.

A. The deferred income tax component reflects the tax expense associated with specific timing differences recognized in the determination of current income tax according to the Internal Revenue Service Code (Code), but deferred (normalized) to a future period for ratemaking purposes. The largest timing difference included in deferred income tax is the difference between the tax deduction for depreciation, under accelerated methods prescribed by the Code, used in calculating current income tax, and the corresponding tax deduction for depreciation under the straight line method, used in the ratemaking process. This timing difference must be deferred (normalized) according to the Code. The deferred income tax amount is calculated by multiplying those tax timing differences that the Staff has normalized by the overall effective tax rate of 38.39% as previously discussed. A description of the tax timing differences, including those to be normalized, will be provided later in my testimony.

Q. Please explain the tax concept of "normalization."

A. Under the Code, the Company recognizes certain items in the calculation of current income tax at different times than when the items are recognized for book purposes. Items for which this tax treatment applies are called "tax timing" differences. Normalization treatment eliminates these differences for ratemaking purposes so that income tax expense is based solely on the book income impact of these timing differences. As an example, the excess of tax depreciation over straight-line tax depreciation is deducted from operating income and results in lower current taxable income and current income tax expense. However, the reduction in current income tax for this timing difference is offset by a corresponding increase in deferred income tax. The net result on total income tax expense is zero.

Q. Please explain the tax concept of "flow-through."

A. The term flow-through refers to the tax treatment that equates the amount provided by the ratepayer for income tax expense with the amount paid to the taxing authority. Under flow-through, no deferred tax is created to offset the impact of the timing difference on current income tax expense.

Q. Please describe the amortization of the deferred income tax component.

A. The amortization of the deferred income tax component represents the amount of excess deferred income taxes flowed back to the ratepayers. These excess deferred income taxes result from the Tax Reform Act of 1986. Prior to 1986, income taxes were deferred at a rate of 46%. After 1986, they were deferred at a 35% rate. The excess deferrals, resulting from the 11% higher rate, must be amortized and flowed back to the ratepayers. The amortization of the deferred income tax component in this case was determined from data provided by the Company in various workpapers. The amount of the amortization is included in the Staff's calculation of deferred income tax, which appears on Line 108 of Accounting Schedule 9, Income Statement.

Q. Please describe adjustment S-97.1.

A. Adjustment S-97.1 represents the amount needed to adjust total test year booked deferred income taxes to the adjusted level of deferred income taxes calculated by the Staff.

Q. How are tax timing differences presented in the Staff's case?

A. Tax timing differences are represented on Accounting Schedule 11, Income Tax, as additions to and as deductions from NOIBT.

Q. Please identify the additions used to arrive at net taxable income in this case.

A. Annualized book depreciation is added back to net income before taxes because the deduction for tax depreciation in determining income taxes is different than for book depreciation. It is necessary to add back this item to avoid deducting depreciation amounts twice for tax purposes. Operations and maintenance depreciation, non-deductible expense and Contribution in Aid of Construction (CIAC) are also added back to NOIBT.

Q. Please list the deductions used to arrive at net taxable income.

A. The deductions are: (1) interest expense, (2) tax straight-line depreciation and (3) excess tax depreciation.

Q. Please explain the deduction for interest expense and how it was calculated.

A. Interest expense is calculated by multiplying the jurisdictional rate base by the Staff's weighted cost of debt (3.65%), which is sponsored by Staff witness David F. Murray of the Financial Analysis Department.

This methodology assures that the amount of interest expense used in the calculation of income tax expense, for ratemaking purposes, equals the interest expense the ratepayer is required to provide the Company in rates. Since the revenue requirement recommended by the Staff is based on a rate of return computation, the interest synchronization method allows an interest deduction consistent with the rate of return computation that is applied to rate base. Interest synchronization has been consistently used by the Staff and adopted by the Commission in past orders.

Q. Please identify the source of the amount of the deduction for tax straight-line depreciation.

A. The amount of this item was determined by using historical information to develop a ratio of the tax basis of depreciable plant to Empire's book basis of depreciable property as of December 31, 2005. This ratio was applied to the annualized book depreciation that was included in the Staff's revenue requirement to determine the Missouri jurisdictional straight-line tax depreciation amount used in the calculation of income tax expense.

Q. Please describe the deduction for excess tax depreciation.

A. The Staff determined the excess tax depreciation amount by subtracting the jurisdictional amount for straight-line tax depreciation, described above, from total tax depreciation. The amount of excess tax depreciation is subject to normalization restrictions under the Code that do not allow flow-through treatment of this item for regulatory purposes. Utility companies like Empire benefit from this restriction because the associated deferred taxes provide enhanced cash flow to their operations. The deferred taxes are accumulated and used as an offset to rate base.

Q. Why does a depreciable basis difference exist between the depreciable book basis and tax basis?

A. A difference exists between the depreciable book basis and tax basis because the Code has allowed expenditures, which are capitalized for book purposes, to be deducted in the year incurred for tax purposes. As a result, the tax basis is typically lower than the basis used to calculate book depreciation.

Q. In reference to the items discussed above, would you please identify the items that the Staff is proposing to normalize in the income tax calculation?

A. The Staff is proposing to normalize excess tax depreciation and CIAC. Since the Staff has recognized these timing differences in its calculation of current income tax, it is necessary to provide corresponding deferred income tax treatment for these items. The Staff calculated the deferred income tax component by multiplying these timing differences by the effective tax rate of 38.39%.

Q. Which of the items is the Staff proposing to flow-through in its income tax calculation?

A. The Staff is proposing to flow-through straight-line tax depreciation and interest expense.

Q. Are there any specific tax-related items that you are sponsoring on Accounting Schedule 2, Rate Base?

A. Yes. I am sponsoring the line item for deferred income taxes that appears on Accounting Schedule 2, Rate Base, as a subtraction from rate base.

Q. Please explain the subtraction of deferred income taxes from rate base.

A. The balance of deferred income taxes included on Accounting Schedule 2 is composed of the accumulated deferred income tax balances related to CIAC, software development costs, loss on required debt, pensions and interest capitalized. The balances of deferred taxes reflect the Missouri jurisdictional balances as of December 31, 2005, updated through March 31, 2006.

Q. With reference to the tax timing differences that were reflected (excess tax depreciation and CIAC), what justification exists for the inclusion in the rate base of deferred income tax balances related to items that were not specifically normalized in the past?

A. As long as it is intended that a tax timing difference be normalized, one should be indifferent to its inclusion for total tax expense. This is because a tax timing difference can be normalized in one of two ways: 1) the item can be used to determine current taxable income and a deferred income tax expense explicitly calculated on that tax timing difference, or 2) the item can be excluded from the tax calculation. Either way, total income tax is unaffected. Normalization represents a shift between the level of the current and deferred components of total income tax expense.

It is the Staff's opinion that these deferred tax balances are legitimate inclusions for the determination of rate base, since the related tax timing differences have been effectively normalized through exclusion from the tax calculation in the past.

Q. How were the amounts of the deferred tax balances determined?

A. The deferred tax balance associated with losses on reacquired debt, tax interest capitalized, CIAC and software costs reflect the Missouri jurisdictional balances accumulated through March 31, 2006. The prepaid pension asset balance, included in rate base, was multiplied by the effective tax rate to determine the deferred tax balance associated with pensions. This balance reflects the deferred income tax associated with the normalization of the tax timing difference that is represented by the prepaid pension asset recognized by the Staff.

Q. Does this conclude your direct testimony?

A. Yes, it does.

SUMMARY OF RATE CASE TESTIMONY FILED

Amanda C. McMellen

COMPANY	CASE NO.	ISSUES
Osage Water Company	SR-2000-556	Plant in Service Depreciation Reserve Depreciation Expense Operation & Maintenance Expense
	WR-2000-557	Plant in Service Depreciation Reserve Depreciation Expense Operation & Maintenance Expense
Empire District Electric Company	ER-2001-299	Plant in Service Depreciation Reserve Depreciation Expense Cash Working Capital Other Working Capital Rate Case Expense PSC Assessment Advertising Dues, Donations & Contributions
UtiliCorp United, Inc./ d/b/a Missouri Public Service	ER-2001-672	Insurance Injuries and Damages Property Taxes Lobbying Outside Services Maintenance SJLP Related Expenses
BPS Telephone Company	TC-2002-1076	Accounting Schedules Separation Factors Plant in Service Depreciation Reserve Revenues Payroll Payroll Related Benefits Other Expenses

SUMMARY OF RATE CASE TESTIMONY FILED

Amanda C. McMellen

COMPANY	CASE NO.	ISSUES
Aquila, Inc. d/b/a Aquila Networks-MPS & Aquila Networks-L&P	ER-2004-0034	Revenue Annualizations Uncollectibles
Fidelity Telephone Company	IR-2004-0272	Revenue Revenue Related Expenses
Aquila, Inc. d/b/a Aquila Networks-MPS & Aquila Networks-L&P	ER-2005-0436	Revenue Annualizations Uncollectibles