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July 20, 2001

Mr. Dale Hardy Roberts
Executive Secretary
Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

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

Dear Mr. Roberts:

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

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

Sincerely yours,

Gary W. Duffy

Gary W. Duffy

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

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

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

FILED[2]
JUL 2 0 2001
Missouri Public Service Commission

INITIAL BRIEF OF

THE EMPIRE DISTRICT ELECTRIC COMPANY

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91

TABLE OF CONTENTS

I. INTRODUCTION AND SUMMARY

Many significant and complex issues presented by this case were settled by the parties. These include fuel and purchased power, class cost of service and rate design, and the in-service criteria and capital costs for the new State Line Combined Cycle (SLCC) power plant. These settlements are awaiting approval by the Commission.

Some issues were not settled and are the subject of this initial brief. The Commission should rule in Empire's favor on all of these issues.

One issue, Operation and Maintenance Expenses, which pertains to several of the power plants, is essentially a true-up item and therefore has not been briefed at this time.

In accordance with the Commission's direction, this initial brief follows the order of the issues presented in the original List of Issues filed with the Commission.

II. COST OF SERVICE - DEPRECIATION

A. Should Empire's test year depreciation expense be adjusted?
(1) What are the appropriate average service lives for plant in service other than at State Line Power Plant ("SLCC")?

a. Service Lives

The disagreement over the appropriate service lives to use for generation plant, other than the SLCC, is somewhat mysterious because it is unclear what the Staff has done, and why it has adjusted these lives from those used when Empire's depreciation rates were last established (***In the Matter of The Empire District Electric Company for Authority to File Tariffs***, Case No. ER-94-174 (Mo.P.S.C. August 2, 1994)).

Staff witness Adam stated very clearly, both in prepared testimony and during cross-examination, that he is proposing to use the same service lives as those determined by Staff in

Case No. ER-94-174 (Adam Dir., Ex. 33, p. 20; Tr. 222). The Commission adopted the depreciation rates developed by the Staff in Case No. ER-94-174, as a result of a Stipulation and Agreement.

In fact, Staff witness Adam made the following statements in regard to the validity of the Case No. ER-94-174 service lives:

- "Staff are unaware of events that would result in a change to the lives determined for the Generating Plant that was studied in ER-94-174." (Adam Dir., Ex. 33, p. 20);
- There was "no rationale to support changing generating plant lives from those determined in the 1994 study." (Tr. 223-24); and,
- Staff's tours and meetings did not bring forth any justification to change any of the lives and depreciation rates determined in the ER-94-174 study." (Ex. 33, p. 20).

Staff alleged that its proposed depreciation rates applicable to generating plant differ from the currently effective rates (adopted in Case No. ER-94-174) "solely" by virtue of its proposal to exclude future salvage costs from depreciation rates. (Tr. 225).

These representations are directly inconsistent with the service lives proposed by the Staff in its spread sheets. A review of the Staff's generating plant service lives, as presented in Schedule 1-1 of Staff witness Adam's Direct Testimony (Ex. 33), reveals that not only have changes to the service lives been made, the changes are significant and far-ranging.

The "Ordered" section on Schedule 1-1 refers to the rates proposed by the Staff in Case No. ER-94-174, and which were ultimately ordered by the Commission in that case. (Tr. 225). Beneath the "Ordered" section, the Staff has included the Service Life, Net Salvage and resulting

Depreciation Rate used in Case No. ER-94-174.

The "Staff's Proposal" section of Schedule 1-1 contains the Staff's proposal in this case. Beneath the "Staff's Proposal" section the Staff has included the proposed depreciation rates and underlying service lives.

Despite the Staff's statements to the contrary, a very cursory review of these sections shows the following discrepancies between the service lives from Case No. ER-94-174 and the service lives proposed by the Staff in this case:

PLANT - ACCOUNT	ER-94-174 / ORDERED LIFE	STAFF PROPOSED LIFE
Asbury-Steam - Account 314	39.0 years	63.0 years
Riverton-Steam - Account 314	56.4 years	63.0 years
Iatan-Steam Account 314	34.0 years	63.0 years
State Line - Account 341	30.5 years	55.0 years

(Ex. 33, Sch. 1-1, 1-2; Tr. 227-29).

A closer review shows that, in fact, the lives have been changed by the Staff in 27 of the 40 depreciation accounts represented on Schedules 1-1 and 1-2. (Ex. 33). Some of the lives have been changed by as much as 40 years or more. (See Riverton-Steam, Asbury-Steam and Iatan-Steam, Accounts 311).

These changes are not only inconsistent with the statements made by the Staff. More damaging is the fact that the broad and wide sweeping changes are made without explanation, i.e. "evidence." In a recent Commission Case, ***In the Matter of St. Louis County Water Company for Authority to File Tariffs***, Case No. WR-2000-844 (May 3, 2001), the Staff also made proposals concerning changes to existing service lives. The Commission in the ***St. Louis County***

Water Company case pointed out that "the Commission is bound to make its findings and conclusions based on the evidence of record. . . ." (***St. Louis County Water Company***, p. 22). In that case, "there was no evidence in the record to support Staff witness Adam's conclusions about what the proper service lives should be." (***St. Louis County Water Company***, p. 21).

Similarly, in this case, the Staff has not justified its proposed changes. Beyond that, it has offered evidence that it is "unaware of events that would result in a change" to the rates and evidence that in Staff witness Adam's expert opinion there is "no rationale to support changing generating plant lives." These statements by Mr. Adam perhaps justify a decision leaving in place the existing depreciation rates. But they do not justify the new rates proposed by Staff.

Empire, on the other hand, provided specific analysis and explanation of the changes in depreciation rates it proposed. This analysis is primarily found in the Direct Testimony of L.W. Loos, and more particularly in his Report on Analysis of Depreciation Accrual Rates which is Schedule LWL-1 thereto. (Ex. 11). Mr. Loos found that in many cases Empire's "[e]xisting rates do not offer a reasonable probability that investment will be recovered through depreciation charges during the service life of the property." (Ex. 11, Sch. LWL-1). A full and detailed description of the analysis used, materials examined and judgment relied upon is included in Mr. Loos' Direct Testimony and supplemented by his Rebuttal and Surrebuttal Testimony. (Ex. 22 and 31).

The Commission should, therefore, adopt the well-supported and reasoned service lives for generation property other than SLCC presented by Empire and reject the Staff's proposal as unsupported in the record and contrary to its statements.

b. Information Request

Staff witness Adam, in his direct testimony, recounted that Empire was unable to access certain generation plant mortality files because of its conversion to a new computer system. (Ex. 33, p. 19). The Staff suggested certain companies that it believed were in the business of converting such data files, but had not identified a cost for such conversion. Mr. Adam went on to suggest that Empire "be ordered to meet the requirements of the previously stated rules by July 1, 2001, by having the data from the Company's retired computer system formatted to the Company's new computer system and that these accounts be submitted to Staff in the Gannett-Fleming format by July 15, 2001." (*Id.* at p. 20).

First, it is unclear that Empire does not meet the requirements cited by Mr. Adam. Commission rule 4 CSR 240-20-030(3)(J) requires the utility to "maintain records." This has been done by Empire, in a form that has been acceptable to the Commission in the past. Nowhere in the rule cited by Mr. Adam does it require a certain software format, nor does it require "Gannett-Fleming format."

Second, this request is now moot. July 15, 2001 has passed without Commission order and a Commission order is not expected in this case until September of this year.

The Staff testimony requests an order of the Commission that is not consistent with the Commission rule cited and is now moot. It should, accordingly, be denied by the Commission.

(2) How shall the net salvage component be treated?

a. Introduction

The Staff has proposed to address the cost of removal and resulting net salvage associated with utility property in a way that is inconsistent with the whole life method that has been utilized historically for Empire by this Commission.

The method proposed by the Staff would take cost of removal, sometimes a very great cost (for example, the removal of a power plant), and, rather than provide for its collection over the life of a piece of utility property, would instead call for its recovery when incurred. The Staff approach is bad policy for at least two reasons: 1) it creates a form of inter-generational inequity; and, 2) it will lead to much more severe swings in rates for customers. It is also beyond the Commission's jurisdiction because of existing Commission regulations.

The inter-generational inequity arises from the fact that by its very nature, cost of removal will not be incurred until the subject property has been retired and is no longer in service. (Tr. 280-81). Under the traditional whole life method, there is an attempt to spread cost of removal over the entire life span of a piece of property. The whole life method, by its nature, therefore spreads responsibility for payment of this cost, which is inherent to the operation of the facility, to all the customers that benefit from the facility. In the case of a power plant, this may be several decades of customers. Rather than allow these many decades of customers to equitably share in this cost, the Staff would instead assign this cost to the unlucky customers that are receiving service from the utility the first year <u>after</u> the power plant has been removed. Thus, the customers paying for removal would be those who no longer get any use of the property.

For the same reason, the Staff proposal would also introduce additional rate spikes for customers. Again, rather than paying for the cost of removal for a power plant, for example, evenly, over many years, the Staff method would propose to assign this cost to the rate payers in a single year (or, in the alternative, over a time period of only a few years).

The driving force for this Staff proposal seems to be supposed "difficulties" with establishing an appropriate amount for net salvage. The Staff makes the unsupported allegation that cost of removal may not be as high as indicated by the Company, that sometimes property is not removed and that there are some uncertainties in arriving at an appropriate net salvage amount for the purposes of the depreciation calculation. These, however, are not problems with the traditional whole life method. They are complaints with the perceived execution of this method which can, and should, be reviewed by the Commission. In the meantime, there is no reason to throw out the entire use of the whole life method (or, in other words "the baby with the bath water").

These are instead reasons to examine the validity of the net salvage numbers utilized in the development of the depreciation rates and change them where, and if, necessary. Unfortunately, the Staff proposal does not provide the Commission the opportunity to do this in this case. Rather than take the time to perform such a study of the net salvage numbers, which perhaps would have provided the Commission with some alternative approaches to individual net salvage numbers and reasons to make such changes, the Staff proposed a radical change in the method utilized. The Commission should reaffirm the use of the whole life method for Empire and direct its Staff to perform a study of the net salvage calculations for future examination by the Commission.

b. Inter-generational Inequity – Or, Failure to Match Costs With the Cost Causer

Under what Staff witness Adam refers to as the "traditional" treatment of net salvage or the "whole life method" (Tr. 215), cost of removal[1] and salvage[2] have been taken into account in the setting of depreciation rates. Cost of removal is subtracted from salvage value to determine

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[1] "The cost of demolishing, dismantling, tearing down or otherwise removing electric plant, including the cost of transportation and handling incidental thereto." (18 CFR Part 101.10 as incorporated by 4 CSR 240-20.030).

[2] "The amount received for property retired, less any expenses incurred in connection with the sale or in preparing the property for sale; or, if retained, the amount at which the material recoverable is chargeable to materials and supplies, or other appropriate account." (18 CFR Part 101.33 as incorporated by 4 CSR 240-20.030).

"net salvage." The net salvage number is then used to offset the original plant costs in the setting of depreciation rates. If net salvage is a positive number, it reduces the amount recovered from ratepayers over the life of the property. If net salvage is a negative number, because of the costs involved, the method spreads this cost equally over the life of the property. This is an approach that is very fair to the ratepayers – where property will be sold at the end of its life and the salvage amount will be greater than the utility spends to prepare or to remove electric plant, the ratepayer receives this benefit in the depreciation rate. Where the removal will cost more than the salvage value, this cost is spread evenly over the life of the property so that all ratepayers who have benefitted from the property will help pay the cost.

Staff instead seeks to make no provision for either positive or negative net salvage during the life of the property. This is a period that in the case of a power plant, could last for decades (Ex. 33, Sch. 1-1) – decades during which the plant would be providing service to any number of customers. The Staff proposes to wait until the end of these decades and then, when cost of removal has been incurred, charge the ratepayers for this cost. The ratepayers paying this cost would be those customers receiving service **after** the plant is retired and no longer used and useful. This is because cost of removal necessarily relates to plant that has already been retired and is no longer in service. (Tr. 280-81).

It is bad policy to have those customers receiving service after a plant has been retired paying the costs related to service provided to the decades of prior customers. Where cost of removal is significant (as it may be in the case of a power plant), it also is bad policy to create this significant, one-time impact on rates.

The Staff seems to recognize the latter policy problem with its proposal. Staff witness Adam stated that "if there is a major retirement and removal, such as a power plant, Staff depreciation engineers will evaluate the Company's cost presentation and will propose an amortization ... ." (Ex. 33, p. 19). How long the Staff would recommend that such an amortization last would depend upon the specific facts of the retirement. (Tr. 214-15). However, it could go on for five or more years beyond the retirement and removal of the subject property. (Tr. 215-16).

The Staff has taken this position in order to avoid "rate shock," in Mr. Adam's words. (Tr. 214). This "solution" will, however, merely exacerbate the inter-generational inequity that is an inherent part of the Staff proposal. Not only will post-retirement customers be required to pay for the removal of a plant from which they no longer receive benefit, but it also will require future customers to pay for this removal of retired plant for the length of the amortization.

Both in its original form and with the amortization description, the Staff proposal ignores the idea that, where possible, costs should be paid by the cost-causer. The whole life method more accurately assesses these costs to those customers benefitting from the subject plant.

c. Power to Establish Depreciation Accounts -- Inconsistency with Commission Rule and FERC Uniform System of Accounts

The Commission's power to establish depreciation accounts and rates is found in § 393.240 RSMo 2000. Section 393.240.1 states that the "commission shall have the power, after hearing, to require . . . electrical corporations . . . to carry a proper and adequate depreciation account in accordance with such rules, regulations and forms of account as the commission may prescribe." (Emphasis supplied). Thus, the Commission does not have the statutory authority to require depreciation accounts to be maintained in a way that is contrary to methods established in its own "rules and regulations."

The Commission has previously prescribed a regulation governing the accounting practices for electrical corporations, to include Empire. 4 CSR 240-20.030(1) requires that "every electrical corporation subject to the commission's jurisdiction shall keep all accounts in conformity with the Uniform System of Accounts Prescribed for Public Utilities and Licensees subject to the provisions of the Federal Power Act, as prescribed by the Federal Energy Regulatory Commission (FERC)... ."

The impact of the FERC Uniform System of Accounts was not discussed by the Staff testimony in this case. Staff witness Adam, who provided support for the Staff's proposed change in the treatment of cost of removal/net salvage, agreed that he was not familiar with what the FERC Uniform System of Accounts requires or does not require in terms of cost of removal. (Tr. 202). Of the various sources Mr. Adam attempted to use as support for his proposal, none of them come from the Commission-required FERC Uniform System of Accounts.

This is understandable. An examination of the Commission-prescribed accounting rule reveals that it requires that cost of removal and salvage be charged to depreciation reserves.[3] (Ex. 22, p. 9). For cost of removal and salvage to be charged to depreciation reserve at retirement, these items must be a part of the underlying depreciation rate during the life of the plant.

More directly, the Commission's own rule specifically states that when implementing the FERC Uniform System of Accounts, "each electrical corporation subject to the Commission's jurisdiction shall . . . charge original cost *less net salvage* to account 108., when implementing the provisions of Part 101 Electric Plant Instructions 10.F. and paragraph 15.060.10.F." (4 CSR 240-20.030(3)(H)) (Emphasis added). In other words, the Commission indicates in its own rule

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[3] Paragraph 10B.(2) of the Electric Plant Instruction requires that "when a retirement unit is retired . . . the cost of removal and the salvage shall be charged or credited as appropriate, to such depreciation account." (Loos Rebuttal, Ex. 22, p. 9).

that net salvage will be a part of the depreciation calculation. Staff instead recommends that cost of removal/net salvage be expensed. (Ex. 22, p. 9). There is no provision made in this situation for a variance or waiver from these provisions.

At a minimum, this means that Empire would be required to maintain two sets of books, one addressing the FERC Uniform System of Accounts requirements and the other addressing Missouri Commission requirements. (Ex. 22, p. 9).

More significantly, under § 393.240 RSMo 2000, the Commission only has authority to require such depreciation rates as are consistent with its own rules. The Staff proposal as to net salvage is not consistent with 4 CSR 240-20.030 (which applies to electrical corporations) and, thus, is beyond the Commission's jurisdiction and power.

d. Used and Useful / Section 393.135 RSMo

The inter-generational inequity created by the Staff proposal also violates a principle represented by both regulatory theory and statute. That is, the idea that ratepayers should not bear plant costs except during the time period when the underlying property provides service to those customers. This idea is described in case law as the "used and useful" theory. The Missouri Court of Appeals has described this theory as follows:

> Under the used and useful theory, the company is allowed to charge customers only for the cost of plant and equipment actually in use to provide service for current customers.

State ex rel. Missouri Power & Light Company v. Public Service Commission, 669 S.W.2d 941, 946 (Mo. App. W.D., 1984).

This general concept has also been codified as a statute solely applicable to *electric plant.*

Section 393.135, RSMo 2000 states as follows:

> Any charge made or demanded by an electrical corporation for service, or in connection therewith, which is based on the costs of construction in progress upon any existing or new facility of the electrical corporation, or any other cost associated with owning, operating, maintaining, or financing any property before it is fully operational and used for service, is unjust and unreasonable, and is prohibited.

This statute, which was adopted by public initiative, at a minimum shows the public's disdain for charges associated with electric plant *before* it is operational and used for service. It is not a great leap to assume that the public would be equally opposed to paying for property that is no longer operational and no longer used for service as a consequence of its retirement.

These concepts should be important to the Commission in assessing the Staff's proposal. This is because depending upon their application, Empire may in fact be *prohibited* from recovering cost of removal in the fashion suggested by the Staff – that is, after plant has been retired and is no longer used and useful.

If so, the Staff proposal would effectively deny recovery of cost of removal -- a result that is contrary both to the law and the Staff's intent. It is recognized that plant depreciates in value and, thus, depreciation expense is included in a utility's cost of service. "To require the company to sell its service at rates which made no provision at all for the replacement or repair of the property when worn out or obsolete, would be plain confiscation, and to require it to sell it at rates which make an inadequate provision for the return of its value when worn out or obsolete as a result of public service can be no less." ***Public Service Commission v. United Railways & Electric***, 155 Md. 572, 142 A. 870 (1928), dismissed 278 U.S. 567.

The Missouri Supreme Court has established that a public utility is entitled to amounts for depreciation. It has stated that "A public utility is entitled to earn a reasonable sum for depreciation of its property, including necessary retirements, ordinary obsolescence and diminishing usefulness which cannot be arrested by repairs ... ." ***State ex rel. City of St. Louis v. Public Service Commission***, 47 S.W.2d 102, 111 (Mo banc. 1931). This statement recognizes that included in "depreciation" are amounts to address "necessary retirements" – in other words, cost of removal.

Staff witness Adam agreed that Staff's proposal is not designed to prohibit recovery of dollars associated with cost of removal, but merely to shift the time period for recovery. (Tr. 195-96). Mr. Adam further stated that when cost of removal is expended, it should be included in a company's revenue requirement. (Tr. 197). He would not write testimony indicating that a company should be denied cost of removal. (Id.) In spite of this, Staff did not consider how the principles outlined in § 393.135 may impact Staff's recommendation. (Tr. 204-05).

It also appears that Staff did not consider the Commission's most recent interpretation of the used and useful theory in creating its recommendation. In ***In the Matter of Missouri-American Water Company's Tariff Sheets***, Case No. WR-2000-281 (August 31, 2000), the Commission was asked by the Office of the Public Counsel ("OPC") to deny recovery, and require the write-off of, Missouri-American's un-depreciated investment in the old St. Joseph treatment plant. The Commission agreed with the OPC based in part on the following reasoning:

> MAWC is permitted a reasonable return only on the value of its assets actually devoted to public service. From the moment of its retirement . . . the old plant was no longer used and useful.

(***Missouri-American***, p. 52).

If the Commission is to be consistent with its previous reasoning, then amounts related to plant can no longer be recovered once that plant is no longer used and useful. The Staff proposal to only allow cost of removal *after* retirement and removal of property would therefore deny

Empire a normal expense related to the ownership and operation of utility property, and as such would be unreasonable and unlawful.

e. Estimation – Future Opportunities for Review

Part of the Staff's objection to the whole life method of addressing net salvage is that it believes there are practical difficulties with "estimating, reporting and accounting for net salvage and cost of retirement." (Ex. 33, p. 11). There does not, however, seem to be any disagreement that cost of removal has indeed increased over time. Staff witness Adam pointed out that "during the very late 1970s and early 1980s, two external conditions changed significantly resulting in a change in the value calculated as net salvage in the 'traditional' Whole life formula. These two external conditions were rapid increases in labor rates and environmentalism. In turn these external conditions have caused net salvage to become a large cost instead of a positive value." (Ex. 33, p. 17). Thus, no matter what the estimate, there is a very real increase in the actual cost of removal that has been experienced over the last several years.

Therefore, the Staff's objection to the current process is not based upon a dispute with whether there is an increase, but rather a discomfort with the fact that estimates must be made to arrive at a net salvage number. This objection should be viewed with much skepticism in light of the fact that the whole depreciation process has the type of "estimating" issues that concern the Staff.

Depreciation rates for ratemaking purposes are set by the Commission, not the utility, in an attempt to match capital recovery with capital consumption. *See, **Re: Depreciation***, 25 Mo.P.S.C. (N.S.) 331, 334 (1982). This process necessarily involves an analysis of expected future events such as useful life, salvage value and cost of removal. *See, **In the Matter of St. Louis County Water Company's tariff revisions designed to increase rates***, 4 Mo.P.S.C.3d 94, 102-103 (1995).

Because of the estimates and unknowns involved with this analysis, it is not unheard of for the depreciation rates to miss their goal to some extent.

> Any attempt to allocate such costs over a period of time requires an analysis of expected future events such as useful life, salvage value, and cost of removal. To the extent such analyses prove incorrect, depreciation rates will fail to match capital recovery with capital consumption resulting in depreciation reserve deficiency.

In the Matter of St. Louis County Water Company's tariff revisions designed to increase rates, 4 Mo.P.S.C.3d 94, 102-103 (1995).

One of the most basic determinations that must be made in the depreciation process, whether cost of removal is included or not, is the average service life of a piece of property. As pointed out by the Commission, this average service life is very definitely an estimate. Staff witness Adam explained that in determining an average service life he must plot various types of information and then "use a curve to overlay" in reaching his estimate. (Tr. 219-20). Mr. Adam must do this because "the future is unknown and it cannot be determined what plant will retire," nor can it be determined "at what time it will retire . . . ." (Ex. 33, p. 16).

The question becomes: What is the consequence if estimates prove to be incorrect? In the case of net salvage, there are "checks and balances" that are built into the process to mitigate against any adverse ratepayer impact. The most significant of these is the fact that amounts added to depreciation reserve are deducted from original plant in determining rate base for ratemaking purposes. (Tr. 145). If a depreciation rate happens to be higher than is necessary, it thus builds reserve more quickly and lowers the rate base more quickly. (Tr. 146). This is also the case during any period after retirement and before removal is actually executed. (Tr. 184). Thus, customers are, in effect, compensated in the interim through rate base treatment. (*Id.*).

There are other checks and balances in the process as the result of Commission rule. 4 CSR 240-20.030(5) requires that electrical corporations perform, and provide to the Commission Staff and Office of the Public Counsel, every five years a depreciation study, database and property unit catalog that will address average service lives, net salvage and depreciation rates. (Tr. 145). As a result of these studies, net salvage amounts are periodically reviewed and reduced where necessary. In this case, Empire witness Loos reduced substantially some of the net salvage allowances that had been employed in existing rates. (Tr. 180-81). There are also examples of *negative* depreciation rates that have been proposed by Empire witness Loos where past depreciation has exceeded experience. (Ex. 11, Sch. LWL-1, Table 7-1).

The bottom line is that there are many opportunities to re-assess, analyze and adjust depreciation rates to include updated and reasonable net salvage computations. This is something that has gone on for many years. To the extent that the Company, Staff, Office of the Public Counsel and other parties do not agree as to what or when adjustments should be made, the Commission is available to review the evidence and to render a decision that will settle the matter.

The Commission need not throw out the entire whole life treatment of net salvage because of some concerns it may have with the net salvage numbers. If concerned, it merely needs to instruct the parties, in particular its Staff, to do a thorough job of working with the depreciation studies and any changes in circumstance so that depreciation rates which are fair to the Company, current customers, and future customers can be ordered by the Commission.

f. General Direction of Reporting Requirements

The proposal made by the Staff to remove net salvage from the depreciation calculation and only reflect in rates expenditures as they are made also runs contrary to accounting trends.

Those trends are to recognize liabilities at the time they are accrued, rather than when they are paid, thus allowing responsibility for expenses to be reflected in current financial statements and paid by benefitting customers. The Staff instead wants to only reflect actual amounts that have been paid (but may have been accrued much earlier) and leave the additional costs hidden.

These are the same general concepts that were at work when the Commission addressed Financial Accounting Standards No. 106 and 87 (FAS 106 and FAS 87) in the early 1990's. In 1990, the Financial Accounting Standards Board (FASB) had issued [FAS 106] regarding Employers' Accounting for Post-Retirement Benefits Other Than Pensions (OPEBs). "Traditionally, such costs [had] been treated, both for financial reporting and for ratemaking purposes, on a 'pay as you go' basis (PAYGO). This meant that OPEB expenses were booked at the time the utility paid out the cash for benefits to its retired employees. FAS 106 mandated that companies change to an accrual method of accounting for OPEBs." ***In the Matter of Missouri-American Water Company's Tariffs***, Case No. WR-95-205, 4 Mo. P.S.C. 3d 205 (November 21, 1995).

Use of the accrual accounting method meant that utilities were required to estimate, and charge to expense, the OPEBs earned by employees during their current period of service with the company. (*Id.*). Similar to how net salvage is treated under the whole life method, "the theory behind FAS 106 and accrual accounting is that costs should be recovered when benefits are earned. Thus, current ratepayers should pay for current employees' future OPEB costs." ***Public Service Commission v. Southwestern Bell Telephone Company***, Case No. TC-93-224, Case No. TO-93-192, 62, 2 Mo. P.S.C. 3d 479 (December 17, 1993).

The Staff opposed the adoption of FAS 106 for reasons very similar to those it uses in this case in regard to the proposed change in depreciation rate methodology. Staff argued, basically, that FAS 106 was not appropriate for ratemaking because there was "no long term legal obligation to pay any determinate level of benefits, and the accrual technique uses data that is difficult to estimate and small variations in data cause dramatic changes in expense calculations." (*Id.*). In spite of these arguments, FAS 106 was later adopted by the Missouri General Assembly and is now incorporated into state law in § 386.315 RSMo 2000.

FASB has also taken steps in this direction in regard to retirement/cost of removal obligations associated with long lived assets. Empire witness Martin J. Lyons indicated that "accounting standards are evolving to (1) embrace a concept that obligations associated with the retirement of long-lived assets are a prerequisite for operating such assets and therefore should be considered a component of such asset's historical cost, and (2) allocate such cost to expense using a systematic and rational method which is no greater than that for which the related asset is expected to provide benefit." (Ex. 25, p. 2-3).

In reaching his conclusion, Mr. Lyons described FASB's recent Exposure Draft entitled "Accounting for Obligations Associated with Retirement of Long-Lived Assets." The preliminary conclusions of these accountants "reflect a reasoning that closure and removal costs are a prerequisite for operating a long-lived asset and that the economic benefit of those costs lies in the productive asset that is used in the entity's operations. As a result, they conclude that such costs should be capitalized and depreciated in order to achieve the objectives of (a) obtaining a measure of cost that more closely reflects the entity's total investment on its assets and (b) allocating that cost to the periods in which the related assets are expected to provide benefits." (Ex. 25, p. 9).

The Staff's proposal to wait and include cost of removal only after property has been retired is inconsistent with concepts reflected both in the past changes through FAS 87 and 106 and as evidenced by the existing Exposure Draft. The current accounting trend is to instead reflect such costs in a way that current customers can be responsible for these costs as they are accrued over the life of an asset.

g. Five Year Average v. Alternative

An additional aspect of the Staff's proposal which should be addressed, if the Commission were to eliminate net salvage from the depreciation calculation, is the appropriate method to compute the current net salvage to be reflected in rates. The Staff proposes to derive this amount through the use of a normalization over several years. (Ex. 33, p. 18; Tr. 198).

This approach has the disadvantage of creating the potential for the over-recovery or under-recovery of net salvage. In a time of steadily rising cost of removal, the Company will never recover its actual cost of removal. (Tr. 199). In a time of decreasing cost of removal, the Company will over-recover. (Tr. 199-200).

An alternative exists that would ensure that the Company recovers the current cost of removal – no more and no less. If the cost of removal were instead included in the depreciation accrual, then any under-collection or over-collection could be adjusted in the Company's next rate case – either to make the Company whole, if there was a shortfall, or to reduce depreciation rates to compensate for an over-collection. (Tr. 199). Consequently, even if the Commission accepts the Staff's proposed removal of net salvage, it should not accept a multi-year normalization of current net salvage and should instead order that this be booked as a part of the depreciation accrual.

h. Summary

Instead of completely abandoning the whole life method, which serves many appropriate and important policy goals, the Commission should direct its Staff to study the net salvage values and come to its own conclusions as to the appropriateness of the numbers involved. The Staff's conclusions could then be examined by the Commission and considered in the setting of depreciation rates without losing the positive aspects of the whole life method.

B. How shall the depreciation for plant and facilities at State Line Power Plant be calculated?

(1) Should future additional plant investments be recognized? And,

(2) What are the appropriate average service lives for plant investment?

The second service life issue is directly linked to the construction of the SLCC. Because this is the first time the SLCC will be included in the rates set for Empire, there are no existing depreciation rates. They must be set by the Commission in this proceeding.

Empire's proposals for these rates are contained in the second part of Mr. Loos' Report on Depreciation Accrual Rates. (Ex. 11, Sch. LWL-1). The Staff's proposal for these rates are contained in the Direct Testimony of Mr. Adam. (Ex. 33, Sch. 1-4).

The difference between the Empire and Staff positions (other than inclusion or exclusion of net salvage as discussed in earlier sections of this brief) is the average service life to be used. Staff witness Adam, based upon a "design life of 35 years, utilizes a 35 year average service life." (Ex. 33, p. 23). Empire witness Loos also initially utilizes a 35 year plant life. However, in developing the depreciation rates, Mr. Loos also considers the interim additions or investment required for the plant to reach this life. (Ex. 22, p. 27).

Without major maintenance (interim additions) during the life of the plant, the unit will fail to operate as designed and the life span of the SLCC will be considerably less that the 35-year life used by Staff witness Adam. (Ex. 22, p. 26). The necessity of this maintenance in the case of SLCC is detailed in the record in the Operation & Maintenance Estimate for State Line Power Plant. (Ex. 11, Sch. LWL-2).

The consequence of not considering these interim additions in setting the depreciation rates is found in the rates to be paid by the customers. Unless capital expenditures are considered in the development of depreciation rates, annual depreciation charges during the early years of the plant are understated with corresponding overstatement in later years. (Id. at p. 29). Capital additions must be made during the 35-year life, not to extend the life span but simply to achieve it. (Id.). Without interim capital investment, there is little chance that the SLCC could run as a baseload unit (or even as a peaking unit) for more than a few years. (Id. at p. 34).

As capital additions are made over the course of the plant life span, they must be recovered over increasingly shorter periods. (Id. at p. 29). This is especially significant in the case of combustion turbine-based plants such as SLCC. Such plants have lower initial capital cost and higher maintenance expense (interim additions) than traditional fossil-fired steam plants. (Id. at p. 30-31). If the investment of capital additions is to be recovered over the remaining life of the plant, depreciation rates must recognize that significant amounts of future investment will have shorter lives than the original investment required to place the plant in service. (Id. at p. 31). Thus, all else being equal, failure to recognize interim investment results in a steadily increasing depreciation rate. (Id. at p. 29).

Interim additions can be reflected in depreciation expense rates in one of two ways -- 1) ignore interim additions, as the Staff has done, until they actually occur and allow such amounts to be paid by rate payers on a significantly increasing basis; or, 2) reflect anticipated interim additions in the calculation of depreciation rates over the life of the plant by either including in the calculation of depreciation rates an allowance for the costs and timing of interim investment or to recognize that the expected life of the plant is reduced substantially, if these additions are not made. (Id.). Either of the latter approaches allows depreciation rates to be calculated in a manner which reasonably attempts to match recovery of investment over the life of the asset provided by the investment.

It is this approach that has been pursued by Empire witness Loos and which forms the basis for his recommended depreciation rates. Staff witness Adam attacks Mr. Loos' use of interim additions by alleging that Mr. Loos does not make similar estimates of plant additions to all other plant. (Ex. 35, p. 5). He goes on to allege that Mr. Loos "fails to explain why he projects future interim Maintenance Capital of over $212 million at the State Line location and zero future interim Maintenance Capital at all other generating locations." (Id.).

During cross examination of Mr. Adam, it was revealed that Mr. Adam was wrong in his analysis of Mr. Loos' work. Mr. Adam failed to examine Mr. Loos' work papers in sufficient detail, although they were available to him, before making these statements. (Tr. 239). It was shown that Mr. Loos was consistent in his approach in that he did include Future Interim Additions for Asbury Unit Train, Asbury Station, Iatan Station, Ozark Beach Station, Combustion Turbine (Riverton, Energy Center) and State Line Units 1 and 2. (Tr. 230-35; Ex. 98).

The Commission should adopt Mr. Loos' recommendation concerning the average service life for SLCC as the best ratemaking policy. Mr. Loos' approach better allows for the spread of the true costs of the SLCC over the life of this piece of property. Failure to take this approach will result in steadily increasing depreciation rates for customers and defeat rate stability. Mr. Loos' recommended use of an implied average service life of 19.72 years in setting the depreciation rate for the SLCC is appropriate and reasonable.

(3) How shall the net salvage component be treated?

Empire's position as to the net salvage component for the SLCC is no different than that expressed in section IIA(2) above in relation to all other electric plant. Therefore, rather than repeat this discussion, Empire respectfully refers the Commission to the above discussion.

III. COST OF SERVICE - BAD DEBTS

Shall Empire's bad debt expense be allowed to follow changes in Missouri jurisdictional revenues?

The amount of bad debt expense which has been included in Empire's cost of service in this case is based on an agreed-to factor of .25% of Empire's revenues. Empire submits that the bad debt expense portion of its cost of service should be increased further through the application of the .25% factor to the revenue increase which the Company is authorized in this case. In other words, the bad debt expense should be "factored up" and allowed to follow the increase in Missouri jurisdictional revenues.

Empire's prepared testimony concerning this issue is found in the rebuttal and surrebuttal testimony of William L. Gipson, Empire's Executive Vice President. (Exs. 21, 28). Mr. Gipson testified that the Commission should make an upward adjustment to the bad debt expense in this case to reflect any revenue increase which the Commission might authorize. Empire's bad debt expense over the last several years has been about 1/4 of 1% (.25%) of its on-system revenues. (Tr. 305). <u>The parties do not dispute this factor</u>. In six of the last eight years, the Company's bad debt expense has increased as its revenue has increased. (Tr. 314). The amount of the adjustment, therefore, should be .25% of the rate increase authorized in this case as there is a direct correlation between an increase in revenues and an increase in the level of bad debt expense. (Ex. 28, pp. 1-2). For example, if the Commission orders a $10 million rate increase, that amount should be adjusted upward by $25,000 to reflect that Empire will incur additional bad debt expense in that amount. (Ex. 21, p. 2, lines 18-23).

Roy Boltz, a veteran auditor with experience in over 100 cases involving approximately 40-50 different utility companies, testified on behalf of the Staff. (Tr. 325). Despite his vast experience, Mr. Boltz indicated that he had never been involved in auditing bad debt expense and in fact really didn't handle the issue in this case. (Tr. 325, 326). Instead, he said that he was just filling in for Staff witness Phil Williams who actually did the work. (Tr. 327).

Mr. Boltz testified correctly that the issue here is whether or not the agreed-to .25% factor should be applied to the rate increase which Empire receives. (Tr. 327). His argument against any such adjustment is his incorrect belief that there is no correlation between an increase in revenues and an increase in bad debt expense. (Tr. 330). In fact, Mr. Boltz probably now realizes that his premise is incorrect. In response to a question from Commissioner Gaw, Mr. Boltz admitted that if a company had no revenue, it would have no bad debt, but if it had $100,000 in revenue he was sure there would be some bad debt. (Tr. 330). This statement, of course, is contrary to his initial claim that there is no correlation between revenue and bad debt expense.

Logically, the Staff's position is wrong and not supported by the record evidence. Furthermore, the Staff's position is directly contrary to this Commission's prior decision on this exact issue in Case No. GR-96-285. In that proceeding, Missouri Gas Energy ("MGE") argued that the agreed-to uncollectible expense ratio should be used to compute uncollectible expense relating to MGE's additional revenues as reflected in the Commission-determined revenue deficiency in that rate case. The Commission ruled for MGE and concluded at page 45 (mimeo) of the Report and Order that the uncollectible expense should be adjusted to reflect additional revenues resulting from the rate case. There the Commission said "... the Commission agrees with MGE insofar as the uncollectible expense should be adjusted to reflect additional revenues resulting from the instant rate case." ***In Re Missouri Gas Energy***, Case No. GR-96-285, January 22, 1997, 5 MoPSC 3d 437 at 463.

Empire's position on this issue is consistent with past precedent, based on sound logic and supported by the evidence. It should be accepted.

IV. PAYROLL - INCENTIVE PAY

Shall discretionary, performance-based incentive pay for employees be allowed?

Empire has in place a program pursuant to which it grants incentive compensation or incentive awards on an annual basis to various employees. The incentive award does not increase base salary. Under the program, at the beginning of the year, each non-officer, non-bargaining unit employee, in conjunction with his or her supervisor, establishes individual goals. The goals are divided into "base goals" and "stretch goals." The "stretch goals" are usually goals which require the employee to go beyond basic job responsibilities. (Ex. 27, p. 2). If both the base goals and the stretch goals are met, the employee becomes eligible to receive incentive compensation. (Ex. 27, pp. 1-2). The program is a cost-effective approach to employee compensation which ultimately benefits Empire's customers.

During the test year, a total of $323,000 in incentive payments were made to various Empire employees who had achieved goals that were beyond their normal job duties and responsibilities. (Ex. 27, p. 3). Empire submits that this standard was satisfied and that the incentive pay should be included in cost of service.

The Staff opposes the inclusion of the $323,000 in cost of service for two reasons. First, the Staff argues that for the year 2000, specific goals were not set for the majority of Empire's employees. Second, without preset goals, the Staff claims that improved job performance could not be measured. (Ex.113 NP, p. 7; Tr. 867). In taking this approach, the Staff says it is following the criteria established in a Union Electric case for rate recovery of incentive compensation. (Tr. 850).

Empire concedes that the year 2000 was not a normal year for Empire and its employees and as a consequence the execution of the program was below par. As explained by Myron W. McKinney, Empire's President and Chief Executive Officer, because of the pending merger with UtiliCorp United Inc. ("UtiliCorp"), Empire experienced a critical shortage of employees throughout 2000 and as a result spent the entire year trying to accomplish the most basic of tasks and simply run the Company. (Ex. 114, p. 5).

> Vacancies ran three times the normal amount and it became virtually impossible, because of the pending merger, to hire employees with any experience levels to fill the existing slots. As a result, those employees who stayed with us were asked to take on additional responsibilities and work longer hours. Consequently, 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, p. 5)

Given these circumstances, instead of creating incentive objectives, Empire managers were instructed to simply exercise discretion in granting incentive awards to those individuals who helped to maintain Empire through the merger process while also considering other aspects of the employee's performance. (Tr. 810, 811).

Notwithstanding the fact that Empire's execution of its incentive awards program was not up to its usual standards, the $323,000 of awards which were made were in fact justified and the amount should be included in cost of service in this case.

First, the Commission should recognize that Empire's incentive compensation plan, although a part of Empire's normal total compensation package, in effect puts a portion of the employee's pay at risk. The goal is an effort to instill in Empire's employees the notion that superior performance will generate greater compensation. It is a cost effective approach with obvious benefits to customers. While the execution of the program in the year 2000 was not perfect, this does not mean that the plan is invalid or that Empire should not be allowed to recover the involved costs. (Ex. 114, p. 8).

Second, the Staff's measurement of Empire's program against the Union Electric management incentive plan is not appropriate. That plan, which was the subject of Case No. EC-87-114, dealt with corporate goals and objectives and applied to management employees. Empire's program, however, deals with individual goals and objectives for mid-level managers and hourly workers. It is not available to employees at the officer level and can in no way be considered a management incentive plan. (Tr. 835; Ex.114, pp. 8-9).

Third, the evidence is clear that the Company's customers benefitted from the incentive awards that were made by Empire. In essence, Empire's employees truly did "stretch" and achieve goals beyond their normal job duties by continuing to provide high quality service to the Company's customers during a year when vacancies three times the normal amount existed because of the pending merger. The fact that Empire's customers were generally unaware of the challenges which the Company faced at the time was in Mr. McKinney's words "a tribute to our employees and their efforts during the year." Given these circumstances, there is no question that "stretch" goals were achieved and the incentive awards were deserved, that Empire's customers benefitted and that the amount at issue should be included in cost of service.

Finally, it is also important to keep in mind the fact that Empire's overall compensation levels are at or below average. (Ex. 114, p. 6). The $323,000 at issue represents roughly a 2.5% increase for the involved individuals which is certainly reasonable considering that this is an era of full employment with upward wage pressures. (Ex.114, p. 6). If the base pay of these employees had simply been increased by about 2.5%, it is unlikely that this amount would have become an issue in this case.

Recognizing, however, that the execution of Empire's incentive program in the year 2000 was somewhat off the mark, rather than including the entire $323,000 in cost of service, as an alternative Empire would accept a five-year average which results in approximately $251,000. (Tr. 820, 821). Empire is also willing to include a four (4) year average expenditure for its incentive awards, but deduct the $323,000 from the total. This would make the issue worth approximately $223,500 on a total company basis. (Ex. 114, p. 9).

V. CLASS COST OF SERVICE / RATE DESIGN

A. What should be the appropriate method of class cost of service allocation in this case?

B. What is the appropriate allocation of any increase in revenues to customer classes?

C. What are the appropriate adjustments to rates for the various customer classes?

D. What is the appropriate rate design treatment of the Interim Energy Charge?

All of these questions were addressed and settled as between the parties to this case in the "Unanimous Stipulation and Agreement Regarding Fuel and Purchased Power Expense and Class Cost of Service and Rate Design" which was filed with the Commission on June 4, 2001. Empire urges the Commission to issue an order adopting that stipulation and agreement as the appropriate resolution of those issues in this proceeding.

The Staff filed suggestions in support of the stipulation on June 5, 2001 which fairly summarize the problems faced by the parties and the unique solution encompassed in the stipulation.

The stipulation addresses the rate design in paragraph 5 where it says that the difference between any increase in Empire's revenue requirement that is approved by the Commission and the revenues to be collected by the Interim Energy Charge are to be allocated to each customer class on an equal-percent-of-current-revenues basis and reflected on all rate schedules as an equal percentage increase or decrease to each rate component on each tariff. As explained further in the Staff's filing on June 5, 2001 (page 4, para. 6), the rate design follows the Staff's direct testimony and the Staff's cost of service study.

The Interim Energy Charge (IEC) approach contained in the stipulation presents a balanced and reasonable approach to deal with the volatility of fuel and purchased power costs. While the IEC concept was originally advocated by the Staff during the pre-hearing conference negotiations, the final product was the result of efforts by all of the parties to deal with the issue in a rational and objective manner. Empire explained its basis for supporting the approach in the supplemental testimony of Mr. Beecher. (Ex. 106). The Staff should be commended for advocating and supporting an approach to solving a problem that overcomes the problems inherent in volatile prices and a strict application of the historical cost rate-making approach.

VI. CAPITAL STRUCTURE / RATE OF RETURN

A. What capital structure is appropriate for Empire?

At the time it filed its direct testimony in November 2000, Empire supported a capital structure of 52.5% debt and 47.5% common equity. Subsequently, Empire's proposed merger with UtiliCorp failed, and the Company sought to pay down its outstanding short-term debt associated with the costs of its State Line project through the issuance of trust preferred securities. (Ex.14, p. 3). As a consequence, the appropriate capital structure for Empire for purposes of the case is 45% common equity, 7.9% trust preferred and 47.1% long-term debt. (Ex.14, p. 4). The December 31, 2000 capital structure proposed by both the Staff and Public Counsel (approximately 40% equity and 60% debt) is wrong because it is not representative of Empire's historical capital structure -- nor is it representative of the capital structure which Empire will have in place in the future. (Ex. 16, p. 25).

Use of Empire's December 31, 2000 capital structure for purposes of setting rates in this case is improper because the then pending merger with UtiliCorp prevented the Company from undertaking any common equity financing. During this time, Empire also took its preferred stock off the market, but increased its debt due to its State Line construction project. (Tr. 402, 403). In addition, the subtraction of the UtiliCorp merger costs from Empire's equity, as in the case of other expenses, further reduced the level of the Company's common equity. (Ex.16, p. 25).

As a result of all of this, when the merger unwound in January 2001, the Company's common equity ratio was very low. As a consequence, the "snapshot" year-end 2000 capital structure is really not representative either of Empire's historical capital structure or of its prospective capital structure. (Tr. 403). As explained by Empire's witness Dr. Donald A. Murry "I looked at both of those and concluded that this end of the year is an anomaly and should be, in my judgment, a temporary position. I think if I were looking for a rock to stand on, I'd probably go back to the history." (Tr. 404).

Empire witness Dave Gibson also testified on this point. In his words, Empire's year-end capital structure was "abnormal." He explained that the Company is moving towards a more balanced capital structure as it is re-instituting its DRIP plan, which will raise common equity. Empire is also planning to issue additional common equity later in 2001. (Tr. 448, 451).

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

Empire submits that the appropriate rate of return on common equity for the Company is in a range from 11.5% to 12%. The Public Counsel supports a range of 10.0% to 10.25%. The Staff argues for a range of 8.5% to 9.5%.

Empire's primary witness on this topic is Donald A. Murry, a Professor Emeritus of Economics on the faculty of the University of Oklahoma. Dr. Murry has a B.S. in Business Administration, and an M.A. and a Ph.D. in Economics from the University of Missouri-Columbia. He is currently affiliated with C.H. Guernsey and Company in Oklahoma City, Oklahoma. (Ex. 13, p. 1).

For purposes of estimating Empire's cost of common stock equity, Dr. Murry used the traditional discounted cash flow ("DCF") analysis. (Ex.13, p. 6). As he explained, the DCF theory is relatively simple. The known present value of the asset (in this case Empire's stock) is considered along with expected returns on that asset to determine the cost of capital. The three basic components of the DCF model are market price, dividends and growth rate. In most instances, the market price and dividends are easily determined. Growth rate is usually the issue. (Tr. 406). Dr. Murry also considered the results of a capital asset pricing model ("CAPM"). (Ex. 13, p. 6). Taking into account the characteristics of each of these methods, Dr. Murry concluded that an adequate range for the allowed return on Empire's common stock is 11.5% to 12%. (Ex. 13, pp. 18-19).

Mark Burdette presented the position of the Public Counsel. He holds a B.S. degree from the University of Iowa and a Masters in Business Administration from the University of Iowa Graduate School of Management. (Ex. 86, p. 1). Relying primarily on a DCF analysis and taking into account a CAPM analysis, Mr. Burdette concluded that Empire should be allowed a return on common equity of 10.0% to 10.25%. (Ex. 86, p. 7). For purposes of determining the dividend yield portion of the DCF formula, to calculate Empire's average stock price Mr. Burdette used a six week period running from February 16 to March 23, 2001. (Ex. 86, p. 17). He used this particular period of time because it was long enough to avoid daily fluctuations and recent enough to indicate a stock price which is representative of current expectations. (Ex. 86, p. 16). According to Mr. Burdette, "The appropriate dividend yield to use in the DCF equation is equal to the *expected* dividend divided by *current* stock price. ... stock prices that are too old simply don't provide a current view of capital costs and are inappropriate to use in the DCF." (Ex. 86, pp. 16-17). Based on this approach he calculated a dividend yield of 6.56%. Using a growth rate of 3.5%, his recommended range becomes 10% to 10.25%. (Ex. 86, p. 17).

Roberta A. McKiddy testified on behalf of the Staff. Ms. McKiddy has been a Financial Analyst for the Staff since May 1998. In July 1997 she earned a B.S. degree in Business Administration from Columbia College. In June 2000 she received a Masters of Business Administration Degree from William Woods University. (Ex. 61, p. 1). Ms. McKiddy utilized a "continuous growth form" DCF model to estimate the cost of equity for Empire. (Ex. 61, p. 20). In determining the dividend yield portion of the DCF formula, she used a monthly high/low average market price of Empire's common stock for the period of October 1, 2000 through March 4, 2001. (Ex. 61, p. 23). During this five month period, Empire's common stock ranged in price from a low of $19.80 per share to a high of $30.75 per share reflecting the pending merger with UtiliCorp. According to Ms. McKiddy, this produced a range for the monthly average high/low market price of $20.11 to $29.00 per share which "reflects the most recent market conditions for the price term ... in the DCF model." (Ex. 61, p. 24). Then, according to Ms. McKiddy, combining Empire's expected dividend of $1.28 per share with the October 1, 2000 through March 4, 2001 market price range produced an approximate expected dividend yield of 5.50%. (Ex. 61, p. 24). Using her 5.50% dividend yield combined with a 3% to 4% growth rate, Ms. McKiddy calculated a common equity rate of return range for Empire of 8.5% to 9.5%. (Ex. 61, p. 24). By contrast she testified that the estimated DCF cost of equity for her nine comparable companies averaged 11.64%. (Ex. 61, p. 32). This is consistent with the 11.43% average return experienced by electric utilities nation-wide in 2000. (Ex. 29, p. 4).

The Fundamental Flaws in the Staff's Recommendation

There are four basic, overriding fundamental flaws in the work of the Staff witness which render her ultimate recommendation invalid.

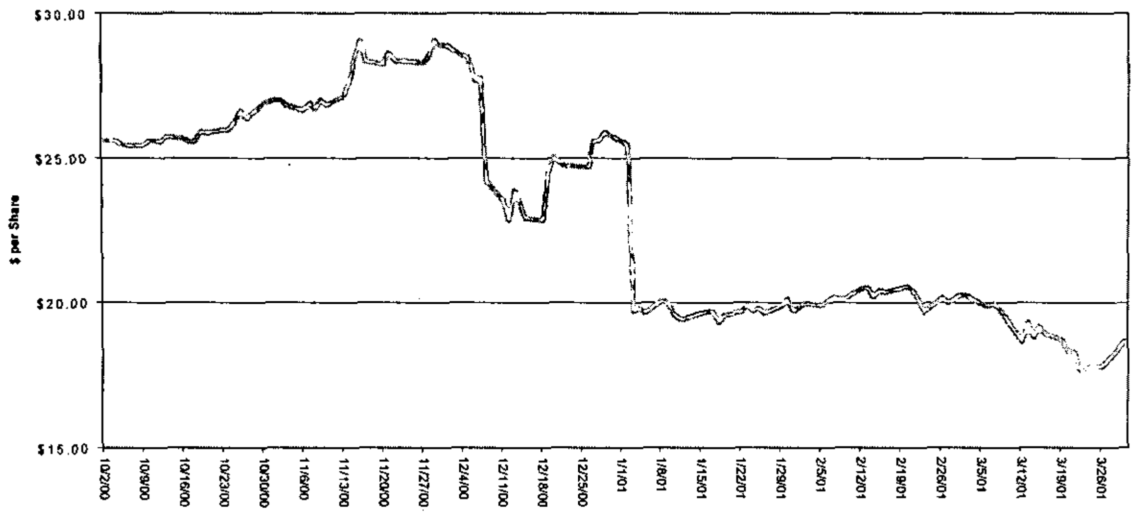
- Ms. McKiddy used share price data reflecting Empire's pending merger with UtiliCorp.
- Ms. McKiddy's recommended return is inconsistent with the basic measures of financial integrity.
- Ms. McKiddy's reliance on the minimal requirements of bond indenture interest coverage is unprecedented.
- Ms. McKiddy's opinion on Empire's relative risk is completely unfounded.

Merger Share Price Data Flaw

In performing her dividend yield calculation, Ms. McKiddy chose to include price data from October 2000 through March 4, 2001. That included Empire stock prices prior to the cancellation of Empire's proposed merger with UtiliCorp and thus reflected the premium UtiliCorp was willing to pay for Empire stock. The evidence is clear that speculation in the merger caused Empire's stock to approach $31 per share. Investors were purchasing Empire's stock in anticipation of an arbitrage opportunity by which they could acquire the stock at a discount when compared to the UtiliCorp stock. As a consequence, Empire's stock price during this time was bid up on the basis of the proposed UtiliCorp merger and not on the basis of Empire's earnings. (Ex.16, p. 17). Ms. McKiddy knew at the time she filed her direct testimony that the merger had failed. (Tr. 416). Nonetheless, she chose to use this "merger inflated" stock information in her calculations.

Empire's share price data for the period prior the merger termination in January 2001 cannot be considered as "current" as it does not accurately represent the value of the Company's common stock in the present or in the near future. (Ex. 16, p. 16). To illustrate this fact, in his Schedule DAM 25 reproduced below, Dr. Murry set out the closing prices of Empire's stock over the five month time period Ms. McKiddy chose for her study.

Empire Daily Closing Price
October 2000 through March 2001



Schedule DAM 25

Prior to the termination of the merger, Empire traded in the range of $22.875 to $30.750. UtiliCorp announced its termination of the merger on January 2, 2001 after the markets closed. Empire had closed at $25.4711 per share that day. On the morning of January 3, 2001, the stock opened at $20.18. (Ex. 16, p. 17) In other words, Empire's stock lost 20 percent of its market value in a matter of minutes when it was announced that the merger with UtiliCorp would not go forward. Since the time Ms. McKiddy filed her direct testimony the stock has traded in a narrow range of between $19-$20 per share. (Tr. 474).

Clearly Ms. McKiddy should have omitted from her analysis any price data prior to January 3, 2001 because it was not representative of a realistic valuation of Empire's common stock. Price data for October, November and December 2000, when the merger was still viable are not only not current and thus should be disregarded on that basis, but also reflect a merger premium making that data inappropriate to use for setting future rates for an independent Empire. (Tr. 416). Use of this data by Ms. McKiddy in estimating cost of capital produced misleading DCF results. (Ex.16, p. 16).

Ms. McKiddy admitted on cross-examination that the DCF model requires the use of a current spot market price. (Tr. 473). She also conceded that since March 2001, when she filed her direct testimony, Empire's stock has traded in a range between $19-$20 per share. (Tr. 474). Exhibit 101 accurately describes the result of Ms. McKiddy's DCF calculation if a $20 share price is substituted for what she used. (Tr. 476). She conceded the resulting cost of equity range of 9.4% to 10.4% is correct and the Commission could rely on it. (Tr. 477). The high end of this range begins to approach the point of reasonableness from Empire's point of view. When the growth rates for her nine comparable electric utility companies are considered, Ms. McKiddy's cost of equity for Empire would become 11.4% to 12.9%. (Ex. 104).[4]

Ms. McKiddy's recommended return fails the basic measures of financial integrity

The major fundamental flaw of Ms. McKiddy's recommended return on common stock equity is the fact that it is "inconsistent with basic measures of financial integrity." (Ex. 16, p. 1). As explained by Dr. Murry, Ms. McKiddy failed to undertake any steps to measure or test whether her recommended return of 8.5% to 9.5% "...would provide sufficient cash or sufficient solvency to the Company that it could successfully borrow or raise equity capital in capital markets to sustain itself in the future... ." (Tr. 390). In the words of Dr. Murry, her testimony "was virtually devoid of the evaluation of the impact of her recommendation on the Company's solvency." (Tr. 390). For example, while Ms. McKiddy's acknowledged the financial exigencies of Empire which resulted from the financing of its State Line construction program and the failed UtiliCorp merger, she completely ignored the impact of these events on the Company. (Ex.16, p. 2). In other words, while she apparently recognized Empire's financial

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[4]In spite of this evidence, Ms. McKiddy would probably not agree to abandon her initial position.

situation, the key indicators of Empire's financial health, and the recognized industry financial standards, Ms. McKiddy completely ignored this evidence and recommended a return on equity for the Company that "is not in touch with financial precedence or reality." (Ex. 16, p. 2).

Several items underscore this point. For example, while Ms. McKiddy did discuss Empire's dividend levels in her testimony, she failed to acknowledge the Company's inability to increase dividends. In this regard, her Schedule 9 shows Empire's constant dividend level and its very high dividend payout ratios during the 1995-99 period. In fact, in three of the years cited by Ms. McKiddy, Empire's payout ratio exceeded 100 percent. Yet she completely ignored this fact in her recommendation.

It is also obvious from her testimony that Ms. McKiddy is aware that the building of Empire's State Line (SLCC) plant has had an adverse financial impact on Empire. In fact, at page 17 of her direct testimony, she recited Standard & Poor's "negative outlook" for Empire which has resulted from its construction program. She also recognized the critical importance of significant rate relief to Empire through Standard & Poor's reference to the "uncertainty of adequate rate relief" which adds to Empire's negative outlook. Once again, what is amazing is the fact that she completely failed to address the implication of her recommendation on Empire's financial condition or to explain why she did not accept the conclusions of Standard & Poor's concerning adequate rate relief. (Exhibit 16, pp. 2-3). Moreover, she also completely ignored the commonly recognized financial standards which are considered measures of financial health. In fact, she acknowledged that the interest coverage ratio that she calculated "does support the 'negative' outlook placed on Empire by Standard and Poor's... ."! (Ex. 61, p. 27).

The bottom line is that in spite of the availability of all of this information and the apparent knowledge on her part of the applicable financial standards she did absolutely nothing to test or evaluate her recommendation on the Company's circumstances in light of these factors!

Mistake of Reliance on Unprecedented Bond Indenture Coverage Test

Although Ms. McKiddy acknowledged the relatively extreme financial circumstances of Empire, she dismissed these serious matters in a cavalier fashion with the following statement on page 30, lines 12-17 of her direct testimony, Exhibit 61:

> The low end of the recommended return on equity range allows enough earnings power for Empire to meet its Net Earnings Requirement of two times the amount of the annual interest requirements *pursuant to provisions of its Supplemental Indenture* (Source: Company Response to Staff Data Request No. 3806). Thus, the pro forma pre-tax interest coverage test shows that there will be enough earnings potential for Empire to meet its capital costs based upon the above referenced return on equity range for Empire. [Emphasis added].

In other words, without analysis or without any other basis, Ms. McKiddy boldly concluded that meeting the bare indenture requirement is an adequate return!

The bond indenture coverage standard which Ms. McKiddy has used to support her 8.5% to 9.5% recommendation is clearly unprecedented. In his 35 years of working as an analyst in this area, in writing, testifying and reviewing scholarly works on the economics of regulation, Dr. Murry testified he has never known of any other analyst who recommended that just meeting a utility's bond indenture minimum coverage was a sufficient return for a regulated utility of any type. (Ex. 16, pp. 9-10).

While Ms. McKiddy's bond indenture coverage standard is completely novel and unprecedented, the most obvious measure of the inadequacy and incredible nature of her recommended return is an application of this standard to the facts. As explained by Dr. Murry, Ms. McKiddy's Schedule 19 shows that she has recommended a return for Empire which, even at the high end of her range, falls far short of the lower quartile of the Before Tax Interest Coverage for those electric utilities maintaining an A rating. The high end of her range, by her own estimation, will produce for Empire a coverage of only 2.29 times when the lower quartile of A rated bonds, according to Standard & Poor's, is 2.95 times. (Ex.16, p. 4).

The significance of this was explained by Dr. Murry. He compared the Before Tax Interest Coverage of the nine utilities that Ms. McKiddy considers comparable to Empire. Dr. Murry's study, shown on his Schedule DAM 20, demonstrates that her recommendation for Empire can in no way be considered as comparable to the interest coverage of her nine companies. (Ex. 16, pp. 4-5). The average Before Tax Interest Coverages of her nine companies is 3.63 times. Black Hills, the highest, has a coverage of 5.10 times. All of these coverages are significantly above the 2.16 to 2.29 range of Before Tax Coverage which Ms. McKiddy's recommendation will produce for Empire. Clearly, Empire is not and cannot by any stretch of the imagination be considered comparable to these companies which have healthy coverage ratios. Moreover, the evidence is clear that the investment community also considers Empire's interest coverage level to be inadequate. Fitch Incorporated recently downgraded Empire's debt. (Ex. 16, p. 5). Moody's downgraded Empire's senior secured debt from A2 to Baa1 and kept the Company's outlook as negative due to the uncertainty surrounding adequate rate relief. (Ex. 29, p. 5).

If Ms. McKiddy had proposed a return for Empire sufficient to place the Company at the level of the "lower quartile" of electric utilities, her recommended return on common equity would have been 14.32 percent. (Schedule DAM 21). This calculation alone illustrates the unrealistic and incredible nature of her rate of return recommendation for Empire in this case.

Ms. McKiddy's standard is inappropriate for another reason, namely the fact that it is a "minimal" solvency condition contained in an agreement between the Company and its bond investors and thus independent of any market-measured returns of similar investments or valuation of a company's common stock. In creating this new arbitrary standard, Ms. McKiddy has dismissed Standard & Poor's objective, independent opinion and scholarly research. Instead, she has substituted her own opinion that a minimal indenture requirement is an adequate measure of a utility's earnings for ratemaking purposes. She apparently either does not recognize the risk to Empire in her recommendation or the impact of that recommendation upon the perception of potential investors. (Ex. 16, p. 8). Dr. Murry testified that he knew "of no regulatory scholar who has recommended basing the rate of return recommendation in a regulatory proceeding on just meeting the minimal requirements of the interest coverage of a bond indenture at the expense of falling short of market-measured return requirements." (Ex. 16, p. 7).

A return based on the minimal indenture requirement ignores the reality of investors' perceptions and their investment alternatives and is disconnected from the realities of the financial markets. (Ex. 16, pp. 7-8). Practitioners and scholars have long recognized that a "market return," the return that investors could earn in other investments of equivalent risk, <u>is the return necessary to attract capital</u>. Not only is this a sound economic principle, it is also the basis of the ***Hope Natural Gas*** case. (Ex. 16, p. 7). By ignoring the way in which potential investors actually evaluate Empire's debt and equity securities, Ms. McKiddy has violated the economic principles upon which the decision of the United States Supreme Court in the ***Hope Natural Gas*** case is based as well as the economic principles of ratemaking for the past sixty years which Ms. McKiddy cites as a basis for her testimony. The indenture ratio standard, which Ms. McKiddy has substituted for the law and well-established economic principles, is simply and fundamentally wrong. The Commission should not adopt as its rate of return standard the test of minimal solvency. There is simply no protection against bankruptcy.

Unfounded Risk Opinion

The fourth fundamental flaw of Ms. McKiddy's work is found at page 34, lines 7-12 of her direct testimony where she concluded, without any analytical support, the following:

> Q. Do you have any other evidence as to the reasonableness of your recommended cost of equity figure for the electric utility industry?
>
> A. Yes. The Value Line Investment Survey: Ratings & Reports. January 5, 2001, predicts the electric utility industry will earn 13.0 percent on common equity for 2000 and 13.0 percent for 2001 through 2003. *In my opinion*, the market views Empire as less risky than the industry due to its competitive rate structure and its strong service area. [Emphasis added].

Ms. McKiddy's unfounded opinion concerning Empire's relative risk reveals the fact that she has done little or nothing to assess either the financial or the business risk of Empire. As explained by Dr. Murry, simply noting the returns predicted by *Value Line* discloses little about risk. (Ex.16, p. 11). Interestingly, Dr. Murry observed that former Staff witness David Broadwater reached the same conclusion concerning Empire's risk in testimony which he filed in Empire's 1997 rate case, Case No. ER-97-81. In fact, Mr. Broadwater used the same precise language in his direct testimony (page 41, lines 8 to 10) except for quoting different earnings predictions from *Value Line*. (Ex.16, p. 11).

All of this is even more remarkable because of the fact that since Mr. Broadwater testified in 1997, Empire has experienced an additional four years with extremely high payout ratios and flat dividends. In addition, the prospective merger with UtiliCorp was not consummated. Also, *Value Line* has changed Empire's stock to an "untimely" investment recommendation. In its April 6, 2001 edition, *Value Line* stated that Empire's prospects for 2001 "were not bright." Standard & Poor's now has a "negative" summary on Empire, while back in 1997 it was "stable." What is also so surprising is the fact that Ms. McKiddy did not appear to consider any of these significant changes in reaching her conclusions regarding Empire's relative risk. Instead, she essentially just copied Mr. Broadwater's four year old testimony without any independent thought or analysis. (Ex.16, p. 12).

The Public Counsel's Recommendation

Mr. Burdette for the Public Counsel recommends a return on equity for Empire of 10% to 10.25%. (Ex. 86, p. 4). His work is at a different level than that of Ms. McKiddy's. His choices of dividend yield and stock prices in connection with his DCF analysis are fundamentally sound. Although he erroneously calculated a growth rate for one of his comparable companies, he later corrected it. He also failed to adjust for size in his CAPM analysis (Ex. 26, p. 2). These mistakes, however, are relatively minor when compared to the extremely serious failures of Ms. McKiddy's work.

Unlike Ms. McKiddy, Mr. Burdette used a proper stock price for his DCF calculation. He explained his stock price approach in response to questions from Commissioner Gaw:

Q. Okay. Now, in regard to stock prices –

A. Yes.

Q. –give me an analysis of why you believe that your figure of around $19 is a better figure, at $19.52 is a better figure to rely upon than what Staff proposed at $24 and some odd cents?

A. Because I think the stock price and dividend yield calculations should be what is available to the investor. I cannot go out - - I mean, if I go out today to buy Empire stock, I'm going to pay 19 to 20 bucks for it, and that's what my yield is going to be based on going forward.

Q. And you believe that taking the last point in time is better than any kind of historical data on what the price of the stock has been over the course of months or years?

A. Well, I average over six weeks. So I can't really say month because I'm at a month and a half. The stock price in December of 2000 is completely irrelevant to the stock price tomorrow.

Q. All right. In this case, if we go back over time, we run into the question of this merger as being a factor on stock prices. Would you agree with that?

A. Oh, yes.

Q. Does that impact what you're doing in this case or is this just your standard way of examining the stock price as a factor?

A. This is standard.

Q. For you?

A. Yes.

Q. Would you say that your method is more or less likely to be the standard in reviewing this than the standard used by Staff or company?

A. Well, the DCF formula calls for a current stock price. By definition, I would say that probably, if you wanted to get technical, you'd use a spot price. You would use today's price today and calculate the DCF cost of equity. But due to variability in prices day-to-day, just things the market reacts to, you take a single-day price and I don't believe its representative. So I spread it over six weeks to hopefully get away from some of that day-to-day kind of fluctuation.

(Tr. 610-612).

Mr. Burdette's $19.52 stock price results in a dividend yield of 6.56%. This, combined with a growth rate of 3.5% results in a return range of 10% to 10.25%. (Ex. 86, p. 17). A more reasonable growth rate i.e. the 4.57% overall average of all growth rates for the Public Counsel's six comparison companies (Ex. 86, p. 15) would take the Public Counsel's return to the 11% range.

Conclusion

For the reasons stated, the Staff's recommendation cannot be given any consideration in this case. Any serious discussion of the appropriate return for Empire must begin with the Public

Counsel's 10.25%. Using a more reasonable growth rate of 4.57% in the Public Counsel's calculation produces a return of 11.13% which approaches Empire's recommended range of 11.5% to 12%. The Commission should find in favor of Empire on this issue.

VII. STATE LINE POWER PLANT AND ENERGY CENTER

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

This issue was addressed and settled as between the parties to this case in the "Unanimous Stipulation and Agreement Regarding State Line Combined Cycle Capital Costs" filed on May 25, 2001. Empire urges the Commission to issue an order adopting that stipulation and agreement as the appropriate resolution of those issues in this proceeding.

The Staff filed suggestions in support of the stipulation on June 1, 2001.

The Commission had the opportunity to question extensively the witnesses of all parties on the issue regarding the underlying facts and the reasons why the settlement proposed by the parties is in the public interest. (Tr. 636-728). That discussion demonstrates that the resolution agreed to by the parties is entirely appropriate under the circumstances.

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

The record clearly demonstrates that operation and maintenance expenses are essential to the proper functioning of generating facilities. Given that the SLCC is a new unit just going into service, it had not been determined at the time of the hearing how much of the operation and maintenance expenses might be covered through a long-term contract or contracts, and how much would not be. There will also be changes in the maintenance amounts for State Line 1 and Energy Center 1 and 2 because those units are being run much differently than in the past. Mr.

Beecher explained that he was concerned from Staff pre-filed testimony it might only be concentrating on expenses covered in a long-term contract. (Tr. 744). Therefore, Empire attempted to demonstrate with the testimony of Mr.Groninger and Mr. Beecher that there are many types of operation and maintenance expenses that would not normally be the subject of a long-term contract. See Exhibits 9, 15 (pp. 23-26) and 30. Mr. Beecher explained that Empire was actively pursuing two long-term contracts. (Tr. 744-745). Other required maintenance would be performed by Empire just as it does at its other power plants by either doing it internally, or through short-term contracts. (Tr. 746).

The Staff acknowledged that it would be looking at the entire scope of O&M expenses as a part of the true-up procedure. (Tr. 752-753). It acknowledged that there will be a need to estimate some expenses. (Tr. 756).

Given these facts, this topic is really not ripe for decision by the Commission at this time, since the Staff will be considering the matter in its true-up audit.

C. 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 addressed in the "Stipulation and Agreement Regarding In-Service Criteria" which was filed with the Commission on May 14, 2001. Since no party requested a hearing on the matters covered by that stipulation, the Commission's rules allow it to treat the stipulation as if it were unanimous. See, 4 CSR 240-2.115(1). Empire urges the Commission to issue an order adopting that stipulation and agreement as the appropriate resolution of these issues in this proceeding.

VIII. CONCLUSION

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

Respectfully submitted,

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Certificate of Service

The undersigned certifies that a true and correct copy of the foregoing document was either hand delivered or placed with the U.S. Postal Service, first class postage prepaid, this 20th day of July, 2001, to the Office of the General Counsel, Office of the Public Counsel, and Stuart W. Conrad.

Gary W. Duffy

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