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August 3, 2001

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Missouri Public
Service Commission

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

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

Dear Mr. Roberts:

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

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

Sincerely yours,

Gary W. Duffy

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

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

FILED[3]

AUG 0 3 2001

Missouri Public Service Commission

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

REPLY BRIEF OF

THE EMPIRE DISTRICT ELECTRIC COMPANY

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August 3, 2001

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I. INTRODUCTION

This brief responds to arguments made in the initial brief of the Staff and the Office of the Public Counsel. Intervenor Praxair, Inc. did not submit a brief.

II. COST OF SERVICE - DEPRECIATION

The only party to address the depreciation issues in its initial brief was the Commission Staff. Thus, this section will respond exclusively to the Staff's brief ("Stf. Brf.").

A. Should Empire's test year depreciation expense be adjusted?

On page 3 of its Brief, the Staff sets out dollar impacts associated with the differences between the Staff and Empire positions as to the various aspects of the net salvage and service lives depreciation issues (SLCC and non-SLCC plant). While Empire agrees with the general order of magnitude represented by the numbers found in the Staff's Brief, it disagrees with the precise numbers utilized by the Staff. Empire understands that a revised accounting run, which should address this issue, among others, will be produced by the Staff and presented to the Commission during the true-up phase of this hearing.

Empire would additionally point out that the impact of the Staff's depreciation recommendation not only represents a reduction from Empire's proposal in this case, it is also significantly less than the amounts produced by Empire's current depreciation rates. The Staff's proposed Missouri jurisdictional depreciation expense of $16,896,121 per year represents a reduction of $5.640 million, or approximately twenty-five percent (25%) less than Empire's current rates. (Ex. 32, Sch. 9-3).

(1) What are the appropriate average service lives for plant in service other than at

State Line Power Plant?

The Staff spends much time in its brief explaining why it believes Empire's proposed service lives are wrong, but very little time explaining why the Staff's own proposed service lives are right. Staff generally states in support of its rates that it used mortality data, visited plants, met with Empire's engineers and created survivor curves in order to derive an average service life for the plant in specific accounts. (Stf. Brf., p. 5-6). However, the Staff completely fails to explain the reasons for its enormous changes from Empire's existing service lives which were developed by the Staff itself in Commission Case No. ER-94-174, presumably through the same process. Instead, the Staff again states in its Brief that it "concluded that the average service lives found in [the depreciation study made for Case No. ER-94-174] are still appropriate." (Stf. Brf., p. 6).

This statement is consistent with other statements made by the Staff in this case in regard to the validity of the Staff service lives which Empire was ordered to use in 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." (Adam, 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." (Adam Dir., Ex. 33, p. 20).

Staff further asserted that its proposed depreciation rates applicable to generating plant differ from currently effective rates (those from Case No. ER-94-174) solely by virtue of its proposal to exclude net salvage from the depreciation process. (Adam, Tr. 225).

The Staff Brief does not address why in spite of this analysis, the service lives proposed have changed the Case No. ER-94-174 lives in 27 of the 40 depreciation accounts represented on Staff Schedules 1-1 and 1-2 (Adam Dir., Ex. 33) and why some of the lives have been changed by as much as 40 years or more. (Id., See Riverton-Steam, Asbury-Steam and Iatan-Steam, Accounts 311). These changes to the ordered lives which were based on Staff's own study and Staff's own service lives would seem to require at least some explanation.

Staff focuses instead on the issues it raised in trying to attack the service lives proposed by Empire. This attack was first based on Staff's observations as to whether the Company's conduct supported the service lives it proposed. The Staff stated that Empire employees did not provide specific retirement dates or plans to replace the subject pieces of generating property. It also described the significance of the power generated by the subject facilities in relation to Empire's system needs over the next several years.

These circumstantial facts are of limited value in this type of analysis. First, the life of the plant is not directly dependant upon either of the described factors. It will be necessary to retire generating plant at some point in time whether or not replacement power is available. Mechanical failures, environmental difficulties and other conditions that may lead to retirement of generating plant do not concern themselves with Empire's planning process.

Second, Empire's planning process is not solely dependent upon its employees. Empire hires experienced consultants, such as Mr. Loos, to assist in the analysis of the condition of its plant, likely retirement dates for its plant and other aspects of the planning process. Thus, while the Staff complains that it did not receive retirement dates from Empire employees, it has in its hands detailed analysis and projections of such retirement dates in the form of Mr. Loos' study. This in itself, because of the experience and work which forms its basis, is significant evidence of what Empire believes to be reasonable retirement dates for the subject property.

Third, the horizon for such capacity planning is beyond the life spans proposed by Empire. The closest ending life span proposed by Empire (2008 for the Riverton units) still provides the opportunity for replacement. Mr. Loos stated that this 7 year period is easily within today's planning horizon for a couple of reasons. (Loos, Sur., Ex. 31, p. 7). The planning horizon for electric generation has shrunk by great amounts over the past 10-15 years. Also, with the availability of merchant power and the relatively short lead times and construction periods for combined cycle plants, a utility can start thinking about new generation perhaps as little four years in advance. As a result, decisions can be made as little as 24 months before power is needed. (Tr. 179).

In particular, the short lives for the identified Riverton units is also specifically justified because, in Mr. Loos' unchallenged opinion, Riverton is "one outage" away from retirement. (Tr. 157). He bases this opinion on the fact that by 2008, Riverton will be 58 years old. The equipment has been subject to the high pressures and relatively high temperatures over that period of time. It also has been subject to thermal stresses, fatigue, corrosion and erosion, among other things. As a result, there is not much life left in the units. (Tr. 182).

The remainder of Empire's recommended service lives are further outside today's planning horizon. Empire's recommended life spans for plants other than Riverton are <u>at a minimum</u> 13 years away. The unknown nature of both the future structure and technology in the electric industry over the next 13 years further reduce the importance of the Staff's statements in regard to planning for replacement power.

As an example of the ground moving changes that can happen over a 13 year period, Empire witness Loos identified some changes in the industry that have happened since 1987 (13 years ago), including the following:

- In 1987, there was no such thing as "open access," "exempt wholesale generators," "independent system operators," and "power exchanges;"
- In the 1980's there was 69,700 MW of coal fired steam generation and only 4,300 MW of combustion turbine generation constructed in the United States. In the 1990's, there were 9,700 MW of coal fired generation constructed and 27,700 MW of combustion turbine generation constructed.

(Loos Sur., Ex. 31, p. 8).

It is impossible and unreasonable for Empire to plan for capacity replacement over the period suggested by Staff witness Adam.

The exception to these future unknowns is found when examining Empire's hydroelectric generating units. While the Staff attacks Empire's other proposed lives because Empire does not have "known" retirement dates, it attacks the Empire hydroelectric service life because the life is based on a known retirement date. The Staff does not agree with the 2022 retirement date Empire uses for these units, which were placed in service in 1931, because it was "based solely on the expiration of its current license." (Stf. Brf., p. 11). This is not an unrealistic assumption. As can be seen, the facility would be 91 years of age in 2022. The expiration of the cited license is a known end to the project (something the Staff complains it does not have as to other generation property). Any further operation of the project would be subject to the approval of the Federal Energy Regulatory Commission ("FERC"). This FERC licensing process is potentially very expensive and not always successful. (Loos Sur., Ex. 31, p. 8). This is a very solid basis for the retirement projected by Empire for the hydroelectric facility.

As to Empire's Asbury units 1 and 2, Staff suggests that they are not likely to be retired near the 2014 date identified by Empire, in part, because they are earning Clean Air credits "that generate electricity at a relatively low production cost." (Stf. Brf., p. 9). This would be an extremely flimsy basis to ignore a necessary retirement and, certainly a reason not recognized by the equipment itself. While there is some advantage to the referenced credits, there is no guarantee that environmental requirements in place today will be the same as of the retirement date used by Mr. Loos. Thirteen years ago there was no such thing as Clean Air credits. (Loos Sur., Ex. 31, p. 9). Empire cannot base its retirement planning on such assumptions.

Staff also criticizes the Asbury retirement dates because Empire is committed to spend $10 million in late 2001, to replace cyclone burners, install a new computer based control system and inspect the large turbine at these units. (Stf. Brf., p. 10). Mr. Loos pointed out that had the Staff looked closer at this expenditure, it would have found that the major part of this project -- the replacement of worn out cyclone burners – has no impact on retirement dates because it is not a life extension project. The replacement is required in order for the plant to continue economic operation. (Loos Sur., Ex. 31, p. 14; Tr. 139).

The continuing nature of the Staff's mistake is that it looks at only indirectly connected surrounding circumstances rather than examining the subject property and its condition. Staff inappropriately "proposes average service lives for each type of plant based upon the FERC account into which it falls and the nature of the energy source that is converted into electricity." (Stf. Brf., p. 8). This is contrary to good practice. It has been stated that "[r]espectable authorities hold that in determining accrued depreciation, evidence of competent valuation engineers who have examined the property and made estimates regarding its condition is more valuable than calculations based on averages and assumed probabilities." ***State ex rel. City of City of St. Joseph v. Public Service Commission***, 30 S.W.2d 8, 12 (Mo. banc 1930).

Rather than basing its proposal on merely the account in which property falls, as the Staff has done, Empire has utilized "competent valuation engineers who have examined the property and made estimates regarding its condition." Empire's services lives and resulting rates are based upon the work of Mr. Loos and the engineers he supervises at Black & Veatch. Mr. Loos called on the experience he has developed during the 30 years that he has been engaged in engineering in the energy industry. As far back as the 1970's, Mr. Loos was looking at life characteristics of plants and the various elements that go into assuring that the plants will last for a certain period of time. Most recently, about a year and a half ago, he performed an extensive analysis of the factors that go into coal-fired, steam generation life and the nature of expenditures that are required to attain the lives that are assumed. (Tr. 179). This review and expertise is far superior to proposing lives based on the "FERC account into which [property] falls."

Lastly, an extension of the Staff's error is found in its approach to life span property, such as power plants. The Staff states that under its approach "plant remains in service until it is retired; therefore, there is no fixed retirement date for the plant." (Stf. Brf., p. 8). What this means as a practical matter is that accounts and categories are relied upon to the exclusion of, and in the face of, common sense.

As an example, Staff witness Adam recommends an average life of 95 years for structures and improvements that are a part of the generating property and 54 to 63 years for other steam production accounts at the same facilities. In reality, the investment life of structures and improvements at a plant cannot be greater than the span of time between the installation of the first generating unit and the final retirement of the last unit at that plant. None of the production plants are scheduled to be in service for 95 years. It is unrealistic to assume, as Mr. Adam has, that the structure at the Asbury plant will be useful beyond the life of the boiler. (Loos Reb., Ex. 22, p. 23).

This erroneous approach is also evident from the fact that the Staff treats all plant investment, whether the initial placement or an interim addition, with the same average service life. For example, under Staff witness Adam's proposal, the 1970 ($14.5 million) initial investment in the Asbury boiler will be recovered over 54 years. He also proposes that the $18.1 million pollution control equipment investment made in 1990 have an average service life of 54 years. The problem with Mr. Adam's approach is that Empire will be unable to recover investment in the pollution control equipment over this 54 year period, since it is of no value without the subject boiler. (Loos Sur., Ex. 31, p. 6).

Finally, as to the service lives for generation property, other than the SLCC, Empire has presented an alternative position for the Commission's review. Empire witness Loos presented in his Surrebuttal Testimony (Loos Sur., Ex. 31, p. 15) a schedule of depreciation expense rates applicable to generating property that assumes an increase in his proposed life spans by five years. (*Id.*; *Id.*, Schedule LWL-5). While Empire believes that its original life spans are reasonable, Schedule LWL-5 provides the Commission with an alternative should it decide that it is more comfortable with a longer life span for the subject property.

In summary, the Staff's approach is not well reasoned nor based on competent and substantial evidence. The Commission should, therefore, adopt the well-supported and reasoned service lives presented by Empire and reject the Staff's proposal as unsupported in the record and contrary to its statements.

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

The net salvage method proposed by the Staff would take cost of removal, sometimes a very great cost (for example, as in the removal of a power plant), and, rather than provide for its collection over the life of a piece of utility property, instead call for its recovery when incurred. The Staff supports its proposal to completely remove net salvage from the depreciation calculation by arguing that it is not convinced that plant is always removed, that even when removed it may be removed by a subsequent owner, that it is wrong to consider net salvage in the setting of the depreciation rate, and that it is easier to avoid the estimation of net salvage.

Empire will explain the weaknesses in these arguments in the following paragraphs. However, even if they had been valid arguments, they do not hide the fact that 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.

As stated above, the Staff argues in an anecdotal fashion that a company may sometimes delay removing plant, or may not remove it at all. (Stf. Brf., p. 14). Empire pointed out in its Initial Brief that there are checks and balances to address this situation and to ensure that the rate payers are not harmed if removal does take place. Empire also pointed out in its testimony that "[w]hen utility assets are sold (absent specific assignment of the liability to the seller), usually the liability of costs of removal and the benefit of net salvage flow to the new owner. The seller does not avoid cost of removal since the sales price of the asset reflects consideration of the value added by salvage and the added cost of removal, which the buyer will ultimately incur." (Loos Reb., Ex. 22., p. 17; Tr. 151-52). Thus, the amounts received are taken into account in subsequent sales where the property is no longer used and useful. Where the property is still used and useful, any sale would be reviewed by the Commission and require the Commission's approval before it could take place. Section 393.190, RSMo (2000).

Additionally, the nature of electric plant itself makes it hard to assume that it will not be removed. Unlike some other utility industries, electric utilities generally do not have a significant portion of their facilities underground. The bulk of an electric utility's property is aboveground and at some point must be physically removed. "One cannot reasonably assume that an electric utility can abandon power plants, transmission lines, and distribution lines with out some requirement to physically remove the equipment. Abandoning their overhead property in place would present considerable safety risk to the public and the environment and would most likely meet with legal opposition in the communities they serve." (Loos Reb., Ex. 22, p. 19). If nothing else, this is a reason that the Commission's approach to this issue should be different from the direction it has taken in regard to natural gas depreciation.

In an attempt to identify a specific piece of property that has not been removed, Staff witness Adam pointed out that Unit 6 of Empire's Riverton Plant is still in place after its retirement. This is not a condition that will continue indefinitely. Right now, it is too expensive to try and extract Unit 6, while leaving Units 7, 8 and 9 operational. It makes more sense to leave it in place and take the units out en masse. (Tr. 161).

Had the Staff examined Empire's past actions in regard to removal, it would have discovered that Empire's units do not remain in place forever. For example, a mere viewing of the same Riverton site referenced by the Staff reveals that Riverton units 1 through 4 were all removed (prior to 1992). (Tr. 182). Unfortunately, the Staff did not perform any study or review of Empire's past practice in retirement and removal of property (Tr. 230) and is unable to testify in this regard.

The Staff further indicates that one of the advantages of its net salvage approach is to "avoid" the need to make various estimates. (Stf. Brf., p. 15). This merely points out that the process is not easy, and it takes a level of skill and experience to derive reasonable numbers. This is true of a great many aspects of the rate making process. Things would be much easier if estimates and projections could be avoided. However, it is a necessary part of the process. In the case of net salvage, the return for such effort is great. Making the estimates allows for costs associated with the operation of a piece of property to be paid for by substantially all, if not all, of the rate payers that have benefitted from that property -- an important goal in the ratemaking process. On the other hand, there is little downside, as the estimation is not performed without a safety net. There are checks and balances that ensure that numbers are reviewed periodically and that rate payers are compensated in the interim for any overage.

These checks and balances are at work in this case. For example, Empire has recommended an overall reduction in cost of removal allowances applicable to production property from the level reflected in the existing depreciation expense rates. (Loos Sur., Ex. 31, p. 17; Tr. 181). Empire made these recommendations after reviewing the historical pattern of retirements, cost of removal and salvage, along with forecast conditions. (Tr. 181). This is something that the Staff also could have done.

The alternative to this process, as proposed by the Staff, is undesirable. It leaves one group of ratepayers with responsibility for payment of amounts that relate to property that has benefitted only their predecessors. For some reason, Staff recognizes this possibility as undesirable in one issue, but not in regard to net salvage.

In the section of its Brief addressing the average service life for the SLCC (Stf. Brf., p. 18), the Staff presents an example to demonstrate its concern that in some instances plant may be depreciated too quickly and create inter-generational inequities. The Staff states in its example that if depreciation expense related to a particular plant is recovered over 30 years, rather than over the hypothetical actual life of 50 years for that property, that customers during the 30 year initial period will pay through rates the original cost of the plant and "the customers during the later 20-year period will pay no part of the original cost of the plant." (*Id.*).[1]

A similar example can be used to illustrate the inequity associated with the Staff's position on net salvage. In regard to net salvage, the Staff recommends that the Company's customers during the 50 year useful life of the described property pay <u>no part</u> of the cost of removal. Instead, the Staff would have the customers in year 51 – the first year <u>after</u> the useful life of the property – pay *all* of the cost of removal. This cannot be described as good policy by any measure.

The Staff accurately states that "[u]nlike the Staff, Empire seeks to have this Commission treat net salvage as part of the value of the plant to be depreciated and, thus, treat it as a factor to be included when setting the depreciation rate." (Stf. Brf., p. 15). Empire believes its approach both addresses the described generational problem and has the added benefit of being supported by precedent. First, the Commission itself has treated net salvage in this fashion for many years. Second, it is consistent with various treatises. The 1989 publication, *An Introduction to Net Salvage of Public Utility Plant*, prepared by the Deprecation Committee, American Gas Association, and Depreciation Accounting Committee, Edison Electric Institute describes net salvage as follows:

> Why the concern for salvage and cost of removal? Because they are costs that must be recorded for financial statements to be meaningful and they are elements of the cost of service to the customers. The *cost to retire a unit of property is just as much a capital cost as are the initial in-service costs and the periodic*

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[1]This example is not realistic in regard to the SLCC average service life issue because the intention (and the effect of subsequent reviews of the depreciation rates) will ensure that recovery is had over something near the full 50 year life of the plant.

improvements. . . .

> The depreciation rate, whether it be based on whole life or remaining life, *includes net salvage as without it there is not a fair allocation of costs over time.* Intergenerational inequity results if net salvage is not accurately reflected in the depreciation rate.

(Loos Reb., Ex. 22, p. 10-11). (Emphasis added).

The issues raised by the Staff do not support a complete abandonment of the whole life method, which serves many appropriate and important policy goals. The Commission should instead 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 Staff used a 35 year average service life for the SLCC because of its belief that the "design engineer" described the "design life" as 35 years. (Stf. Brf., p. 7). While the Staff's analysis stopped at what it believed to be an engineer's "design life," Empire took the extra steps necessary to analyze additional factors (as it did with all its generating plant) in an attempt to reach a service life that would best ensure that investment would be recovered as smoothly as possible over the life of the property. These additional factors included consideration of interim additions in the setting of the appropriate service life. The Staff's approach of using blinders in regard to interim additions will result in depreciation rates that must be increased in significant amounts at uneven intervals over the life of the plant. Empire believes that following this approach will intentionally create a lack of rate stability for rate payers.

The Staff disagrees with Empire's approach because it believes that it would be "inappropriate to recognize estimated future plant investments until the investments until the investments are actually made, i.e., the Staff would only recognize future expenditures after they are incurred." (Stf. Brf., p. 17). To the contrary, Empire's approach does not violate this concept. The depreciation rate proposed for the SLCC by Empire includes only recovery of those dollars that have been invested by the Company. No recovery of the interim additions will or can be made until after these monies are expended. Empire's proposal does not increase the amount to be recovered. It recognizes that the expected life of the plant is shortened substantially if interim additions are not made. (Loos Reb., Ex. 22, p. 31). Thus, the average service lives of the property are impacted because without the additions the SLCC will not last for 35 years.

The Staff's recommended service life was reached with a complete dependance on the "design engineer's" "design life," and a complete refusal to look at the rest of this same engineer's work and opinion. The Staff decided to take out of context only that part of the engineer's statement that suited its purpose. What the Staff ignored was the fact that this engineer also supervised the preparation of the operation and maintenance forecast for the SLCC found at Schedule LWL-2 -- items which would be necessary to reach the "design life." (Loos Dir., Ex. 11; Loos Reb., Ex. 22, p. 28). Empire witness Loos' interim additions that he considers are directly based on capitalizing some of these major maintenance costs, using proper accounting standards. (Loos Rebuttal, Ex. 22, p. 28). Thus, while the Staff bases its entire average service life recommendation on the "design life," it ignores the fact that the same engineer's opinion reveals that the 35 year average life cannot be achieved without a reasonable level of interim additions. This is a very misleading representation of the "design life."

If the interim additions are not recognized in the setting of the SLCC service life, the alternative is an ever increasing depreciation rate. As the new additions are made, they must be recovered over increasingly shorter periods of time. (Loos Reb., Ex. 22, p. 34). This defeats the theory of straight-line depreciation, which is to spread costs in a uniform and constant manner.

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.

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

The Staff's Brief addresses all net salvage issues in one section. Consistent with its Initial Brief, 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 again 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?

There is no argument concerning the appropriate dollar amount of bad debt expense to be included in Empire's cost of service in this case. All parties also agree that the Company's bad debt expense amount included for ratemaking is based on a factor of .25% of Empire's revenues. The issue here is whether this agreed-to .25% bad debt factor should be applied to the rate increase which the Company will be authorized in this case.

The Staff opposes "factoring up" the rate increase by the .25% amount arguing that there is no correlation between revenues and bad debt expense. The Staff's opinion, however, is just that -- an opinion unsupported by any facts.

The record evidence in this case supports "factoring up" the rate increase by .25%. In six of the last eight years, Empire's bad debt expense has increased as its revenues have increased. (Tr. 314). In addition, over the last several years Empire's bad debt expense has equaled .25% of revenues (Tr. 305) and .25% of Empire's present rate revenues have been included in the cost of service in this case. Simple logic leads to the inescapable conclusion that for each dollar of additional revenues, the Company will experience additional bad debts, in this case one-fourth of one cent. This logic did not escape the Staff witness who admitted that if a company had no revenue it would have no bad debt, but if that same company had $100,000 in revenues, it would have some bad debt expense. (Tr. 330). The Staff witness' initial opinion in opposition to the adjustment must be considered in light of this concession, as well as the fact that he had no prior bad debt audit experience and, in fact, was not responsible for the bad debt expense issue in this case. (Tr. 325-327) This underscores that his opinion testimony has no factual basis.

When faced with this same issue previously, the Commission held that an agreed-to bad debt expense ratio should be applied to the additional revenues resulting from the rate increase. See ***In re Missouri Gas Energy,*** Case No. GR-96-285, January 22, 1997, 5 MoPSC 3d 437 at 463. In that case, 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."

The facts of this case and logic demonstrate a correlation between revenues and bad debt expense. This, coupled with the precedent of Case No. GR-96-285, should cause the

Commission to rule in favor of Empire on this issue.

IV. COST OF SERVICE - PAYROLL - INCENTIVE PAY

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

This issue has resulted from one aspect of Empire's incentive compensation program under which employees who meet both "base goals" and "stretch goals" become eligible to receive additional compensation. (Ex. 27, pp. 1-2). During the test year in this case, Empire made $323,000 in incentive payments to various employees who had achieved goals which were beyond their normal job duties and responsibilities. (Ex. 27, p. 3). The Staff opposes including these costs in rates.

The Staff begins its brief on this matter by claiming that the issue has created "a considerable amount of confusion." (Staff brief, p. 21). The Staff then offers up twelve pages of somewhat disjointed text in an effort to deal with this subject, a reading of which leaves one with the impression that, with all due respect, the Staff is confused.

The facts concerning that aspect of Empire's incentive program which are at issue are relatively simple and straight-forward. If an employee meets both his or her base and stretch goals, that person becomes eligible to receive incentive compensation. Also, simple and straight-forward is the fact that 2000 was not a normal year for Empire and its employees. As a consequence, Empire has conceded all along that the execution of its incentive program was somewhat off the mark. This does not mean, however, that the plan itself is bad or that Empire should not be allowed to recover the involved costs. (Ex. 114, p. 8).

The fact of the matter is that in the year 2000 with the UtiliCorp merger pending, Empire's customers did benefit from the incentive awards which are at issue. The record evidence in this case demonstrates that the Company's employees did "stretch" and achieve goals beyond their normal job duties by continuing to provide high quality utility service to Empire's customers during a year in which employee vacancies were *three times* the normal amount. As a consequence, those employees who remained with Empire during the merger turmoil went beyond the norm and kept the Company up and running. (Ex. 114, p. 5). The fact that Empire's customers were not only unaware of this critical shortage of employees but also continued to enjoy the benefits of high quality, reliable electric utility service is reason enough to include the $323,000 in rates.

A second reason to include the involved incentive compensation in rates is the fact that the plan itself is a cost effective approach to compensation, which in turn directly benefits the Company's customers. In other words, the plan puts a portion of pay at risk causing employees to recognize that superior performance will generate greater compensation.

A third reason which justifies rate treatment is the fact that Empire's compensation levels are at or below average to begin with and the $323,000 amount would only represent a 2.5% increase for the involved employees. (Ex. 114, p. 6).

Finally, the Staff argues that Empire's program does not meet the management performance plan criteria established in a Union Electric case and therefore the costs must be disallowed. The Union Electric management incentive plan, however, concerned corporate goals and objectives which applied to management employees. Empire's program, on the other hand, concerns individual goals and objectives for mid-level managers and hourly workers. It is not available to officer level employees. (Tr. 835, Ex. 114, pp. 8-9). The Union Electric test is not applicable. Empire should prevail on this issue.

As an alternative to an "all or nothing" approach, however, rather than penalizing Empire for a lack of execution by eliminating the entire $323,000 from cost of service, the Commission could utilize a five year average of these amounts which would result in $251,000 being included in rates. Another possibility is a four year average, deducting the $323,000 from the total, resulting in $223,500 in rates. This approach on the one hand recognizes that during the test year Empire's execution of the plan was not up to standard, but on the other hand also preserves the value of the plan which requires employees to achieve performance above normal job duties to gain that portion of their compensation which is at risk.

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?

Given that these matters were settled and there was no argument in the initial briefs of the other parties, no reply is necessary.

VI. CAPITAL STRUCTURE / RATE OF RETURN

A. What capital structure is appropriate for Empire?

The appropriate capital structure for Empire for purposes of this case is 45% common equity, 7.9% trust preferred and 47.1% long-term debt. (Exhibit 14, p. 4). The Staff and Public

Counsel propose a capital structure of approximately 40% equity and 60% debt, which is inappropriate because it is not representative of Empire's historical capital structure nor is it representative of the capital structure which Empire will have in place in the future when the rates established in this case will be in effect. (Exhibit 16, p. 25).

As with the Staff's evidence, the Staff's brief ignores the circumstances surrounding Empire's capital structure. For example, at page 34, the Staff claims that Empire did not come close to achieving the year-end "pro forma" capital structure. This argument completely ignores the fact that Empire's actual year-end capital structure was the result of its combined financing needs and the limitations placed on it by the pending merger with UtiliCorp.

The Staff's brief also neglects to mention the fact that because Empire was prohibited from issuing more common stock during the merger proceedings with UtiliCorp, this has actually resulted in a benefit to ratepayers. This is because debt was issued instead of equity. Empire normally has a common equity ratio in the 45-50% range. If the Commission adopts the Staff position, it will be passing along the savings resulting from the failed merger without passing along any of the merger costs, recovery of which have not been sought by Empire. (Ex. 14, p. 2-3; Tr. 443, 444.)

When the merger was pending, the Staff recognized that the transaction would reduce Empire's capital costs by $2.5 million per year for 10 years. (Ex. 26, p. 10-11). The Staff now ignores its previous position and the implications of the termination of the merger by its failure to update to the required capital structure to one which the market anticipates for an independent Empire. These two Staff positions taken within a few months of each other are logically incompatible. (Ex. 26, p. 12).

The Staff's suggestion in the footnote at page 33 of its brief, that a 40% common equity ratio was endorsed by Dr. Murry in his Schedule DAM-3, is simply wrong. Furthermore, the footnote at page 36, suggesting that Dr. Murry's proposed capital structure represents only Empire's intentions, takes his testimony out of context. Schedule DAM-3 was used by Dr. Murry to demonstrate that the common equity ratios of his six comparable companies are equivalent to the equity ratio proposed by Empire in this case. This fact was clearly indicated by Dr. Murry's direct testimony where he said at page 8, lines 7-8 "... the common equity ratio of Empire used in this case is similar to the common equity ratios of six comparable companies." The five year average common equity ratio for the six companies is 46.6%. (Schedule DAM-3). Empire is proposing 45% in this case.

In the past, the Commission's goal in determining a capital structure for ratemaking purposes has been to utilize a capital structure which is representative of the one which would prevail during the period in which new rates would be in effect. ***In the Matter of Laclede Gas Company***, Case No. GR-78-148, 22 Mo. P.S.C. (N.S.) 360 (1978). On this point, in response to questions from Commissioner Lumpe, Dr. Murry testified:

> When the merger unwound, the company by the end of the year had a very low common equity ratio. It's my opinion in looking at the history of what the equity ratio had been previously and what the company says it is trying to go to, it appears to me that the snapshot at the end of the year is not representative of where the company as an independent company needs to go and where it says it's going.

(Tr. 403).

Also, in response to a question from Commissioner Lumpe, Dr. Murry testified that Empire's year end 2000 capital structure was "an anomaly and should be, in my judgment, a temporary position." (Tr. 404).

At page 37 of its brief, the Staff concedes that Empire's common equity percentage is lower than it has been at other times in recent years. But then Staff makes two absolutely incorrect statements. First, Staff says Empire's common equity percentage is not abnormally low for the electric utility industry and, second, there is no reason for the Commission to believe that it will increase substantially in the near future.

On the first point, Empire is not typical or representative of the electric utility industry. The electric utility industry is moving more and more into non-regulated areas as companies get larger and larger. (Tr. 452). Empire, on the other hand, continues to be a "pure play" company as over 99% of its business is regulated. (Tr. 453). What may or may not be "normal" in terms of capital structures for the industry doesn't matter. Empire is not "normal" in this regard.

On the second point, the Staff is asking the Commission to disbelieve the testimony of Empire witness Dave Gibson who testified under oath that Empire has reinstated its Dividend Reinvestment Plan and is planning to issue additional common equity later in 2001. (Ex. 14, p. 3; Tr. 448, 451). Both of these events will increase Empire's equity ratio. Empire takes strong exception to the Staff's apparent effort to characterize Mr. Gibson's sworn testimony as unbelievable.

Perhaps the basic flaw in the Staff's entire cost of capital approach can be found at page 36 where the following statement is made:

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

As will be explained below, it is true as the Staff states that Empire contends that a current stock price should be used in the DCF calculation because that is what is required by the DCF model. On the other hand, what is required as a capital structure for ratemaking purposes is one that will reflect the capital structure in place when the rates are in effect - not necessarily an actual capital structure at a particular point in time. The Staff's failure to recognize this fundamental difference is inconceivable. Moreover, it is the Staff that is inconsistent. The Staff uses historical data prior to the merger to justify its stock price, but ignores historical data prior to the merger for its capital structure.

The Public Counsel also recognizes that its proposed capital structure is inconsistent with Empire's historical capital structure. The Public Counsel, however, incorrectly reports the financing history of Empire when it says at page 3 of its brief that the Company "voluntarily" chose to retire its preferred stock, to issue debt, and elected not to issue additional common stock. The record evidence sets out the reasons and motivations for the circumstances surrounding Empire's current capital structure. The decline in equity was a requirement of the merger provisions and the write-off of the merger expenses to equity. (Tr. 402, 403; Ex. 16, p. 25). The present situation is clearly an anomaly. It is only logical to assume that absent the merger, Empire will return to its historical capital structure.

The Public Counsel's argument, at page 4 of its brief, that its comparable companies have similar capital structures is not relevant. That is because the companies which make up the Public Counsel's group have not experienced a forced adjustment of their capital structures because of failed mergers. Moreover, while these six so-called "comparable" companies may have a common equity ratio which averages 40.8%, compared to Empire's year-end 2000 40%, Mr. Burdette's evidence also shows that Value Line's Common Equity Composite Index for the electric utility industry is 44.5% for the year 2000. Based on the Public Counsel's own evidence, then, Empire's proposed 45% common equity ratio is clearly reasonable.

Nor, as suggested by the Public Counsel at page 5 is Empire's present capital structure in a "zone of reasonableness" when it is compared with the historical capital structure of the Company. Before 1999 and the UtiliCorp merger, Empire's common equity ratio was 45.8% in 1996; 48.9% in 1997; and, 45.2% in 1998. (Schedule DAM-3). Since 1992 and prior to the merger its equity ranged between 45% and 50%. (Ex. 14, p. 2) These historical Empire capital structures are very comparable to the historical capital structure of Dr. Murry's comparable companies. (Schedule DAM-3).

Forty-five percent (45%) plus is where Empire has been in the recent past and that is the direction it is headed in the future according to its witness. As Dr. Murry said, "I think if I were looking for a rock to stand on, I'd probably go back to the history." (Tr. 404).

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

Empire submits that its appropriate rate of return on common equity is in the range from 11.5% to 12%. The Public Counsel supports a range of 10% to 10.25%. [2] The Staff argues for a range of 8.5% to 9.5%.

In its initial brief Empire pointed out in detail the four fundamental flaws in the work of the Staff witness which render the Staff's ultimate return on common equity recommendation completely invalid. The Staff's brief fails to deal with any of these matters. Specifically, the Staff's brief fails to present any compelling reason to support its use of inflated share price data reflecting Empire's pending merger with UtiliCorp; fails to contradict the fact that the Staff's

[2]The Staff misrepresents the Public Counsel's position at page 38 of its brief. The Public Counsel supports a range of 10% to 10.25%. Its position is not 10.06%.

recommended return is inconsistent with the basic measures of financial integrity; fails to justify the Staff's reliance on the minimal requirements of bond indenture interest coverage; or, fails to the justify the Staff's opinion on Empire's relative risk.

Stock Price Flaw

For starters, while at page 38 of its brief the Staff concedes that the DCF formula requires the use of "the present stock price," the Staff's evidence comes nowhere near to meeting this standard.

At the time she filed her testimony in March of 2001, Ms. McKiddy knew that the proposed Empire/UtiliCorp merger had failed.[3] (Tr. 416). She was apparently also aware that from the time it was announced that the merger would not go forward through the time she filed her direct testimony and up to the time of the hearing in this case that Empire's stock had traded in a relatively narrow range between $19 and $20 per share. (Tr. 474). Nonetheless, for purposes of making her recommendation she included share price data from October 2000 through March 2001, including prices prior to the cancellation of the proposed merger - prices which reflected the premium that UtiliCorp was willing to pay for Empire stock. This gross error in and of itself renders her work unacceptable.

Public Counsel witness Burdette would agree. He testified that the DCF formula calls for a current stock price. (Tr. 611) "... [S]tock 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).

Ms. McKiddy's apparent after-the-fact justification for her incredible approach is found

[3]Dr. Murry did not have the benefit of this knowledge when he filed his direct testimony in October of 2000. He used prices which were representative of the then-correct market prices. (Ex. 26, p. 6).

buried at page 42 of the Staff's brief where the statement appears that Empire's stock price was temporarily driven down in early 2001 because of the merger termination. On cross-examination on this point she claimed to have knowledge (apparently possessed by no one else) that the efficient market hypothesis, (which she claims to endorse) should not apply to Empire because of her unique special knowledge of the true value of the Company. "It would be accurate to say that I don't believe the rule (the efficient market hypothesis) necessarily applies to Empire at this point in time, although it is an underlying assumption of the DCF." (Tr. 508-509). In other words, she says a key feature of the DCF doesn't apply to Empire. Incredible! But there is more as she goes on to say, "I believe absent the merger, that Empire stock could have continued to trade at a level around $23"! (Tr. 516-518).

It is hard to understand what the Staff could possibly mean by the use of the phrase "temporarily driven down," or why Ms. McKiddy continues to hold to the belief that the stock is worth $23 per share. Schedule DAM-25 reflects that prior to the termination of the merger Empire stock traded in a range of $22.875 to $30.750. After the merger was terminated on January 2, 2001, the stock opened at $20.18 (Ex. 16, p. 17) and has traded in the narrow range of between $19 and $20 per share since then up to the June hearings, a period of five months. (Tr. 464). Hardly "temporary."

These facts clearly demonstrate why it can honestly be said that Ms. McKiddy has not performed a valid DCF analysis. She has ignored one of the basic theoretical principals of the DCF model, based on the efficient market hypothesis, which is the use of a <u>current</u> stock price.

This same failure to properly apply the DCF model in terms of share price is not an isolated event. Ms. McKiddy also violated the fundamental forward-looking theory of the DCF model by her failure to take into account investor expectations. The price reflected in the market represents investor expectations. The fact that the price of Empire's stock fell after the UtiliCorp merger failed is a reflection of investor expectations. This is precisely the reason why her price prediction is wrong and why Empire's stock price level after the merger failure was announced should be utilized in the DCF model rather than being ignored as Ms. McKiddy has done.

Nowhere does her failure to look forward, as required by the DCF model, become more clear than when looking at her position on growth rates. At page 46 of its brief in explaining Ms. McKiddy's averaging of low historical growth rates, one can see this problem. Averaging low historical growth rates, as Ms. McKiddy has done, only serves to produce a low growth rate number which, in turn, drives down the revenue requirement resulting in inadequate rate relief, which in turn further drives down the growth rate. In other words, this is a classic example of a "death spiral."

The Staff's resulting low growth rate number is without any theoretical justification. Throughout her testimony Ms. McKiddy avoided explaining why investors would anticipate such a low growth rate. She could only repeat that mechanically this is the method the Staff has often used, suggesting that somehow investor expectations are in fact determined by some mechanical means. It is readily apparent, however, that there is no reason to believe that this mechanical averaging does in fact represent investor expectations on a going-forward basis or the returns investors might experience from an investment in Empire's common stock. Conceptually, it takes more to produce a DCF estimated cost of capital than simple mechanical calculations. The analyst must exercise some judgment. Ten-year old growth rates, in the words of Dr. Murry "... do not represent realistic expectations of Empire's investors." (Ex. 16, p. 14).[4]

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[4]The statements at pages 39 and 45 of Staff's brief that Dr. Murry relied on earnings at the exclusion of dividends ignores his careful explanation of the importance of Empire's earnings

Correcting her work for her share price and growth rate errors causes Ms. McKiddy's DCF analysis to produce a return on equity estimate for Empire in the range of 11.42% to 12.20%. (Ex. 16, p. 19)

Unprecedented Bond Indenture Coverage Test

Also glaringly absent from the Staff's brief is a justification for Ms. McKiddy's reliance on the mechanical standards of bond indenture interest coverage. This unprecedented return on common equity standard relied on by the Staff has never been recommended by any scholar as a measure for an allowed return in a regulatory proceeding.

The fact that the Commission does not have an absolute obligation to ensure the financial integrity of the Company, relied on by the Staff, is not an answer to the inappropriateness and inadequacy of Ms. McKiddy's testimony. The simple truth is that after being put on notice that she was creating a new conceptual principle of adequacy of a return in a regulatory proceeding, at no point did Ms. McKiddy respond or produce any citation, rebuttal or conceptual justification for her new theory.[5]

Unfounded Risk Opinion

As in the case of the other fundamental flaws, the Staff's brief made no real effort to deal with Ms. McKiddy's unfounded opinion concerning Empire's relative risk, namely her view that

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growth to investors in today's equity market. He explained in detail why the high dividend payout ratio of Empire diminishes the value of the dividend growth in a DCF analysis. He concluded that, "Consequently, the DCF analysis based on the earnings growth estimates becomes a more reliable measure." (Ex. 13, p. 12, lines 16-19)

[5]Ms. McKiddy did make the extraordinary claim for the first time at the hearing that pre-tax coverages do not reflect all revenues (Tr. 538), suggesting that some other revenues will mysteriously appear to save the utility. This absurd notion was rejected out of hand by Public Counsel witness Burdette. (Tr. 601, 602). See also Exhibit 16, page 10.

the market considers Empire as less risky than the industry due to its competitive rate structure and its strong service area. (Ex. 61, p. 34, lines 7-12). She uses this bold, unsupported conclusion to ignore the return results of her nine comparable companies (10.15% - 11.65%). On this topic, Ms. McKiddy simply copied the work of a prior Staff witness completed four years previously without any independent thought or analysis. (Ex. 16, p. 12). No consideration was apparently given to the fact that in the four years since this testimony was first written Empire has experienced extremely high pay out ratios and flat dividends. Also during this time, its prospective merger with UtiliCorp failed. Also during this time, Value Line has changed Empire's stock to a "untimely" investment recommendation and in April concluded that Empire's prospects for 2001 "were not bright." Standard & Poors has changed its summary on Empire from "stable" to "negative." (Ex. 16, p. 12).

Probably none of this really matters to Ms. McKiddy. When asked whether or not she would agree with the following statement, "All else being equal, a lower bond rating would indicate a higher risk. In turn, investors would require a higher return in order to compensate them for accepting such higher level of risk," Ms. McKiddy said that she would never make that statement. (Tr. 542). This is amazing given that <u>it was a direct quote from her own Rebuttal Testimony which she filed only twelve months earlier in Case No. EM-2000-369</u>! (Tr. 542).

<u>Failure to Measure Financial Integrity</u>

Finally, the major fundamental flaw of Ms. McKiddy's recommended return on common stock equity for Empire is the fact that it is "inconsistent with basic measures of financial integrity." (Ex.16, p. 1). Having reached her conclusion, she did not take the required final step of performing a basic test to measure the financial integrity of her recommendation. (Ex. 26, p. 2). In other words, Ms. McKiddy made absolutely no evaluation of the impact which her recommendation would have on Empire's solvency. She 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 & Poors concerning adequate rate relief. (Ex. 16, pp. 2-3). She completely ignored the commonly recognized financial standards which are considered measures of financial health. She admitted that the interest coverage ratio she calculated supported the negative outlook placed on Empire by Standard & Poors. (Ex. 61, p. 27). And as previously indicated, she renounced her testimony of one year ago that lower bond ratings indicate a higher level of risk which in turn requires a higher return in order to compensate investors for accepting such higher levels of risk. (Tr. 542).

What is extraordinary about all of this is the fact that the Staff is supposed to balance the interests of the customers and shareholders while the Public Counsel is an advocate for the residential ratepayers. However, the Staff's return recommendation is <u>lower</u> than that of the Public Counsel! What this must mean is that, as indicated, the Staff's work is unintentionally, but nonetheless so fundamentally, flawed that it is unreliable; or, alternatively, that the only underlying concept driving the Staff's return recommendation is an intentional desire to force down the revenue requirement without consideration being given to the integrity of the work.

In either event, the Staff's brief fails to rehabilitate Ms. McKiddy's testimony by ignoring the four fundamental flaws in her case. This is why Dr. Murry testified that "the bottom line is that I do not believe that one can fairly say that Ms. McKiddy has performed a DCF analysis or has produced a DCF cost of capital."[6] (Ex. 16, p. 20). As a consequence, the Staff's rate of

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[6]On page 39 of the Staff brief, the Staff states: "Company witness Murry, on the other hand purported to use the DCF method, but he used it very selectively and with significant modification." In fact, Dr. Murry confirmed the theoretical and empirical application of the DCF model outlined by the Staff brief on page 38. (See Murry Direct, Ex. 13, p. 9, line 11 to p. 11,

return recommendation cannot be given any serous consideration by the Commission in this proceeding. Instead, any serious discussion of the appropriate return for Empire must begin with the Public Counsel's recommendation of 10.25%.

As indicated previously, the work of Mr. Burdette for the Public Counsel is at a different level than the work of Ms. McKiddy.

First and foremost, unlike Ms. McKiddy, Mr. Burdette demonstrated an understanding of the fundamental concepts of the DCF model. He testified that the DCF formula calls for a current stock price. He further testified that while technically one might use a "spot price" a single day price probably wouldn't be representative and therefore he spread his stock price calculation over a six-week period to get away from any day-to-day fluctuation. As a result he utilized a $19.52 stock price resulting in a dividend yield of 6.56%. This combined with his selected growth rate of 3.5% resulted in a Public Counsel recommendation of a return range of 10% to 10.25% (Ex. 86, p. 17).

The weakness in the Public Counsel's case is in its growth rate calculation. In its evidence and at page 6 of its brief, the Public Counsel <u>correctly states that the growth rate for the DCF model should be what investors should expect for the indefinite future</u>. In other words, <u>it should be forward looking</u>.

This point cannot be over-emphasized. Mr. Burdette repeatedly explained in his direct testimony the correct growth rate to use in a DCF analysis. Time and again, he recognized the principle that the DCF is forward looking. For example, he stated, that

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line 4). This formula expression is the exact same one that the Staff refers to in (McKiddy Direct, Ex. 61, p. 20, line 11 - p. 21, line 20). The Staff does not elaborate nor does it enumerate on what it describes as "significant modification." Ms. McKiddy did not address any of these issues in her rebuttal or surrebuttal testimony.

> The DCF model is based on two basic financial principles. First, the current market price of any financial asset, including a share of stock, is equivalent to the value of all expected future cash flows associated with that asset discounted back to the present at the appropriate discount rate. The discount rate that equates anticipated future cash flows and the current market price is defined as the rate of return or the company's cost of equity capital.

(Ex. 86, p. 8). He also testified, "Consequently, *projected* data on earnings retention and return on book equity are generally more representative of investors' expectations." (Ex. 86, p. 10)

Although Mr. Burdette acknowledged that the appropriate growth rate in a DCF analysis should be focused on investor expectations, he ignored this principle and based his growth rate primarily on historical growth rates and the averaging together of various numbers. In fact, Mr. Burdette's growth rates, which are very clearly displayed in his Schedule MB-8, do not represent investors' expected growth rates for Empire. For example, in Schedule MB-6 is shown the calculation of his 4.77% growth rate, which he used to calculate the high end of his recommended range illustrated in Schedule MB-8. This 4.77% number is clearly the *average* of three *historical* growth rates presented on the schedule. Moreover, he virtually ignored the 6.0% earnings per share growth rate forecast by *Value Line* in Schedule MB-6 by averaging it with the First Call 0.30% forecast.

Once again, the point is that despite Mr. Burdette's recognition that the DCF method requires the capture of investor expectations, the Public Counsel has ignored the fact that <u>earnings</u> growth rates (as opposed to dividend growth rates) are more important to investors when they are flat, as in the case of Empire. On this point Dr. Murry testified to the importance of earnings growth to investors in today's equity market in general and with respect to Empire in particular. (Ex. 13, p. 12, lines 16-19). Dr. Murry explained in detail <u>why Empire's high dividend pay-out ratio diminishes the value of the dividend growth in a DCF analysis</u>. Dr. Murry concluded that as a consequence "the DCF analysis based on the earnings growth estimates become a more reliable measure." Therefore, the Public Counsel's analysis does not result in a proper determination of investor expectations of Empire's future earnings growth and is unreliable.

Taking the Public Counsel's dividend yield of 6.56% (based on a stock price of $19.52) but substituting a realistic earnings per share growth rate of 6%[7], which is forward looking as required by the DCF model, produces a return on equity for Empire of 12.56%.

Conclusion

For the reasons stated, the Staff's recommendation must be disregarded. The Public Counsel comes close, but its failure to use a proper growth rate is a serious flaw. The credible evidence supports Empire's recommended range of 11.5% to 12%.

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?

No reply is necessary on this point.

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

No reply is necessary on this point.

C. What are the appropriate in-service criteria for determining whether the new State

[7]The 6% earnings per share growth rate finds support in Dr. Murry's testimony (Ex. 13, Schedule DAM-10 and Schedule DAM-13) as well as Mr. Burdette's testimony (Ex. 86; Schedule MB-6). Mr. Burdette testified that he did not include 0.0% projections. (Ex. 86, p. 15, lines 9, 10). His First Call projection of 0.30% rounds to 0.0% and should not have been considered by Mr. Burdette based on his stated method.

Line Combined Cycle Unit should be included in rate base?

No reply is necessary on this point.

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 3rd day of August, 2001, to the Office of the General Counsel, Office of the Public Counsel, and Stuart W. Conrad.

Gary W. Duffy

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