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September 4, 2001

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

**FILED<sup>2</sup>**  
SEP 4 2001  
Missouri Public  
Service Commission

**RE: Empire District Electric - 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 Reply Brief of The Empire District Electric Company On True-Up Issues. Please stamp the enclosed extra copy "filed" and return same to me.

If you have any questions concerning this matter, then please do not hesitate to contact me. Thank you very much for your attention to this matter.

Sincerely,

BRYDON, SWEARENGEN & ENGLAND P.C.

By: *James C. Swearengen*  
James C. Swearengen *lykg*

JCS/rhg

Enclosures

cc: Office of the Public Counsel  
Office of the General Counsel  
Stuart Conrad

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

In the matter of The Empire District Electric )  
Company's Tariff Sheets Designed to )  
Implement a General Rate Increase for )  
Retail Electric Service Provided to )  
Customers in the Missouri Service Area )  
of the Company )

Case No. ER-2001-299

**FILED<sup>2</sup>**  
SEP 4 2001  
Missouri Public  
Service Commission

**REPLY BRIEF OF  
THE EMPIRE DISTRICT ELECTRIC COMPANY  
ON TRUE-UP ISSUES**

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## **I. INTRODUCTION AND SUMMARY**

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

## **II. PROPERTY TAXES ON NEW PLANT**

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

This issue here is whether Empire should be allowed to recover in rates the approximately \$884,042 Missouri jurisdictional annual property taxes associated with its plant additions. The Staff has arbitrarily elected to cut off recognition of Empire's property taxes related to the Company's plant as of December 31, 2000 even though "property taxes" was specifically set out

as an item to be included in the true-up in this case.

The Staff, at page 3 of its True-up Initial Brief, and Praxair, in its brief, both argue that Empire has been made "whole" because capitalized property taxes have been included as part of the State Line Combined Cycle ("SLCC") plant. While this might be true for Empire's capitalized property taxes, it does not address those property taxes that will be expensed from the time the plant was placed in service which is the issue before the Commission. In other words, there is a real distinction between "capitalized" taxes, on the one hand, and "expensed" taxes on the other hand.

Capitalized taxes represent a different time frame than that which is typically measured in a rate case. This is so because capitalized taxes are those taxes incurred over the construction cycle of a plant, not just those taxes incurred in a single rate case "test" year. While it is proper to recover capitalized costs over the life of the asset, that is not the issue here. The issue here involves expensed taxes.

No provision has been made in this case for rate recovery of any of the ongoing (expensed) property taxes associated with the new SLCC plant. The following example is of assistance in making this point: Assume one starts a construction project in 1999 and it is completed in 2001. Also assume that property taxes do not increase in spite of the fact more plant is added. The table below illustrates these assumptions.

	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
Expensed taxes	1,000	950	900	1,000
Capitalized taxes	0	50	100	0
Total taxes	1,000	1,000	1,000	1,000

As the table shows, in 2000 a portion of property taxes will be capitalized and the remainder expensed. In 2001, additional taxes are capitalized and once again, the remainder is expensed. In 2002, the entire amount of the tax is expensed since the project was completed in 2001. Although the assumption is that there is no increase in taxes over the three year period, it is quite apparent that the amount of "expensed" property taxes will nonetheless increase in 2002. The amount capitalized is for taxes paid in 2000 and 2001.

In this simple example, and according to the Staff's approach, nothing would be included in rates for the additional \$100 in taxes that will be expensed in 2002 due to the new plant. While there is recovery of those capitalized taxes paid in 2000 and 2001, this does not make the company "whole." This is because the amortized taxes result from the two year construction period and are thus properly amortized for ratemaking purposes over the life of the asset. This does not, however, reflect the ongoing tax expense. According to the Staff's reasoning, the only way to get these ongoing expenses is to file a rate case in 2002.

At page 4 of its brief the Staff and at page 2 of its brief Praxair make the assertion that every other element of this rate case is subject to strict cut-off as of the end of the true-up period. This claim is simply incorrect. In determining a revenue requirement, the Staff has included an estimate of additional revenues that Empire will experience as a result of customer growth. While these revenues will not be realized by Empire until 2002, but were recognized by the Staff as relating to the true-up test year. The criticism made by the Staff that SLCC property taxes are not known and measurable could, therefore, also apply to the customer growth revenues that the Staff has recognized for purposes of determining a revenue requirement in this case.

At page 5 of its brief, the Staff attempts to show that property tax expense may decrease

over the coming years because it decreased from 1999 to 2000. This claim, however, ignores the fact that Empire's total taxes increased by approximately \$300,000 during that time period. The Staff has attempted to mask the fact that total taxes have been rising by pointing out only pieces of Empire's total tax liability.

Also on page 5, the Staff claims that Empire is implicitly assuming that increased revenues or decreased costs will not offset increased property taxes. This is interesting because using that type of logic one could assume that all costs would go down and therefore none of them would need to be included in the rate case. Put another way, "Don't worry about increased property taxes because they will probably be offset by other costs and increased revenues." The concept that deficiencies in revenue requirement should be assumed to simply go away is novel to say the least. Would the Staff put forth this same logic in an alleged overearnings situation, i.e., that costs will increase to take away any "excess earnings" that a company may allegedly be receiving?

At page 6, the Staff argues that property taxes go well beyond the operation-of-law date. The same could be said for the customer growth adjustment that has been made by the Staff and included in this case.

Also on page 6, the Staff makes the argument that property taxes on SLCC will not be assessed until 2002. This is only partially true. The part of SLCC that was included in CWIP as of January 1, 2001 was assessed. This is why Empire capitalized a portion of the property taxes. If the Staff did not want to include any "estimates" of property taxes, then all the Staff would have to do is to include the amount of capitalized property taxes that were paid in 2000 or approximately \$980,000.

The Staff and Praxair also raise the "known and measurable" issue as a basis to deny Empire's request. In response, Empire would point out that the Commission should not be led to believe that all of the Staff's data is devoid of any estimates. For example, in the case of weather normalization, the Staff uses weather data to "estimate" the impact of weather on revenues. This type of Staff adjustment is full of variables that would be subject to more disagreement than those used to calculate property taxes. No one has proposed to eliminate all adjustments made by the Staff just because the Staff used some estimates in arriving at an adjustment.

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

### **III. 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 ("TOPrS") and 47.1% long term debt. Nothing said by the other parties in their initial true-up briefs changes this fact. Empire's actual test year capital structure, as updated by both the Staff and the Public Counsel to June 30, 2001, is inappropriate to use for rate-making purposes because it is not representative of Empire's historic capital structure, nor is



it representative of the capital structure which Empire will have in place in the future when the rates established in this case will be in effect. (Ex. 16, p. 25). The current actual capital structure is an anomaly and should be ignored for rate-making purposes. Since 1992 and prior to Empire's failed merger with UtiliCorp United Inc., Empire's common equity ratio ranged between 45% and 50%. A 45% plus equity ratio is where Empire has been in the recent past and that is the direction it is headed in the future. (Tr. 404). 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.

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

Whether the issuance costs associated with Empire's TOPrS should be included as a part of the embedded cost of debt in this case is an issue between the Company, Staff and Praxair, on the one hand, and the Public Counsel, on the other hand. Moreover, the Public Counsel seeks to expand the issue from one involving a specific item in a rate case to a full-blown "regulatory policy" matter. That is to say, as indicated in its Initial True Up Brief, the Public Counsel continues to insist that this issue is whether TOPrS should be considered debt or equity for "regulatory purposes." The real issue, however, is much narrower.

Empire submits that it would be unwise, and probably unlawful, for the Commission to make a broad policy determination in this proceeding. TOPrS, as a hybrid security, have characteristics of both debt and equity. This is why in the Missouri Gas Energy case, Case No. GR-96-285, the Commission found that TOPrS constituted equity for capital structure purposes in determining whether MGE had satisfied certain criteria it had agreed to in a prior case. In that same proceeding, however, the Commission treated TOPrS as debt for the purpose of calculating

the costs associated with it. In other words, while the Commission has treated TOPrS as equity for capital structure purposes, this does not mean TOPrS must be treated as equity when calculating the embedded costs of a capital structure for rate-making purposes. This is the same treatment which Empire seeks in this case. In other words, TOPrS should be considered by the Commission as debt for purposes of determining the embedded cost of capital.

Finally, even the Public Counsel, through its witness, seems to concede the issue.

"... absent a ruling from this Commission that they are equity, I believe TOPrS are debt." (Tr. 1225).

The facts are not disputed: Empire has incurred costs in issuing the TOPrS. The TOPrS have a definite redemption date. The issue costs associated with the TOPrS are amortized by Empire over the life of the securities as required by GAAP. In the past, this Commission has included TOPrS issuance costs as a portion of the embedded cost of that security for ratemaking purposes. Given these facts, Empire should prevail on this issue.

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

Empire had hoped that given the circumstances the Staff would make an upward adjustment to its return on common equity recommendation in its Initial True Up Brief, but this did not occur.

The Staff's recommended ROE range of 8.5% to 9.5% and the work which produced this result continues to border on the irresponsible. The Staff, which purports to be an impartial balancer of the interests of both customers and shareholders, has obviously ignored this role. The Staff apparently continues to insist that there is nothing wrong with its DCF calculation, based on an Empire stock price of \$23.00 per share, when the record evidence is that Empire's stock has

traded in a narrow range of \$19.00 - \$20.00 per share since January 2, 2001! The incredible nature of this position cannot be overemphasized. Empire takes strong exception to the manner in which the Staff has distorted the return on common equity process by ignoring one of the basic theoretical principles of the DCF model, that is the use of a **current** stock price.

Empire also takes strong exception to the Staff's use of its unprecedented bond indenture "standard" as a justification for its distortion of the process. This purported "standard" is a complete fabrication as it has never been recommended by any scholar as a measure for an allowed return in a regulatory proceeding. The Staff's work on the ROE issue is either unintentionally, but nonetheless so fundamentally flawed that it is unreliable; or alternatively, it reflects an intentional desire to impose the lowest possible return and establish "minimal solvency" regulation, as the Missouri standard, without consideration being given to the integrity of the work. "Minimal solvency" regulation designed to simply keep a utility out of bankruptcy is not only unreasonable, it is unlawful and does not satisfy Empire's constitutional right to a fair and reasonable return on its investment. "Minimal solvency" regulation is unjust and unreasonable and contrary to the economic principles upon which decisions of the U.S. Supreme Court in its *Bluefield Water Works* and *Hope Natural Gas* cases are premised.

Adopting a return on equity within the Staff's recommended range would be an extremely unfortunate event, not only for Empire, but for the entire Missouri utility industry and the State as a whole. First and foremost, it would represent a complete distortion of the DCF process. Second, it would brand Missouri as a "minimal solvency" state thereby making this State an extreme outlier in terms of authorized returns and investment opportunities.

Such a result would completely and totally ignore the reality of investors' perceptions and

their investment alternatives. (Ex. 16, pp. 7-8). It would also completely ignore what is going on in the rest of the world. For example, the Staff's own nine comparable companies have returns which range from 10.15% to 11.65%. In addition, the Staff's evidence on capital structure relies on companies with authorized returns averaging 11.91%. (Ex. 120, p. 5). Closer to home and more recently, the Kansas Corporation Commission has authorized an 11.02% return on equity for Western Resources and a 10.91% return on equity for UtiliCorp United Inc.'s West Plains Energy Division. (See, *In the Matter of the Application of Western Resources, Inc. and Kansas Gas and Electric Company for Approval to Make Certain Changes in its Charges for Electric Service*, KCC Docket No. 01-WSRE-456-RTS, Order on Rate Applications (July 25, 2001), paragraph 50, pages 19-20 the Kansas Corporation Commission "adopts 11.02% as a fair and reasonable ROE" for Western Resources and *In the Matter of the Application of UtiliCorp United, Inc. d/b/a West Plains Energy Kansas, for Approval of the Commission to Make Certain changes in its Rates for Electric Service*, Docket No. 01-WPEE-473-RTS, Order on Application (August 15, 2001), paragraph 40, pages 18-19, "The Commission finds that the utility industry is in the midst of restructuring. Utility companies are attempting to become more diversified in the marketplace, using retained earnings to invest in other business activities. Such structural changes call into question whether the DCF model utilizing Value-Lines dividend growth forecasts is meaningful. The results of the model which relies on dividend growth forecasts are deleted ... . Removing from the analysis the DCF model which relies on Value-Line's dividend growth estimate for the proxy companies increases the cost of equity (with flotation costs) to 10.91 percent." ). The KCC's cases are reported on the KCC's Internet site <http://www.kcc.state.kc.us>.

Given these facts, the Commission must ask the question: If you were a utility, where would you make your next substantial investment? Missouri or Kansas? Where would you build your next plant? Missouri or Kansas? What responsible corporate board of directors would direct that investments be made in a state which adopts a "minimal solvency" standard? What will an endorsement of the minimal solvency approach mean for investment opportunities, economic development, labor relations and jobs in Missouri? What will an endorsement of the Staff's position ultimately mean for the quality of utility services provided in this State? If utilities are regulated under the Staff's "minimal solvency" standard, will "minimal service" follow?

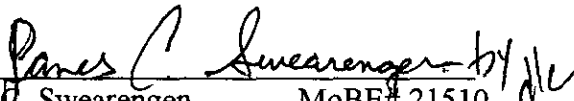
The Commission should not condone the Staff's reckless approach. It is obvious that the Staff has failed to perform a valid DCF analysis and has failed to produce a credible DCF cost of capital for Empire in this case. The Staff's recommendation should be completely and totally ignored by the Commission.

Clearly, given the gravity of the situation, any serious discussion of the appropriate return on equity for Empire in this case can only begin with the Public Counsel's recommendation of 10.25%, but even this level of return is inadequate. However, starting with Public Counsel's dividend yield of 6.56% (based on Public Counsel's stock price of \$19.52) and combining it with a proper earnings per share growth rate of 6% will produce a return on common equity for Empire of 12.56%, a rate of return somewhat above Empire's proposal. In the final consideration, the credible evidence supports Empire's recommended range of 11.5% - 12%.

#### **IV. CONCLUSION**

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

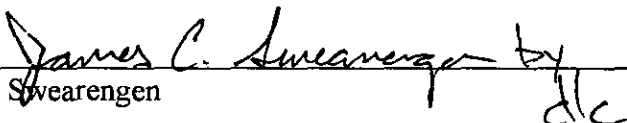
Respectfully submitted,

  
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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 4<sup>th</sup> day of September, 2001, to the Office of the General Counsel, Office of the Public Counsel, and Stuart W. Conrad.

  
James C. Swearngen

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