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September 12, 2001

FILED[3]
SEP 12 2001
Missouri Public Service Commission

Mr. Dale Hardy Roberts
Executive Secretary
Public Service Commission
Governor State Office Building
Jefferson City, Missouri

HAND DELIVERED

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

Dear Mr. Roberts:

Enclosed for filing in the above-referenced proceeding please find nine copies of Empire's proposed findings of fact and conclusions of law for this case. This filing is made in response to the Order Directing Filing issued on September 11, 2001, which requested supplemental findings and conclusions regarding the true-up hearing. When Empire submitted proposed findings and conclusions originally on August 3, 2001, that document made several references to the anticipated true-up. Rather than submit a separate document dealing only with true-up issues, Empire has chosen to re-do its original document to reflect the true-up issues and the changes in the original document resulting from the true-up.

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

Sincerely yours,

Gary W. Duffy

Enclosures
cc w/encl: John Coffman, Office of Public Counsel
Tim Schwarz, Office of the General Counsel
Stuart W. Conrad

THIS IS THE EMPIRE DISTRICT ELECTRIC COMPANY'S PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW INCLUDING THE TRUE-UP ISSUES, AS REQUESTED BY THE "ORDER DIRECTING FILING" ISSUED SEPTEMBER 11, 2001.

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

Regulatory Law Judge Vicky Ruth

REPORT AND ORDER

Findings of Fact

On November 3, 2000, The Empire District Electric Company (Empire or Company) submitted to the Missouri Public Service Commission proposed tariff sheets intended to implement a general rate increase for electric service provided to retail customers in the Missouri service area of the Company.

The Company is a public utility engaged in the provision of electric service to the general public in the state of Missouri and, as such, is subject to the general jurisdiction of the Commission pursuant to Chapters 386 and 393, RSMo 2000.

The proposed tariff sheets bore a requested effective date of December 3, 2000. The proposed electric service tariff sheets were designed to produce an annual

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increase of approximately 19.3 percent ($41,467,926) in the Company's revenues. Together with its proposed tariff sheets and other minimum filing requirements, the Company also filed prepared Direct Testimony in support of its requested rate increase.

On November 13, 2000, Praxair, Inc. (Praxair) filed its application to intervene. By order dated December 22, 2000, that intervention was granted.

On November 16, 2000, the Commission issued its Suspension Order and Notice which suspended the proposed tariff sheets until October 2, 2001. The order also directed notice and established an intervention period, set dates for the filing of test year and true-up recommendations, set an early pre-hearing conference, directed the parties to jointly prepare and file a proposed procedural schedule, set an evidentiary hearing in June 2001, and proposed dates for a true-up hearing.

On November 22, 2000, Empire filed its motion for a protective order. The Commission issued a protective order on November 28, 2000.

On November 30, Empire filed its test year recommendation and its Motion for True-Up and Motion to Reschedule True-Up Hearing. On December 15, 2000, Staff filed its Test Year Recommendation and its True-Up Recommendation and Concurrence in Empire's Motion to Reschedule True-Up Hearing. Also on December 15, Praxair filed its Statement Regarding Test Year. On December 21, 2000, an early pre-hearing conference was held. On December 28, the parties timely filed their Joint Proposed Procedural Schedule and Clarification of True-Up and Updates.

On January 4, 2001, the Commission issued its Order Setting Test Year, Setting True-Up Hearing, and Adopting Procedural Schedule. The Commission adopted the procedural schedule recommended by the parties and ordered the use of a test year of

the twelve months ending December 31, 2000, updated with respect to certain agreed items for known and measurable changes. The Commission also adopted the true-up with respect to Empire's new State Line Combine Cycle (SLCC) generating plant which extended the true-up until July 31, 2001.

The parties pre-filed prepared testimony in accordance with the Commission's order.

During the week of April 16, 2001, the parties participated in a pre-hearing conference.

On April 23, 2001, the Commission conducted a local public hearing in Joplin, Missouri.

On May 14, 2001, Empire, the Staff of the Commission (Staff) and the Office of the Public Counsel (Public Counsel) filed a Stipulation and Agreement Regarding In-Service Criteria. On that same date, the same parties also submitted a Stipulation and Agreement Regarding Fuel and Purchased Power Expense.

Also on May 14, 2001, the Staff, on behalf of all the parties, filed a Proposed List of Issues, List of Witnesses, and Order of Cross-Examination. Thereafter, each of the parties timely filed their statement of position on the List of Issues.

On May 15, 2001, Staff filed a proposed procedural schedule regarding the stipulations and agreements.

On May 18, 2001, counsel for Praxair filed a letter with the Commission which stated that Praxair requested a hearing on all issues comprehended by the May 14 non-unanimous Stipulation and Agreement Regarding Fuel and Purchased Power Expense.

On May 22, 2001, Empire and the Public Counsel filed a joint Motion to Schedule Hearing on Fuel and Purchased Power Issues.

On May 23, 2001, the Staff on behalf of all parties filed a Reconciliation of Parties' Positions on the Revenue Requirement Issues.

In an Order Directing Filing issued May 24, 2001, the Commission noted that while Praxair had made a timely request for hearing on the May 14 Stipulation and Agreement Regarding Fuel and Purchased Power Expense, no such request was filed by any party regarding the Stipulation and Agreement Regarding In-Service Criteria. The Commission ruled that the Stipulation and Agreement Regarding In-Service Criteria would be considered as unanimous pursuant to 4 CSR 240-2.115(1) and (3). The Commission denied the motion of Empire and Public Counsel for a procedural schedule and rejected the proposed procedural schedule submitted by the Staff. The Commission ordered the parties to file a supplement to the List of Issues and Witnesses previously filed regarding fuel and purchased power expense, and directed the parties to address in their opening statements and briefs the effect, if any, of passage of Senate Committee Substitute for Senate Bill 387 on this case.

On May 25, 2001, the parties filed a Unanimous Stipulation and Agreement as to State Line Combined Cycle Unit Capital Costs.

On May 29, 2001, the Commission commenced the evidentiary hearing in this matter. The hearing concluded on June 6, 2001.

On June 4, 2001, the Staff on behalf of all parties filed a Revised List of Issues, List of Witnesses and Order of Cross-examination.

Also on June 4, 2001, the parties filed a Unanimous Stipulation and Agreement

Regarding Fuel and Purchased Power Expense and Class Cost of Service and Rate Design.

On June 5, 2001, the Staff on behalf of all parties filed a Revised Reconciliation.

On June 19, 2001, the Commission issued an Order Rescheduling True-Up Hearing. The true-up hearing was held as scheduled on August 23 and 24, 2001.

In the remainder of this section of this Report and Order, the Commission will make findings of fact on each disputed issue. The following section will contain the Commission's conclusions of law on each issue.

The Commission makes its findings of fact having considered all of the competent and substantial evidence upon the whole record. The positions and arguments of the parties have been considered by the Commission in making this decision. Failure to specifically address a piece of evidence, position or argument of any party does not indicate that the Commission has failed to consider relevant evidence, but indicates rather that the omitted material was not dispositive of this decision. The numbering on each of the contested issues follows that used by the parties in their list of issues.

I. COST OF SERVICE - DEPRECIATION

(1) What are the appropriate average service lives for plant in service other than at State Line Power Plant?

a. Service Lives

"The service life of a particular group of assets (sometimes grouped for the

purpose of depreciation accounting as a plant account) is the time over which the cost of those assets will be recovered." *In the Matter of St. Louis County Water Company*, Case No. WR-2000-844 (MoPSC May 3, 2001). Both Empire and the Staff proposed changes to the service lives of many plant accounts.

Empire's depreciation rates, and, thus, its service lives, were last established in *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). In that case, the Commission adopted the depreciation rates developed by the Staff, as a result of a Stipulation and Agreement between the parties and its finding that the stipulation was "reasonable and in the public interest."

The service lives proposed by Empire in this case are 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 provided specific analysis and explanation of the changes in depreciation rates proposed by Empire.

Based upon this analysis, the Commission finds that in many cases Empire's existing rates do not offer a reasonable probability that investment will be recovered through depreciation charges during the service life of the property. (Loos Dir., Ex. 11, Sch. LWL-1).

On the other hand, there was no evidence adduced that shows how the Staff's proposed lives were determined. The Staff itself produced evidence that "tours and meetings did not bring forth any justification," there was "no rationale to support' and "Staff are unaware of events that would result in" changes to the existing lives and depreciation rates, as determined in Case No. ER-94-174 (Adam Dir., Ex. 33, p. 20;

Adam Tr. 223-24). The Staff's evidence, at best, justifies leaving in place the existing depreciation rates.

It also seriously harms the credibility of the Staff's proposal as a review of the Staff's proposal shows that it has proposed changes to service lives in 27 of the 40 depreciation accounts addressed. (Adam Dir., Ex. 33, Sch. 1-1 and 1-2). Some of the lives have been changed by as much as 40 years or more without explanation. (See Riverton- Steam, Asbury-Steam and Iatan-Steam, Accounts 311).

b. Information Request

Staff witness Adam, in his direct testimony, recounted that Empire was unable to access certain generation plant morality files because of its conversion to a new computer system. (Adam Dir., Ex. 33, p. 19). 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).

July 15, 2001 has since come and gone, so the Commission will view that request as moot.

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

"Depreciation is the loss in service value primarily due to age and use of capital assets used to provide water service to the Company's customers. Depreciation accounting is the system that spreads the cost of these assets over their useful lives. In the whole life method of accounting, net salvage is accounted for in depreciation rates, and in straight line whole life depreciation, the original cost of an asset less net salvage

is allocated in equal amounts to each year of an asset's service life. Net salvage is the difference between the value of retired plant and the cost of removing that plant. If it costs more to remove a piece of plant than that piece's value, net salvage is negative. Conversely, if at retirement a piece of plant has value in excess of the cost of removal, net salvage is positive." *In the Matter of St. Louis County Water Company*, Case No. WR-2000-844 (MoPSC May 3, 2001).

Thus, in the whole life method, net salvage is used to offset the original plant costs in the setting of depreciation rates. Where net salvage is a positive number, it reduces the amount recovered from all ratepayers who have benefitted from the property over the life of the property. Where net salvage is a negative number, these costs are spread equally over the life of the property so that all ratepayers who have benefitted from the property will help pay the cost.

The Commission Staff has proposed to address cost of removal[1] and resulting net salvage associated with utility property in a way that is inconsistent with the whole life method that has been utilized by the Commission in setting Empire's depreciation rates in the past. The Staff proposes to take cost of removal, sometimes, as in the case of a power plant, a very great cost, and rather than provide for its collection over the life of a piece of utility property, instead provide for its recovery after the plant has been retired. Empire has taken the position that the Commission should again adopt the whole life method treatment of net salvage.

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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 CSR Part 101.10 as incorporated by 4 CSR 240-20.030).

The general concept that ratepayers should not bear plant costs except during the time period when the underlying property provides service to those customers has been expressed in both regulatory principle and statute. It has been stated that "[U]nder 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 idea also underlies § 393.135 RSMo (2000) which was adopted by public initiative to apply solely to *electric plant*. The Commission believes that the public would be very much opposed to paying for property that is no longer operational and used for service, as would be the result of the Staff's proposal.

Recent accounting trends have also moved toward a recognition and payment of costs by those that benefit. The most obvious example of this is the Financial Accounting Standards Board (FASB) adoption of Financial Accounting Standards No. 106 and 87 (FAS 106 and FAS 87) in the early 1990's. Traditionally, pension costs (FAS 87) and Post-Retirement Benefits Other Than Pensions (OPEBs) (FAS 106) had been treated, both for financial reporting and for ratemaking purposes, on a "pay as you go" basis. This meant that the expenses were booked at the time the utility paid out the cash for benefits to its retired employees. FAS 87 and 106 mandated that companies change to an accrual method of accounting for OPEBs. *See 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 benefits 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). This argument was persuasive enough that FAS 106 was later adopted by the Missouri General Assembly and is now incorporated into state law in § 386.315 RSMo 2000.

FASB has more recently taken steps to move in this same direction in regard to retirement/cost of removal obligations associated with long lived assets as represented by its Exposure Draft entitled Accounting for Obligations Associated with Retirement of Long-Lived Assets. This is further evidence 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 the original cost to expense using a systematic and rational method. (Lyons Reb., Ex. 25, p. 2-3).

The proposal made by the Staff to remove net salvage from the depreciation calculation and only reflect in rates expenditures as they are made runs contrary to the idea that current customers should be responsible for costs as they are accrued over the life of an asset. 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, these costs should be capitalized and

depreciated in order to achieve the objectives of (a) obtaining a measure of cost that more closely reflects Empire's total investment on its assets and (b) allocating that cost to the periods in which the related assets are expected to provide benefits. (Lyons Reb., Ex. 25, p. 9).

Establishing depreciation rates necessarily involves an analysis of expected future events such as useful life, salvage value and cost of removal. As Staff witness Adam stated, "the future is unknown and it cannot be determined what plant will retire," nor can it be determined "at what time it will retire ... ." (Adam Dir., Ex. 33, p. 16).

The Commission has recognized that because of the estimates and unknowns involved with depreciation analysis, it is not unheard of for the depreciation rates to miss their goal to some extent. *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). ("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.").

However, the Commission is comfortable that there are sufficient "checks and balances" built into the regulatory 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 should be higher than is necessary for a period of time, it builds the reserve more quickly and thereby lowers the utility's 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 that allow the Commission to make adjustments based on actual experience. Specifically, 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. (Loos Dir., Ex. 11, Sch. LWL-1, Table 7-1).

The Commission need not throw out the entire whole life treatment of net salvage because the net salvage numbers are estimates. There are many opportunities to reassess, 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.

Lastly, because the Commission has determined that it will not eliminate net salvage from Empire's depreciation calculation, it is not necessary to address the appropriate method to compute the current net salvage to be reflected in rates.

However, the Commission will make certain findings in this regard.

An element of the Staff's proposal was its intention to derive current net salvage through the use of a normalization over preceding several year period of time. (Adam Dir., 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 by the Company. In a time of steadily rising cost of removal, the Company will never recover its actual cost of removal. (Adam, Tr. 199). In a time of decreasing cost of removal, the Company will over recover. (Tr. 199-200).

The Commission finds that a better alternative is to reflect cost of removal in the depreciation accrual. This would allow any under-collection or over-collection to be adjusted in the Company's next rate case by either making the Company whole, if there was a shortfall, or by reducing depreciation rates to compensate for an over-collection. (Adam, Tr. 199).

B. How shall the depreciation for plant and facilities at State Line Power Plant (SLCC) 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. (Loos Dir., Ex. 11, Sch. LWL-1). The Staff's

proposal for these rates are contained in the Direct Testimony of Mr. Adam. (Adam Dir., Ex. 33, Sch. 1-4).

The difference between the Empire and Staff positions (other than inclusion or exclusion of net salvage as is discussed elsewhere) 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." (Adam Dir., Ex. 33, p. 23). Empire witness Loos also initially utilizes a 35 year plant life. However, in developing the depreciation rates, Mr. Loos additionally considers the interim additions or investment required for the plant to reach this life. (Loos Reb., 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. (Loos Reb., Ex. 22, p. 26; Loos Dir., Ex. 11, Sch. LWL-2). Capital additions must be made during the 35-year life, not to extend the life span but simply to achieve it. (Loos Reb. at p. 29). 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. (Loos Reb. at p. 34).

The consequence of not considering these interim additions in setting the depreciation rates is found in the impact on 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).

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 will be followed by the Commission.

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

Conceptually, the treatment of net salvage in establishing the depreciation rates for the SLCC is no different than the treatment of net salvage as to Empire's other property, as discussed above. Therefore, the Commission will incorporate and adopt

those findings by reference.

2. COST OF SERVICE - BAD DEBTS

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

The parties have agreed upon an amount to be included in Empire's cost of service in this case reflecting Empire's bad debt expense. This amount is based on a factor of one quarter of one percent (0.25%) of Empire's revenues. Empire proposes that this .25% bad debt factor be applied to the rate increase which the Company will be authorized in this case. The other parties oppose factoring up the rate increase by the .25% amount.

Over the last several years, Empire's bad debt expense has been equal to .25% of revenues (Tr. 305) and .25% of Empire's present rate revenues have been included in the cost of service in this case to represent this amount. In six of the last eight years Empire's bad debt expense has increased as its revenues have increased. (Tr. 314) The Commission has previously held that an agreed to bad debt expense ratio should be applied to the additional revenues resulting from a rate increase. (See *In re Missouri Gas Energy,* Case No. GR-96-285, January 22, 1997, 5 MoPSC 3rd 437 at 463.)

The Commission finds that the record evidence demonstrates a correlation between revenues and bad debt expense. The Commission finds that Empire's bad debt expense should be adjusted to reflect the additional revenues resulting from this proceeding. The Commission therefore finds that the rate increase authorized in this

case should be further adjusted upward by .25%.

3. COST OF SERVICE - PAYROLL - INCENTIVE PAY

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

One aspect of Empire's incentive compensation program allows employees who meet both "base goals" and "stretch goals" to 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 under this aspect of its incentive compensation program. (Ex. 27, p. 3) Empire seeks to recover this $323,000 in rates. The other parties oppose including these costs in rates.

The Commission finds that pursuant to Empire's incentive compensation program, if an employee meets both his or her base and stretch goals, that person become eligible to receive incentive compensation. The Commission finds that during the year 2000 Empire was involved in a pending merger with UtiliCorp United Inc. (UtiliCorp). As a consequence, the execution of Empire's incentive program was not up to its previous standard. The Commission finds that, nonetheless, Empire's employees did in fact achieve goals beyond their normal job duties by continuing to provide high quality utility service to Empire's customers during 2000, a year in which employee vacancies were three times the normal amount.

The Commission finds that Empire's plan is a cost effective approach to compensation which in turn directly benefits the Company's customers given that a portion of employee pay is at risk causing employees to recognize that superior

performance will generate greater compensation. The Commission also finds that Empire's compensation levels are at or below average and that the $323,000 at issue would represent only a 2.5% pay increase for the involved employees. (Ex. 114, p. 6)

The Commission finds that the $323,000 in incentive payments at issue were made to employees who did in fact achieve goals which were beyond their normal job duties and responsibilities and thus the Company's customers benefitted from these expenditures. Consequently, the $323,000 should be included in rates.

4. 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?

As noted, on June 4, 2001, the parties filed a Unanimous Stipulation and Agreement Regarding Fuel and Purchased Power Expense and Class Cost of Service and Rate Design. That Stipulation and Agreement purports to resolve all of the above-listed issues regarding Class Cost of Service and Rate Design. The parties have agreed that "the difference between any increase in the Company's revenue requirement that is approved by the Commission and the revenues collected by the IEC will be allocated to each customer class on an equal percent of current revenues basis and reflected on all Empire Missouri rate schedules as an equal percentage increase (or decrease) to each rate component on each tariff." (Stipulation and Agreement,

paragraph 5).

The Commission recognizes this approach as a means of essentially maintaining the same rate design as exists and is presently lawful and approved, since it increases each charge by an equal percentage basis.

The Commission has the legal authority to accept a stipulation and agreement as offered by the parties as a resolution of the issues raised in this case, pursuant to § 536.060 RSMo 2000. The requirement for a hearing is met when the opportunity for hearing has been provided and no proper party has requested the opportunity to present evidence. See, *State ex rel. Rex Deffenderfer Enterprises, Inc. v. PSC*, 776 S.W. 2d 494, 496 (Mo.App. 1989). Since no one has requested a hearing on this issue in this case, and the Commission has satisfied itself that the Stipulation and Agreement represents a reasonable resolution of many complex issues, the Commission may grant the relief requested in the Stipulation and Agreement.

5. CAPITAL STRUCTURE / RATE OF RETURN

A. What capital structure is appropriate for Empire?

Empire proposes a capital structure for purposes of this case of 45% equity, 7.9% trust preferred and 47.1% long term debt. Staff and Public Counsel propose a capital structure of approximately 37.76% equity, 54.36% debt, and 7.88% preferred stock which is the June 30, 2001 actual capital structure of the Company. Two of the Public Counsel's figures differ from those of the Staff by a minor amount due to the position of Public Counsel regarding recovery of the issuance cost of the trust preferred

securities, which is discussed under Item 8 in this Report and Order. Empire contends that the actual capital structure as of June 30, 2001 is not a normal capital structure for Empire and therefore should not be used for rate-making purposes.

The evidence clearly shows that since 1992 and prior to its proposed merger with UtiliCorp, Empire's common equity ratio ranged from 45% to 50%. (Ex. 14, p. 2) During the pendency of its merger with UtiliCorp, Empire was prohibited from undertaking any common equity financing. During this same time period, Empire took its preferred stock off the market and increased its debt due to its SLCC construction project. In addition, the subtraction of the UtiliCorp merger costs from Empire's equity further reduced the level of the Company's common equity. (Tr. 402, 403; Ex. 16, p. 25). As a consequence, when the UtiliCorp merger unwound in January, 2001, Empire's actual common equity ratio was much lower than its historic norm. Empire is now moving towards a more balanced capital structure as it has re-instituted its dividend reinvestment plan, which will raise common equity, and is also planning to issue additional common equity later in 2001. (Tr. 448, 451)

The proper capital structure to utilize for rate-making purposes is one which is representative of the capital structure which will be in effect during the period in which new rates established in a rate proceeding will likewise be in effect. (See, *In the matter of Laclede Gas Company,* 22 MoPSC (N.S.) 360 (1978))

The Commission finds that the evidence in this proceeding demonstrates that neither Empire's actual year end 2000 capital structure, nor the actual capital structure at June 30, 2001, is 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. The Commission further finds that Empire is taking steps to increase its equity ratio.

The Commission finds that 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. What return on common equity is appropriate for Empire?

Empire submits that the appropriate rate of return on common equity for purposes of this case is in a range of 11.5% to 12%. The Public Counsel supports a range of 10% to 10.25% while the Staff argues for a range of 8.5% to 9.5%.

All three parties performed the traditional discounted cash flow (DCF) analysis, among other things, in arriving at their recommendations. The DCF model has been accepted by this Commission in the past. In simple terms, the DCF model consists of two components -- the current dividend yield plus the expected sustainable growth rate.

In this case, there is no argument as to the current dividend. It is $1.28 per year and it has not been increased since 1992. Critical to a calculation of dividend yield and the appropriate use of the DCF model is the use of a current stock price. On this point, the Commission Staff witness utilized Empire share price data for the period October, 2000 through March, 2001 which data included share prices prior to the cancellation of the proposed merger between Empire and UtiliCorp. Consequently, the Staff's share price data reflected the premium which UtiliCorp was willing to pay for Empire's stock.

The Commission finds that the Staff's stock price data is inappropriate for two reasons. First, it represents stock prices during a period in which Empire's proposed

merger with UtiliCorp was still pending, stock prices which included a merger premium. Second, stock prices dating back to October, 2000 can in no way be considered representative of Empire's "current" stock price. Stock prices this old do not provide a current view of capital costs and are thus inappropriate to use in the DCF model. Accordingly, the Commission will not rely on the Staff's analysis for purposes of its decision on this issue in this proceeding.

The Public Counsel's DCF analysis does not suffer this same infirmity. In determining the stock price to use for purposes of the dividend yield in its DCF calculation, the Public Counsel looked at a six week period of time from February 16 to March 23, 2001. Based on this time period the Public Counsel determined that a price of $19.52 per share should be used in the DCF model. The Commission finds the $19.52 stock price to be appropriate for use in this case. This $19.52 stock price combined with the $1.28 dividend results in a dividend yield of 6.56% which when combined with the Public Counsel's growth rate of 3.5% results in a rate of return range of 10.0% to 10.25%.

Empire's DCF calculation and analysis, based on stock prices available in October 2000 and a $1.28 dividend, results in a recommended rate of return range of 11.5% to 12%. The growth rate utilized by Empire in its calculation and analysis is based on earnings growth rates on the theory that these type of growth rates better capture investor expectations, especially with respect to a company such as Empire.

The issue here thus becomes the appropriate growth rate.

Having to choose between the recommendation of the Company, on the one hand, and that of the Public Counsel, on the other hand, the Commission finds in favor

of the Company. Public Counsel's DCF calculation is defective in that the growth rate which it utilizes does not properly capture investor expectations as it ignores the fact that earnings growth rates are more important to investors than dividend growth rates. In the case of Empire, given its high dividend payout ratio and the fact that its dividends have not increased since 1992, the value of the dividend growth rate in a DCF analysis is diminished. The Commission finds that Empire's DCF analysis which is based on earnings growth estimates, is a more reliable measure of investor expectations. The Commission finds that a growth rate of six percent is appropriate for use in this case.

Therefore, the Commission finds that the appropriate return on common equity for Empire in this case is 12%.

6. 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?

As noted previously, on May 25, 2001, the parties filed a Unanimous Stipulation and Agreement as to State Line Combined Cycle Unit Capital Costs. A part of that document is Empire's agreement that it waives its right to seek, in any subsequent rate proceeding in Missouri, recovery of $3.984 million related to the Fru-Con construction contract regarding SLCC. If the parties had not reached a unanimous agreement on a disallowance regarding costs of the Fru-Con contract, the Commission would have been required to analyze and rule on many complex issues related to alleged construction cost overruns. The Commission fully explored the ramifications of the settlement by questioning several witnesses on the record.

The Commission has the legal authority to accept a stipulation and agreement as offered by the parties as a resolution of the issues raised in this case, pursuant to § 536.060 RSMo 2000. The requirement for a hearing is met when the opportunity for hearing has been provided and no proper party has requested the opportunity to present evidence. See, *State ex rel. Rex Deffenderfer Enterprises, Inc. v. PSC*, 776 S.W. 2d 494, 496 (Mo.App. 1989). Since no one has requested a hearing on this issue in this case, and the Commission has satisfied itself that the Stipulation and Agreement represents a reasonable resolution of many complex issues, the Commission may grant the relief requested in the Stipulation and Agreement.

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

The Staff performed an analysis of the operation and maintenance expenses at the State Line Power Plant and the Empire Energy Center as a part of the true-up process. The parties announced to the Commission that there were no issues between them regarding operation and maintenance expense issues given the level of revenue requirement the Staff was proposing as a result of the true-up audit. Therefore, since there are no identified issues on this topic, the Commission will accept the level of expenses in this category as reflected in the Staff's revenue requirement filing as a part of the true-up.

C. What are the appropriate in-service criteria for determining whether the new State Line Combined Cycle Unit should be included in rate base?

As noted previously, on May 14, 2001, Empire, Staff and Public Counsel filed a

Stipulation and Agreement Regarding In-Service Criteria. No other party requested a hearing on this non-unanimous stipulation, so the Commission is allowed to treat it as if it were unanimous. 4 CSR 240-2.115(1).

The Commission has the legal authority to accept a stipulation and agreement as offered by the parties as a resolution of the issues raised in this case, pursuant to § 536.060 RSMo 2000. The requirement for a hearing is met when the opportunity for hearing has been provided and no proper party has requested the opportunity to present evidence. See, *State ex rel. Rex Deffenderfer Enterprises, Inc. v. PSC*, 776 S.W. 2d 494, 496 (Mo.App. 1989). Since no one has requested a hearing on this issue in this case, and the Commission has satisfied itself that the Stipulation and Agreement represents a reasonable resolution of many complex issues, the Commission may grant the relief requested in the Stipulation and Agreement.

7. What methodology for the recovery of fuel and purchased power expense should be adopted by the Commission in this case and what level(s) of fuel and purchased power expense should the Commission approve?

As noted previously, on June 4, 2001, the parties filed a Unanimous Stipulation and Agreement Regarding Fuel and Purchased Power Expense and Class Cost of Service and Rate Design. The Stipulation and Agreement provided that $91,599,932 be included in Missouri jurisdictional cost of service on a permanent (i.e., not interim) basis. This figure was subject to true-up and was trued up, and according to Staff's schedules is $93,496,866. The Stipulation and Agreement also provided for the establishment of an Interim Energy Charge (IEC) to be reflected on all Empire rate schedules on an equal cents per kilowatthour basis at 0.54 cents per kWh,

commencing October 1, 2001. The revenue from the IEC is to be collected by Empire on an interim and subject to true-up and refund basis under the terms of the Stipulation and Agreement. Other Empire rate schedules which contain charges which assume a certain amount of kWh usage will also be affected by the IEC as provided by the Stipulation and Agreement.

The Stipulation and Agreement also provided for a change to the monthly credit for interruptible demand on the rate schedule applicable to Praxair.

During the course of the hearing, the Commission extensively questioned representatives of the Staff, Public Counsel, and Empire regarding the nature of the Stipulation and Agreement and whether it was in the public interest. The parties emphasized that Empire is different from other electric utilities in the state with regard to its dependence upon natural gas-fired generation and purchased power, especially with the addition of the natural gas-fired SLCC. The parties also noted that while some fuel costs are relatively stable, there has been recent volatility in the price of natural gas and purchased power and there is great difficulty for anyone to attempt to predict with reasonable certainty what the market price of natural gas or purchased power will be at any given time in the future. All of those parties have assured the Commission that the suggested resolution of this issue, for this particular company in this particular circumstance, is appropriate and reasonable, in that it incorporates a forecasted fuel method which the Commission has utilized in other forms in previous cases, and it includes a "true-up" to actual cost method which the Commission finds appropriate in this situation for the protection of customers. Utilizing the "traditional" approach of attempting to ascertain a fixed cost for natural gas and purchased power prices carries

with it the prospect of the ratepayers either paying significantly more or less than the actual costs. The Commission does not wish to subject either Empire or its customers to such potential extremes. The compromise approach fashioned by the parties in this proceeding ensures rate stability and seeks to prevent either "windfall" profits or dramatic losses by ensuring that actual fuel and purchased power costs are the basis for the process to be used.

The Commission has the legal authority to accept a stipulation and agreement as offered by the parties as a resolution of the issues raised in this case, pursuant to § 536.060 RSMo 2000. The requirement for a hearing is met when the opportunity for hearing has been provided and no proper party has requested the opportunity to present evidence. See, *State ex rel. Rex Deffenderfer Enterprises, Inc. v. PSC*, 776 S.W. 2d 494, 496 (Mo.App. 1989). Since no one has requested a hearing on this issue in this case, and the Commission has satisfied itself that the Stipulation and Agreement represents a reasonable resolution of many complex issues, the Commission may grant the relief requested in the Stipulation and Agreement. In so doing, however, the Commission does not intend to indicate that this particular approach to the recovery of fuel costs is appropriate for any other utility.

TRUE-UP ISSUES

8. Should the Commission increase the total company revenue requirement by $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 concerns whether Empire should be allowed to recover in rates

$884,042 for Missouri jurisdictional annual property taxes associated with its plant additions which were recognized in the true-up audit. The Staff utilized a process which essentially recognizes an estimate of property taxes related to the Company's plant in service as of December 31, 2000. The true-up audit demonstrated that Empire's plant in service increased substantially between the end of 2000 and June 30, 2001, mainly due to the completion of construction on the SLCC power plant. Empire argues that the rates set in this proceeding should reflect the property taxes that Empire will have to pay on that additional plant in service.

There is no dispute that the Staff developed a property tax rate by dividing the amount of property taxes paid by Empire in 2000 by the total balance of Empire's electric property at January 1, 2000. (Boltz direct, Ex. 39, p. 5). There is no dispute that the total balance of Empire's electric property increased by $122,479,047 between January 1, 2000 and June 30, 2001, which was the end of the true-up period. (Tr. 1165). The dispute is whether the Commission should recognize a similar estimating process for property taxes and apply it to the balance six months later in time.

The Staff and Praxair both argue that Empire has been made "whole" because capitalized property taxes have been included as part of the SLCC. The Commission recognizes that 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. That is the issue before the Commission. 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.

The Staff and Praxair assert 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. These revenues will not be realized by Empire until 2002, but were recognized by the Staff as relating to the true-up period. 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. The same is true for the argument that recognition of these property taxes goes 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.

The argument is also made that these amounts are not "known and measurable." The Commission recognizes that property taxes are more than an ordinary expense of an electric company. They are not an expense where the company's management has discretion to increase or decrease the amount spent. They are an expense levied by governmental bodies and there are extreme sanctions imposed if they are not paid when due. These expenses 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, which is what Empire proposes. 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.

Since the Commission has utilized estimates for customer growth revenues which, in strict terms, relate to but go beyond the end of the true-up period, the Commission sees little harm in applying an even-handed approach to also recognize expenses associated with plant that is undeniably in service and used for the benefit of ratepayers, even though it may not be paid until after the end of the true-up period. While the Commission might take a different approach on an expense which the company has the discretion to avoid, it cannot in good conscience do that with an unavoidable obligation imposed by government such as these property taxes. Therefore, the Commission finds that Empire's permanent Missouri jurisdictional revenue requirement in this case should be increased by $884,042 to reflect the estimated property taxes on the increased plant in service which has been recognized by the Commission in the true-up portion of this case.

9. Should the issuance costs associated with Empire's TOPrS be included as part of the imbedded cost of debt?

The issues of the appropriate capital structure and return on equity were addressed in the true-up proceeding since both were subject to true-up, and the Commission has considered the evidence from the true-up in its earlier discussion of those topics herein. A distinct issue arose during true-up, however, when the Public Counsel argued that the Commission should rule on whether the issuance costs associated with Empire's trust originated preferred securities ("TOPrS") should be included as a part of the embedded cost of debt. The Public Counsel also seeks to

expand the issue from one involving a specific item in a rate case to a "regulatory policy" matter – whether TOPrS should be considered debt or equity for "regulatory purposes."

The underlying facts are not in dispute. Empire issued TOPrS in March of 2001 and incurred issuance expenses in the amount of approximately $1.6 million. (Ex. 121, p. 2). The issuance costs will be amortized over their 30 year life as required by Generally Accepted Accounting Principles. (Ex.121, p. 2). The proceeds from the TOPrS were used to fund the general operations of the Company. There is no allegation that these proceeds and the related issuance costs did not benefit customers. (Ex. 121, p. 3; Tr. 1227). In fact, the opposite is true. In connection with the issuance of its TOPrS, Empire created a trust which makes payments to the holders of the TOPrS. Empire has issued $50 million in unsecured debt to this trust which guarantees the TOPrS dividend payments. (Ex.121, p. 2; Tr. 1203). The TOPrS dividend rate is 8.5%. (Tr. 1232). Both the TOPrS and the unsecured debt will be retired in 2031. (Tr. 1204; 1229).

The Commission recognizes that TOPrS have characteristics of both debt and equity. For example, TOPrS are issued for a definite term and are treated as debt by the Internal Revenue Service. This feature results in a benefit for Empire's customers. (Tr. 1207; 1211). TOPrS costs or payments, however, are referred to as "dividends" and the instruments receive equity treatment by Standard and Poor's up to approximately 10 percent of total capitalization. (Ex. 121, p. 1; Tr. 1205). There is no argument that Empire has experienced costs associated with issuing the TOPrS.

In a previous 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, Case No. GM-94-40. In GR-96-285, 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 certain 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.

The Commission finds that, unlike commonly recognized forms of equity securities, the TOPrS have a definite redemption date. The issue costs associated with the TOPrS are required to be amortized by Empire over the life of the securities by GAAP. In the past, the Commission has included TOPrS issuance costs as a portion of the embedded cost of that security for ratemaking purposes. The Commission is not convinced there is any sufficient reason to deviate from its previous treatment of the issuance costs of TOPrS, or any necessity presented for it to take a position on the matter for "regulatory" purposes. The Commission therefore finds that the issuance costs should be treated as debt and included as a part of the imbedded cost for capital structure purposes in this case.

CONCLUSIONS OF LAW

The Missouri Public Service Commission has arrived at the following Conclusions of Law:

The Empire District Electric Company is an investor-owned public utility engaged in the provision of electric service in the State of Missouri and, therefore, is an "electrical corporation" as defined under section 386.020(15), RSMo 2000, subject to

the jurisdiction of the Commission under Chapters 386 and 393, RSMo 2000.

Orders of the Commission must be based upon competent and substantial evidence on the record. Section 536.140, RSMo 2000.

All relevant factors must be considered in establishing rates for a public utility. *State ex rel. Missouri Water Co. v. Public Service Commission*, 308 S.W.2d 704, 718-719.

Based upon its findings of fact and the following conclusions of law, the Commission concludes that in order to set just and reasonable rates, Empire is authorized and required to file tariff sheets consistent with this order to increase total revenue by the amount of $_____. For the same reason, the Commission concludes that the tariffs as submitted by Empire on November 3, 2000, are not supported by competent and substantial evidence and shall be rejected.

1. 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?

a. Service Lives

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, there is no evidence in the record to support the Staff's proposal to drastically change the existing rates. 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.

Therefore, the Commission finds that the service lives proposed by Empire are the most reasonable starting point for the development of Empire's depreciation rates and concludes that they should be adopted.

b. Information Request

Staff's testimony failed to describe or establish how Empire has violated the requirements cited by Mr. Adam. 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. The Commission rule cited by Mr. Adam does not require a certain software format, nor does it require the "Gannett-Fleming format."

Furthermore, this request is now moot. July 15, 2001 has passed. The Staff's request that Empire be ordered to convert data from the Company's retired computer system to the Company's new computer system, and that these accounts be submitted to Staff in the Gannett-Fleming format by July 15, 2001, is, therefore, denied by the Commission.

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

Denial of the recovery of cost of removal would be contrary to the law. It is recognized that plant depreciates in value and, thus, depreciation expense must be 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. Thus, the question for the Commission is not whether or not cost of removal/net salvage should be recovered by Empire, but rather when and how it should be recovered.

The whole life method, to include its treatment of net salvage, serves many appropriate and important policy goals. First, it allows net salvage, be it positive or negative, to impact rates over the entire life of a piece of property such that all customers that have benefitted from that property share in the costs or mitigation, as the case may be. Second, this same process promotes stability of rates by spreading the net salvage and avoiding cost spikes that then must be reflected in rates over a

comparatively short period of time.

Additionally, the Commission does not have the power to impose the Staff's proposed treatment of net salvage on an electrical corporation. 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 power 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)... ."

An examination of the Commission prescribed accounting regulation reveals that it requires that cost of removal and salvage be charged to depreciation reserves.[2] (Loos Rebuttal, 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

[2] 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).

during the life of the plant. Also, the Commission's 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 has indicated in its own rule that net salvage will be a part of the depreciation calculation. There is no request and no justification in this case for a variance or waiver from these provisions of the Commission rules and regulations.

The Commission has the authority to require such depreciation rates as are consistent with its own rules and regulations. 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.

To extent that the Staff believes that current net salvage calculations are not accurate, the Commission would encourage it to conduct a study of the net salvage values and present those findings, with the underlying justification for changes, to the Commission in Empire's next rate case. This will allow the Commission to examine its Staff's conclusions, along with those of the Company and other interested parties, to reassess the appropriateness 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 service life of a particular group of assets (sometimes grouped for the purpose of depreciation accounting as a plant account) is the time over which the cost of those assets will be recovered." *In the Matter of St. Louis County Water Company*, Case No. WR-2000-844 (May 3, 2001). In the case of the SLCC, this is an initial determination of service lives because this Empire's first rate case where the SLCC will be included in rates.

The Commission will adopt Empire witness 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?

Conceptually, the treatment of net salvage in establishing the depreciation rates for the SLCC is no different than the treatment of net salvage as to Empire's other property. Therefore, the Commission will incorporate and adopt those conclusions by reference.

2. COST OF SERVICE - BAD DEBTS

The Commission has the ability to determine the appropriate level of expenses for a utility's cost of service. The Commission concludes that the record evidence demonstrates a correlation between revenues and bad debt expense. The Commission

concludes that Empire's bad debt expense should be adjusted upward by .25% to reflect the additional revenues resulting from this proceeding.

3. COST OF SERVICE - PAYROLL - INCENTIVE PAY

The Commission concludes that the $323,000 in incentive payments at issue were made to employees who did in fact achieve goals which were beyond their normal job duties and responsibilities and thus the $323,000 should be included in rates in this proceeding.

4. CLASS COST OF SERVICE / RATE DESIGN

The Commission has the legal authority to accept a stipulation and agreement as offered by the parties as a resolution of issues raised in this case, pursuant to § 536.060 RSMo 2000. The Commission accepts the Unanimous Stipulation and Agreement Regarding Fuel and Purchased Power Expense and Class Cost of Service and Rate Design as the resolution of all issues contemplated thereby.

5. CAPITAL STRUCTURE / RATE OF RETURN

The Commission concludes that 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.

The Commission concludes that the appropriate return on common equity for Empire in this case is 12%.

6. 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?

The Commission has the legal authority to accept a stipulation and agreement as

offered by the parties as a resolution of issues raised in this case, pursuant to § 536.060 RSMo 2000. The Commission accepts the Unanimous Stipulation and Agreement As To State Line Combined Cycle Unit Capital Costs as the resolution of all issues contemplated thereby.

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

The Commission concludes that this is no longer an issue given Empire's acceptance of the Staff's position on this issue in true-up.

C. What are the appropriate in-service criteria for determining whether the new State Line Combined Cycle Unit should be included in rate base?

The Commission has the legal authority to accept a stipulation and agreement as offered by the parties as a resolution of issues raised in this case, pursuant to § 536.060 RSMo 2000. The Commission accepts the Stipulation and Agreement Regarding In Service Criteria as the resolution of all issues contemplated thereby.

7. What methodology for the recovery of fuel and purchased power expense should be adopted by the Commission in this case and what level(s) of fuel and purchased power expense should the Commission approve?

The Commission has the legal authority to accept a stipulation and agreement as offered by the parties as a resolution of issues raised in this case, pursuant to § 536.060 RSMo 2000. The Commission accepts the Unanimous Stipulation and Agreement Regarding Fuel and Purchased Power Expense and Class Cost of Service and Rate Design as the resolution of all issues contemplated thereby.

8. Should the Commission increase the total company revenue requirement by $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?

The Commission concludes that Empire should be allowed to recover in rates $884,042 for Missouri jurisdictional annual property taxes associated with its increased plant investment demonstrated to have occurred between January 1, 2001 and June 30, 2001, and recognized as a result of the Staff's true-up audit.

9. Should the issuance costs associated with Empire's TOPrS be included as part of the imbedded cost of debt?

The Commission concludes that the issuance costs associated with Empire's trust originated preferred securities should be included as a part of the embedded cost of debt and amortized over their life in accordance with GAAP.

IT IS THEREFORE ORDERED:

_. That the Commission hereby adopts the depreciation rates that are attached hereto as Appendix A to this Report and Order.

_. That the Commission hereby adopts the several Stipulations and Agreements discussed herein as the appropriate resolution of the issues which they addressed.

_. That all pending motions not specifically ruled on herein are denied.

_. That the proposed electric service tariff sheets filed by Empire on November 3, 2000, are hereby rejected.

_. That Empire is hereby authorized to file proposed tariff sheets in compliance with this Report and Order, and that upon approval of same by the Commission, they shall become effective for service rendered on and after October 2, 2001.

_. That this Report and Order shall become effective on _____.