Missouri Public Service Commission

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August 3, 2001

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: Case No. ER-2001-299

Dear Mr. Roberts:

Enclosed for filing in the above-captioned case are an original and eight (8) conformed copies of a **REPLY BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION.**

This filing has been mailed or hand-delivered this date to all counsel of record.

Thank you for your attention to this matter.

Sincerely yours,

Dennis L. Frey

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Enclosure
cc: Counsel of Record

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

REPLY BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION

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93

TABLE OF CONTENTS

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

REPLY BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION

COMES NOW the Staff ("Staff") of the Missouri Public Service Commission ("Commission") and for its Reply Brief respectfully states:

I. INTRODUCTION

The Staff's reply brief follows the same format as its initial brief (filed July 20, 2001). There are, however, some subject areas for which the Staff is not submitting a reply, based on its determination that there is no need to do so.

II. ARGUMENT

Depreciation

Should Empire's test year depreciation expense be adjusted?

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

In the section of its initial brief where it addresses average service lives for depreciation purposes, Empire states, "The disagreement over the appropriate service lives to use for generation plant, other than the SLCC, is somewhat mysterious because it is unclear what the

Staff has done, and why it has adjusted these lives from those used when Empire's depreciation rates were last established (*In the Matter of the Empire District Electric Company for Authority to File Tariffs*, Case No. ER-94-174 (Mo. P.S.C. August 2, 1994))." Empire goes on to assert that contrary to statements by Staff witness Adam "that he is proposing to use the same service lives as those determined by Staff in Case No. ER-94-174," he is proposing different service lives as shown by "Schedule 1-1 of Staff witness Adam's Direct Testimony (Ex. 33), [which] reveals that not only have changes to the service lives been made, the changes are significant and far-ranging." Empire is wrong.

Empire is mistaken in presuming that the lives for generation plant shown in the column labeled "Ordered Life" on schedules 1-1 and 1-2 attached to his direct testimony (Ex. 33) are the average service lives that Staff witness Adam is referring to as having been determined by the Staff for Case No. ER-94-174; they are not. In describing the differences between the column labeled "Ordered Life" and the column labeled "Staff's Proposal Life," Staff witness Adam testified as follows:

> Well, the difference is in the life that is projected by the Staff which appears to be longer, and is in the table longer than the life that is stated as ordered. But, the ordered life had a life span cut-off on it. As I described to Commissioner Gaw, that cut-off shortens the life, the average service life. And these columns are average service lives.

(Tr. 282, ll. 13-20). The description to Commissioner Gaw to which Staff witness Adam refers follows:

> [Commissioner Gaw] . . . From the standpoint of other plants that are already in service, the remaining life that you estimated on those plants, was it the same or different than what the Company –
>
> [Staff witness Adam] On the other plants, the life that is the life given on the schedules is calculated from interim retirements.
>
> In other words, even in a big power plant you're always retiring something and replacing it. Maybe replacing it with something newer that's better or similar but better, more efficient.

And those interim retirements still allow you to develop a survivor curve. And you can then do a[n] overlay of a type curve to the actual events that have occurred and develop an average service life on those interim retirements.

Now, when you have that, at some point in time you've got all of these additions that have occurred since the original construction of the plant.

At some point in time there will be a final retirement of that whole plant, and it will retire all together.

And so you'll have some of that plant that was bought later and have a very short life up to that retirement date. Some of it maybe is from the original plant.

And at that point in time you have to analyze what is the life based on that retirement date.

Q. And did your dates -- did the dates of Staff --how did they compare with the dates of the Company?

A. Well, they're considerably different, because the Company picks a retirement date in that table that was talked about earlier.

They picked that Riverton would retire in 2000 -- or several units at Riverton would retire in 2008. They picked that Asbury would retire 2014 and that Iatan would retire 2014. So they're putting the cut on that curve.

The area under the curve represents the average service life. So if you cut that curve off, you're reducing the area under the curve. You reduce the average service life.

(Tr. 257, l. 15 to Tr. 259, l. 6).

As the foregoing testimony makes clear, the average service lives that Staff determined in Case No. ER-94-174 to which Staff witness Adam refers as being the same as those the Staff recommends in this case are not those found in the column labeled "Ordered Life" in Schedules 1-1 and 1-2 attached to Staff witness Adam's direct testimony (Ex. 33). Instead of referring to the average service lives shown in that column, which the Staff determined by using fixed retirement dates for the generating units, i.e., with a "cut" on each survivor curve and resultant shortening of average life span, Staff witness Adam is referring to the average service

lives that the Staff determined without fixed retirement dates, i.e., without a "cut" on each survivor curve and resultant shortening of average life span. Because these average service lives are the same as those shown in the column labeled "Staff's Proposal Life" in Schedules 1-1 and 1-2 attached to Staff witness Adam's direct testimony (Ex. 33), there was no need to create this column again with a different label. Empire's claim of inconsistency in the testimony of Staff witness Adam on this point is without merit. Further, there is nothing "mysterious" about how the Staff determined average service lives in this case. The Staff's approach differs from that of Empire only in that the Staff did not fix dates for when all remaining plant at each generating unit will be retired, i.e., the Staff did not "cut" each survivor curve.

In response to the Staff's recommendation that Empire be required to submit account information in Gannett-Fleming format, Empire argues first that "it is unclear that Empire does not meet the requirements cited by Mr. Adam" and second that because the Staff recommended a compliance date of July 15, 2001, the recommendation is moot. Empire itself, through its witness Mr. Loos, recommends "that depreciation rates be reviewed every 3 to 5 years." (Loos Direct, Ex. 11, Sch. LWL-1, p. 1-1). Essential to developing the most accurate depreciation rates is the mortality data that is used to develop the survivor curves which in turn are used to determine average service lives. The Staff's recommendation that "[Empire] be ordered to submit all accounts, specifically generation accounts, in the Gannett-Fleming format to [the] Staff by July 15, 2001" (Adam Direct, Ex. 33, p. 27, ll. 1-3) was made for the purpose of enabling the Staff to recommend the most accurate depreciation rates possible for Empire, before the operation of law date in this case. Regardless, for evaluating depreciation rates in the future, the Staff is still recommends that the Commission require that Empire provide to the Staff plant mortality data in Gannett-Fleming format.

How shall the net salvage component be treated?

Empire's first criticism of the Staff's approach is that it leads to what Empire calls "inter-generational inequity." The Staff disagrees. The Staff is proposing that Empire recover in rates an amount based on the net salvage cost that it is actually incurring rather than on a predicted net salvage cost. This is because the net salvage cost component determined by the method Empire touts, the whole-life method, results in annual net salvage cost that far exceeds the annual net salvage cost that Empire is actually incurring. On average, Empire, on a Missouri jurisdictional basis, has incurred net salvage cost of $1,065,342 per year. (Ex. 32, Sch. 9-3, l. 98). This is the amount that the Staff proposes that the Commission include as a test year expense. In contrast, Empire proposes that $5,596,942, an additional $4,531,600, be included in the test year for net salvage cost. (Ex. 119).

The Commission should not lose sight of the fact that all of the parties arguing over net salvage cost in this case are predicting the net salvage cost that Empire will actually incur. Even Empire, through its witness Mr. Loos, agrees that this issue should be reviewed every 3-5 years. (Loos Direct, Ex. 11, Sch. LWL-1, p. i). While Empire bases its recommendation for net salvage cost, also unknowable, to be included in rates on predictions of when plant will be retired at some future presently unknown date and the net salvage cost at that predicted retirement date, the Staff relies on the recent actual net salvage cost that Empire has actually incurred in the recent past for the recommendation that it makes.

A fundamental flaw in Empire's inter-generational inequity argument is the absence of any present obligation by Empire to remove any plant at some future date. The Staff presented testimony that it is possible that a utility such as Empire may sell the site of a generation unit and *never* incur any removal costs for the plant at that site. (Tr. 263, ll. 20-24). In such a case there

should be no inter-generational inequity since there would be no net salvage cost; however, if the company had recovered net salvage cost through rates on the prediction that it was going to incur removal costs and realize gross salvage value at the time it retired the plant, then the company would have over-recovered in rates from its customers.

Empire's inter-generational inequity argument is also flawed in that it relies upon predicted retirement dates, not removal dates. As stated by Staff witness Adam, actual removal dates often do not correspond to actual retirement dates. (Tr. 213, ll. 6-10). For example, as Empire witness Mr. Loos testified, Unit 6 at Empire's Riverton Plant is retired, but has not been removed. (Tr. 161, ll. 6-18). Further, the uncertainty of predicted retirement dates is shown by the foregoing section of this reply brief which reflects the wide disagreement between the Staff and Empire over the appropriate predicted retirement dates of generation plant.

While the Staff could argue that net salvage cost is not a cost that a utility necessarily incurs in order to provide service to its customers and, therefore, is a cost that should not be recovered from customers, it has not done so but, instead, the Staff has taken the position that in the event a generating unit is removed, it would recommend an amortization for recovery of net salvage cost. (Tr. 254, ll. 16-25; Tr. 267, ll. 2-10).

Empire argues that this Commission is without authority to treat net salvage cost as an expense separate from depreciation because: a) 4 CSR 240-20.030(3)(H), in part, states: "[E]ach 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." (emphasis added by Empire) and b) § 393.240.1 RSMo 2000 provides, "The commission shall have power, after hearing, to require any or all 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." is not compelling. Empire reads the statutory subsection as a limitation as well as a grant of authority and ignores the subsection following. That subsection, § 393.240.2 RSMo 2000, provides:

> The commission may, from time to time, ascertain and determine and by order fix the proper and adequate rates of depreciation of the several classes of property of such corporation, person or public utility. Each gas corporation, electrical corporation, water corporation and sewer corporation shall conform its depreciation accounts to the rates so ascertained, determined and fixed, and shall set aside the moneys so provided for out of earnings and carry the same in a depreciation fund and expend such fund only for such purposes and under such rules and regulations, both as to original expenditure and subsequent replacement, as the commission may prescribe. The income from investments of moneys in such fund shall likewise be carried in such fund.

While subsection 1 of § 393.240 RSMo 2000 grants the Commission the authority to require Empire to prescribe depreciation accounts, subsection 2 grants the Commission the authority to "fix the proper and adequate rates of depreciation of the several classes of property of such corporation . . .." The Staff views these as independent and cumulative grants of authority, not limitations. As such, the Commission can easily obviate Empire having to maintain two sets of depreciation accounts by granting Empire a variance from Commission Rule 4 CSR 240-20.030(3)(H) when it sets Empire's depreciation rates.

Empire also attempts to employ the "used and useful" requirement of § 393.135 RSMo 2000 as support for its inter-generational inequity argument. That statute merely requires that before an electric utility such as Empire can begin recovering the cost of plant in rates, the plant must be "used and useful." The Staff fully agrees with Empire's statement on page 14 of its initial brief that follows: "This statute, which was adopted by public initiative, at a minimum shows the public's disdain for charges associated with electric plant *before* it is operational and used for service." (Emphasis in original). However, the Staff disagrees with the following sentence in which Empire states, "It is not a great leap to assume that the public would be

equally opposed to paying for property that is no longer operational and no longer used for service as a consequence of its retirement." As the Staff indicated at page 17 of its initial brief, the Staff is of the view that § 393.135 RSMo 2000 supports the Staff's position, not Empire's position. This is because the Staff views § 393.135 RSMo 2000 as an embodiment of the public's opposition to making payments to a utility that may not benefit the public. The Staff views the prepayment of costs that may never actually be incurred to fall within this public view. Unlike net salvage cost, there is no dispute that Empire's plant will depreciate and that it is entitled to recover its depreciation expense; however, depreciation is separate and apart from net salvage cost.

To the extent that Empire has correctly characterized the Commission's Report and Order in *In the Matter of Missouri-American Water Company's Tariff Sheets*, Case No. WR-2000-281 (August 31, 2000), the Staff disagrees that no longer being "used and useful" is a basis for disallowing recovery net salvage cost of major plant retirements through an amortization beginning at the time of removal. The Staff notes that the Commission's Report and Order is not final and that on review the Cole County Circuit Court in *State ex rel. Missouri-American Water Company, relator v. Public Service Commission*, Case No. 00CV325014, the Court reversed that part of the decision that Empire quotes. The matter is presently pending before Missouri Court of Appeals, Western District as *State ex rel. Missouri-American Water Company et al. v. Public Service Commission of Missouri,* Case No. WD60080.

As the Staff has indicated above, it believes that its approach better estimates Empire's annual net salvage cost than the approach that Empire supports.

Accounting Trends

In its initial brief, Empire agrees that the Staff's proposed treatment of net salvage runs counter to recent "accounting trends" and references the adoption of FAS 87 (pensions) and FAS 106 (post-retirement benefits) in the early 1990's and a recently issued "exposure draft" by the Financial Accounting Standards Board ("FASB") on accounting for asset retirements as supporting this contention. Empire's claims on this point are not persuasive.

First, the Commission is not required to adopt generally accepted accounting principles (GAAP) for rate purposes. GAAP is are intended to prescribe how investor-owned entities report their financial results on published financial statements, a very different process than that used for setting rates. On this point, it is ironic that Empire points to FAS 106, concerning OPEB expense, as indicating a trend towards accrual accounting. Initially, the Commission rejected the use of the accrual accounting method called for in FAS 106 in setting rates for utilities. (See Case No. TC-93-224, et al., Southwestern Bell Telephone Company.) It was only after lobbying by utilities and other parties led to passage of a law in Missouri mandating rate recovery of FAS 106 by utilities under certain circumstances that the Commission changed its rate policy for OPEBs to incorporate GAAP treatment.

Second, as Empire witness Mr. Lyons admits, the asset retirement exposure draft is only preliminary in nature, and was issued by the FASB so that it could obtain comments from interested parties on the proposals contained within. (Lyons Rebuttal, Ex. 25, p. 4, l. 22 to p. 5, l. 2) The exposure draft is subject to change by FASB when a pronouncement is issued in final form, if a pronouncement on this topic is ultimately issued at all.

So, even though the Commission is under no requirement to adopt GAAP for ratemaking purposes, this exposure draft cannot even be considered as GAAP at this time. The Commission

should entirely disregard Empire's arguments concerning set salvage as they relate to alleged "trends" in financial reporting.

Empire argues that the Staff's approach of treating net salvage cost as an expense could lead to over or under-recovery of net salvage cost. The same point can be made regarding essentially all bases on which the Commission relies when setting rates. To view net salvage cost in isolation is akin to engaging in single-issue ratemaking. Net salvage cost is just one of the many factors that the Commission considers when setting rates. The response to Empire's argument is that if it feels rates are inadequate, for whatever reason, it may initiate seek a rate increase, as it has done in this case, and, if any party feels that Empire is over-earning, then it may file a complaint seeking to reduce rates.

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?

Empire has correctly stated in its initial brief at page 22 the primary differences between the Staff and Empire on the treatment of the State Line Power Plant; that the Staff is treating net salvage cost separate from depreciation and that the Staff is not including costs for the major maintenance during the average service life of 35 years projected by its witness Mr. Loos. Like Empire the Staff has used an average service life of 35 years for this new generation unit. (Adam Direct, Ex. 33, p. 23, ll. 1-13). Similar to its reliance solely on the judgment and experience of Mr. Loos for the fixed retirement dates for generating plant that it used to develop the depreciation expense (Tr. 134, l. 17 to Tr. 137, l. 9; Tr. 156, l. 10 to Tr. 160, l. 21; Loos Surrebuttal, Ex. 31, p. 7, ll. 10-17), Empire relies solely on the judgment and experience of Mr.

Loos for the major maintenance that it projects for the State Line Combined Cycle unit. (Loos Direct, Ex. 11, Sch. LWL-2).

The Staff considers Empire witness Loos' projections of major maintenance expenditures to be made years in the future to be both unknown and unmeasurable and, as Staff witness Adam testified, "In Staff's meetings with Company employees, nobody mentioned the need for the consultant's [(Loos)] proposal of these estimated future capital expenditures" and "To Staff's knowledge, the consultant's [(Loos)] proposed capital expenditures are not in Empire's budget." (Adam Surrebuttal, Ex. 35, p. 3, ll. 7-13). Empire's projected major maintenance expenditures are as speculative as the retirement dates and net salvage costs that it proposes. Like cost of removal and gross salvage value, the date a major maintenance expenditure will be made, as well as the amount of that expenditure are both presently unknown and unmeasurable. Unlike Empire's proposal where Empire receives in rates money that may not benefit the public, the Staff proposes that major maintenance expenditures be given rate treatment when the date and amount of the expenditure is readily ascertainable, at or near the time the expenditure is actually made, and public benefit is assured.

In its initial brief, at page 24, Empire criticizes Staff witness Adam for stating that Empire witness Loos had included projected major maintenance expenditures for Empire's State Line Combined Cycle unit, but not its other generation units when seven pages, numbered 717, 736, 754, 771, 788, 805 and 842, (Tr. 244, ll. 10-14) of Mr. Loos' workpapers that were provided to the Staff showed that he had included projected major maintenance expenditures for all of Empire's generation units. Empire witness Loos described his workpapers as follows:

> These workpapers show the development of, in detail, the depreciation rates that I propose in this matter.

> It includes details with respect to historical additions, retirements, includes forecast of future, interim activity based on historical additions and retirements, excluding major environmental, maintenance and other items. Just the routine things, and the development of the base depreciation rate and then adjusted for salvage.

At the evidentiary hearing Empire witness Loos testified that the workpapers presented to him in the hearing numbered from 713 to 855 and were not all of his work papers, but "[a] subset with respect to production plant." (Tr. 246, l. 21 to Tr. 247, l. 4; Tr. 245, l. 22 to Tr. 246, l. 1). A fair inference from this testimony is that Empire witness Loos' workpapers exceed 855 pages in total.

While it is unfortunate that Staff witness Adam overlooked the seven pages of workpapers that are found in Exhibit 98, as he testified, those workpapers "wouldn't change [his] position on rates." (Tr. 239, ll. 23-24). Further, as he testified, had he been aware of those particular workpapers before preparing his surrebuttal testimony, he would not have included the statements that Empire attacks. The Commission should not discount the Staff's position on depreciation, average service lives or net salvage value in this case because of this collateral matter.

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

The Staff agrees that net salvage cost for the State Line Combined Cycle unit should be treated no differently than for other Empire generating units. Rather than repeating its responses to Empire's arguments made above, the Staff directs the Commission's attention to the above discussion of the treatment of net salvage cost for other plant.

Bad Debt

Staff would like to respond to several points raised by Empire in its initial brief. On page 25 of its initial brief, Empire states that "[e]mpire's prepared testimony concerning [the bad debt]

issue is found in the rebuttal and surrebuttal testimony of William L. Gipson, Empire's Executive Vice President." While this is in and of itself an accurate statement, Staff strongly believes that Empire should have properly proposed this adjustment as part of its direct filing. This would have given all parties to the instant case a better opportunity to discuss this issue before the filing of testimony and the evidentiary hearing.

On page 26 of its initial brief, Empire, in responding to an answer given at the evidentiary hearing in this matter by Staff witness Roy Boltz, states that "[t]his statement, of course, is contrary to his initial claim that there is no correlation between revenue and bad debt expense." The issue here is not whether there is *any* correlation between revenue and bad debt expense; rather, the issue is whether there is a direct and predictable correlation between the two such that the Commission can have confidence that ordering a rate increase in a certain amount will lead to a proportional increase in bad debts. Staff's position is that there is no such direct correlation. (Tr. 335, lines 7-10). Again, Schedules 1 and 2 to Boltz's Surrebuttal Testimony depict the widely varying amounts of bad debt write-offs from year to year, at the same time that revenues increased every year.

Again on page 26 of Empire's initial brief, the Company states "the Staff's position is directly contrary to this Commission's prior decision on this exact issue in Case No. GR-96-285." Staff would suggest that whether a direct correlation can be established between revenue levels and bad debts for a utility is dependent upon case-by-case circumstances. This is illustrated by the Commission's *Report & Order* in Case No. GR-96-285, wherein the Commission said that "[t]he Staff has not submitted persuasive testimony to counter the proposition that delayed payment revenue would remain a constant 0.3098 percent of the Company's revenue". (5 Mo. P.S.C. 3d, p. 447.) However, the Commission has also held that

"[t]he purpose of the revenue conversion factor is to insure an appropriate amount of revenue is authorized to generate the necessary net income, after taxes. There is a direct correlation between income tax expense and revenue requirement levels. The Commission fails to see this direct correlation between revenue requirement and collectibles. The correlation, if any, is remote and speculative. Inclusion of collectibles in the revenue conversion factor is clearly inappropriate." (TR-93-181 and TO-93-309, 2 MPSC 3d, p. 419.) In the instant case, Staff believes that it has supplied persuasive evidence to the Commission on the lack of a direct correlation between Empire's revenues and bad debt expense, as set out in its testimony filings and testimony adduced at the evidentiary hearing.

Payroll – Incentive Pay

The parties' List Of Issues and Revised List Of Issues, in part, may have contributed to the confusion surrounding the terms used concerning the issue of incentive compensation. The List Of Issues and Revised List Of Issues show the following question respecting the issue "Payroll – Incentive Pay": "Shall *discretionary*, performance-based *incentive pay* for employees be allowed?" (Emphasis supplied in italics). This same question appears on page 27 of Empire's initial brief, immediately preceding Empire's narrative argument regarding this issue. In his supplemental surrebuttal testimony, Empire witness Mr. McKinney in responding to the question "Would you please define the payroll terms which might have led to this confusion?" identifies that "[f]or non-bargaining unit, non-officer employees, there are three separate components of compensation": (1) merit increases, (2) incentive awards and (3) discretionary awards. (Ex. 114, pp. 2-3). Given that Empire distinguishes between "incentive awards" and "discretionary awards", Empire's repetition of the term "discretionary" to describe "incentive"

pay, may not help to end the confusion regarding the jargon surrounding the non-bargaining unit, non-officer employees incentive compensation issue.

Empire in testimony, at hearing and in its initial brief at page 29 made a major effort to distinguish between the Staff's non-officer, non-union employee incentive compensation adjustment in the pending case and the incentive compensation adjustment approved by the Commission in the Staff's 1987 excessive earnings complaint case against UE. Empire seeks to impress upon the Commission that the adjustment adopted by the Commission in Case No. EC-87-114 was denominated a management incentive plan with corporate goals, whereas the Empire plan for which the Staff proposes a disallowance is an employee plan with individual goals and objectives. First, the Commission's rationale in Case No. EC-87-114 for adopting the Staff's proposed adjustment in that proceeding has nothing to do with the UE incentive compensation plan applying to management employees and not applying to non-management employees. (See *Re Missouri Gas Energy*, Case No. GR-96-285, Report And Order, 5 Mo.P.S.C.3d 437, 458 (1997)). Second, Mr. McKinney himself testified that the Staff's adjustment covered a plan that rather than excluding management, "includes hourly employees *through mid managers*" and that of those who are covered by the plan "about a third would be managers and probably two-thirds are not." (Vol. 9, Tr. 794-95; Emphasis supplied in italics.)

Next respecting Empire's effort to draw distinctions between the Commission holding in Case No. EC-87-114 and the Empire non-bargaining unit, non-officer incentive compensation plan at issue is the very language of Empire's own Employee Handbook describing the plan for the Empire employees in the section "Performance, Compensation and Career Development Approach," which supports the Staff's approach. Empire does not want to acknowledge the language in its very own Employee Handbook which links the incentive plan at issue to Empire's

corporate goals. The following language contained in Empire's Employee Handbook is contrary to Empire's position that the Commission's decision in Case No. EC-87-114 is inapplicable to the present case:

> **Section 1 - Introduction**
>
> . . . Employees directly drive the positive results of the Company. With enhanced communication and performance planning, overall *corporate results can be significantly improved.*

(Page 1.1; Emphasis supplied in italics).

> . . . Employees also need to know how their achievements will be measured, and how their contributions relate to the overall success of the Company.
>
> . . . .
>
> **Part I – Base Objectives**
>
> . . . Objectives should be established for routine and non-routine accountabilities and should have the following **SMART** characteristics or qualities:
>
> - Specific. Clear tasks and activities derived from the principal accountabilities section of the position description.
>
> - Measurable. *Quantitative* (or qualitative) *results.*
>
> - Achievable. Challenging, but not impossible.
>
> - Relevant. *Contribute to what is important for the company.*
>
> - Time-bound. The target date by which an objective is to be completed.
>
> **Part II – Incentive Objects**
>
> Part II includes incentive objectives. ***Incentive Objectives describe results which go beyond those normally associated with your position that, when accomplished, add significant financial, strategic or cultural value to the Company. An Incentive Objective should never be written simply as a means of giving an employee more money.*** . . .

(Page 1.2; Emphasis supplied in italics).

. . . .

Not only is this *important* for your individual career development, but also *for purposes of organizational development*, in that the Company will have a pool of highly competent and well-developed employees to draw from when positions become available within the organization.

(Page 1.4).

. . . *High performance results from a process that is directly linked to the Company's strategic and business plans. . . .*

STEP	KEY ACTIVITY	FORMS UTILIZED	RESULT
1	Performance Planning	Part 1 Base Objectives/ Appraisal Part 2 Incentive Objectives/ Appraisal	• Mutually agreed upon objectives • Clear expectations • Specific measurements • *Performance criteria linked to the position description and organization's goals*

(Page 1.8; Emphasis supplied in italics).

Section 4 – Compensation

Purpose

The Pay For Results approach rewards those employees who make significant contributions to the overall success of our Company. . . .

The Pay For Results approach provides:

- Merit Increase (Adjustment to Base Salary)
- Incentive Award (Lump Sum)

(Page 4.1; Emphasis supplied in italics).

Empire states at pages 29-30 of its initial brief that "it is also important to keep in mind the fact that Empire's overall compensation levels are at or below average." Mr. McKinney explained at the hearing why this is so, which is not for the reason implied elsewhere by Empire:

> [Dottheim] I'd like to direct you to again to your supplemental surrebuttal testimony, page 6, line 18.
>
> [McKinney] Yes.
>
> Q. Where you state that Empire's compensation levels are at or below average. At or below what average Mr. McKinney?
>
> A. The average of the surveys that we are comparing with. Typically the reason we say that is typically there's some increase in those surveys from year to year. We're always using a survey setting wages that are usually several months old. So as the surveys are updated, we typically are falling below the average.

(Vol. 9, Tr. 798-99).

Furthermore, as stated in Empire's Employee Handbook at page 1.2, "An Incentive Objective should never be written simply as a means of giving an employee more money." Mr. McKinney identified merit increases, not incentive awards as the vehicle for adjusting employees base salary "to the value of the job as determined through a surveying process to insure that the Company's pay practices are in line with industry, state and local values." (Ex. 114, Supp. Sur., pp. 2-3). The Staff included in its case the full $300,000 in merit awards, which are base salary increases, made by Empire for non-union employees for 2000. This $300,000 constitutes a 2.39% increase in overall 2000 wages/salaries of non-union employees. (Ex. 53, Fischer Reb., pp. 8-9; Ex. 114, McKinney, Supp. Sur., p. 6).

Empire asserts at page 29 of its initial brief that its incentive compensation plan "puts a portion of the employee's pay at risk." Employees' pay was not put at risk when "managers and supervisors were not required to formulate base and incentive objectives" and "[i]n place of

incentive objectives, managers were instructed to use discretion in awarding incentives to those employees who played a role in maintaining the organization through the merger process . . ." (Ex. 116HC). In fact, Ms. Fischer testified that for the year 2000, virtually all eligible Empire employees received an incentive award. (Ex. 113, Fischer Supp. Sur., p. 5).

Empire seeks to impress upon the Commission that the incentive awards program is very important. Yet Empire's management did not think that the program was so important that it made an effort to see that UtiliCorp would have made incentive awards if the merger with UtiliCorp had occurred:

> [Dottheim] Mr. McKinney, if the merger with UtiliCorp had occurred in January 2001, do you know whether there would have been any lump sum Incentive Awards paid to Empire employees in February 2001?
>
> [McKinney] I don't know whether there would have been or not. That would have been a decision that UtiliCorp would have made, assuming the merger closed by February.
>
> Q. Is that something that Empire had sought, Empire management had sought any commitment from UtiliCorp regarding?
>
> A. No, we had not.

(Vol. 9, Tr. 807).

At page 30 of its initial brief, and page 9 of the supplemental surrebuttal testimony of Mr. McKinney, Empire states that as an alternative to recovery of the full $323,000, it would accept, since "the execution of Empire's incentive program in the year 2000 was somewhat off the mark," a five-year average of approximately $251,000 or a four-year adjusted average of approximately $223,500." (See also Ex. 114, McKinney Supp. Sur., p. 9). Staff witness Janis Fischer stated in her surrebuttal testimony that since Empire's level of incentive compensation has fluctuated over the last five years, if the Staff determined that recovery of incentive awards from ratepayers were appropriate, the Staff would use a five-year average of allowable incentive

awards for the payroll annualization. She further testified that it would be inappropriate for Empire to recover the test year amount of its incentive awards, even if the Staff did not seek a disallowance of the incentive awards, because recovery of the full $323,000 would assume that in future years the incentive awards would benefit ratepayers to the same degree as accomplished during the test year in the present case. (Ex. 54, Fischer Sur., p. 12).

It should be remembered that the Staff requested from Empire, data for the five-year period including all of the years that the present incentive awards plan has been in existence, for the purpose of making a determination whether a five-year average would be appropriate. (Ex. 113, Fischer Supp. Sur., pp. 3-4; See Ex. 115HC and Ex. 116HC). Ms. Fischer testified that in the case of each individual for which documentation was provided to the Staff for review for incentive awards for the years 1996 through 2000, the incentive objectives did not meet the rate recovery criteria utilized by the Commission for incentive compensation. Thus, the Staff has not proposed that Empire should recover any five- or four-year average of incentive award compensation. (Ex. 113, Fischer Supp. Sur., pp. 8-9; Vol. 9, Tr. 868-70).[1] Accordingly, the Staff does not recommend that the Commission adopt either of Empire's alternative positions on this issue of allowing non-bargaining unit, non-officer incentive awards in rates.

Capital Structure/Rate of Return

1. What capital structure is appropriate for Empire?

The Company states in its initial brief that "the 'snapshot' year-end 2000 capital structure is really not representative either of Empire's historical capital structure or of its prospective capital structure." (Company Initial Brief, p. 32). The year-end 2000 capital structure was an

[1] Empire has a Management Incentive Plan which covers Empire's five senior officers. The Staff proposed in its case that Empire be permitted to recover a portion of those costs based on a five-year average of allowed amounts. (Ex. 51, Fischer Direct, pp. 18-19).

"anomaly," according to Company witness Dr. Donald A. Murray, who thought the Commission should "go back to the history" to determine the Company's true capital structure. (Tr. 404, lines 3-6). From this, the Company somehow concludes that "the appropriate capital structure for Empire for purposes of the case is 45% common equity, 7.9% trust preferred and 47.1% long-term debt." (Company Initial Brief, p. 32).

The Staff and the OPC, on the other hand, submit that the Commission should adopt the Company's actual capital structure, trued up to June 30, 2001. (McKiddy Rebuttal, Ex. 62, p. 2, lines 2-8; Tr. 599, lines 12-23).

The Commission should reject the Company's argument, for several reasons:

1. The capital structure that the Company recommends is not based "on the history," as it implies, because the recommended capital structure includes the trust preferred stock ("TOPrS"). This stock did not exist in "history," but only came into existence in early 2001. According to Company witness David W. Gibson, 7.9% of the Company's capital was trust preferred stock, *as of March 31, 2001.*

2. But the capital structure that the Company recommends is not based on March 31, 2001, either, because the Company wants the Commission to adopt a capital structure with 45% common equity, whereas the common equity on March 31, 2001 was only 37.31%, according to Company witness Gibson. (Gibson Surrebuttal, Ex. 29, p. 2, line 20 – p. 3, line 4). It therefore appears that the Company is asking the Commission to adopt some sort of future capital structure that assumes that the Company will issue new common equity to retire 7.69% of its existing debt.

3. The Company has not explained in detail exactly what it plans to do to accomplish this exchange of equity for debt, other than to say – vaguely – that it will reinstate its

dividend reinvestment plan (DRIP), and it will "issue additional common equity later in 2001." (Tr. 451, line 5 – Tr. 452, line 1).

4. The Company made no attempt whatsoever to quantify the effect of these changes that it is thinking about making. That is, it did not tell how much common equity it could expect to receive from the DRIP or when it would be received, nor did it tell how much common equity it would issue or when it would issue it. It also did not say which issues of long-term debt it would seek to retire.

5. The Company has not made a firm commitment to take any action at all. It only talks about what it "hopes" to do (Tr. 425, line 23 – Tr. 426, line 1) or plans to do "later this year" (Tr. 451, line 23 – Tr. 452, line 1), but it does not promise to do anything. It thus asks the Commission to make a leap of faith and assume that the capital structure will be transformed sometime soon.

There is one other flaw in the Company's argument that is worth noting. The Company complains that the year-end 2000 "snapshot" is an anomaly, implying that the Staff and the OPC are promoting the use of this "snapshot." In fact, as noted above, the Staff and the OPC advocate the use of a *June 30, 2001* snapshot. It appears that, in reality, the Company is opposed to the use of any snapshot at all. The Company no doubt opposes the use of a June 30, 2001 snapshot – or a snapshot on any other date, for that matter – because even though it has been free to issue new common equity since January 3, 2001 (when the proposed merger with UtiliCorp failed), it has taken no steps to increase its common equity percentage.

The Commission should not adopt a capital structure for Empire that is based on the Company's fond recollection of the way things were in the "good old days," but should base it

on evidence of what the company has actually done, and upon the capital structure that actually existed as of June 30, 2001.

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

The Company makes four principal points in its initial brief in support of its claim that Ms. McKiddy's recommended return on equity ("ROE") is too low. It claims that she has used the wrong figure for the stock price (P_0) in her Discounted Cash Flow ("DCF") Method calculations (Company Initial Brief, pp. 35-38); that she ignores "basic measures of financial integrity" (Company Initial Brief, pp. 38-40); that she relies on an "unprecedented bond indenture coverage test" (Company Initial Brief, pp. 40-42); and that she expresses an opinion about how the financial markets view Empire's risk, without providing analytical support for that opinion (Company Initial Brief, pp. 43-44). The Commission should reject each of these points for the reasons that are set forth below.

Reliance on bond indenture coverage

The heart of the Company's argument against the Staff's position on the ROE issue is its complete misunderstanding of what it calls Ms. McKiddy's "reliance on unprecedented bond indenture coverage test." Empire presents this argument at pages 40-42 of its initial brief.

The Company apparently believes, and would have the Commission believe, that Ms. McKiddy relied exclusively upon the Company's indenture requirement in determining what her ROE recommendation must be, and that she "concluded that meeting the bare indenture requirement is an adequate return." (Company Initial Brief, p. 40). That is absolutely untrue, it is an inaccurate paraphrase of the excerpt from Ms. McKiddy's direct testimony that is set forth on page 40 of Empire's initial brief, and it turns Ms. McKiddy's analysis upside down.

The Company states that Ms. McKiddy relied, first and foremost if not exclusively, upon the bond indenture coverage test. In fact, her analysis relies primarily upon application of the Discounted Cash Flow Method, and only utilizes the bond indenture coverage test as one of four *checks* on the reasonableness of the result achieved through application of the DCF Method. A brief review of Ms. McKiddy's direct testimony will demonstrate this fact.

Ms. McKiddy discusses "The DCF Model" at pages 20 through 24 of her direct testimony, and applies it to the facts in Empire's case. As a result of this, she reaches the tentative conclusion, at page 24 of her direct testimony, that the appropriate ROE for Empire lies within the range of 8.50% to 9.50%.

After reaching this tentative conclusion, Ms. McKiddy conducts several checks on the "Reasonableness of DCF Returns for Empire." These appear at pages 25-34 of her direct testimony. It is vital to note that this discussion *follows* the tentative conclusion that Ms. McKiddy reached by applying the DCF Method, and that these are *checks* only. They are not the substantive basis for Ms. McKiddy's ROE recommendation.

Furthermore, the bond indenture coverage was *only one of four checks* on the reasonableness of the DCF result. The first check was the risk premium analysis, discussed at page 25 of the direct testimony. The second check was the Capital Asset Pricing Method ("CAPM") analysis, discussed at pages 25-27 of the direct testimony. The third check was the analysis of the pre-tax interest coverage, discussed at pages 27-30 of the direct testimony. The final check was the analysis of comparable companies, discussed at pages 30-34 of the direct testimony. This last check (the analysis of comparable companies) consisted of several parts: a DCF analysis of the nine comparable companies that Ms. McKiddy identified, a CAPM analysis of those nine comparable companies, an analysis of the returns on equity reported by those nine

comparable companies, and a comparison of Ms. McKiddy's recommended ROE with Value Line's predictions of the returns it expects electric utilities to earn.

Returning now, to page 40 of the Company's initial brief, it is clear that the Company has incorrectly paraphrased Ms. McKiddy's testimony. What Ms. McKiddy said was: "Thus, the pro forma pre-tax interest coverage test shows that there will be enough earnings potential for Empire to meet its capital costs based upon the above referenced return on equity range for Empire." (McKiddy Direct, Ex. 61, p. 30, lines 15-17, quoted at Company Initial Brief, p. 40). Ms. McKiddy clearly stated that the earnings generated at her recommended ROE range (8.50% to 9.50%) would be sufficient to provide the interest coverage that the Company's indenture requires. She did not anywhere say that an "adequate" return was equivalent to the minimum return that is required to meet the Company's indenture requirement. Rather, she said that her recommended ROE was sufficient to meet this one particular minimum requirement that is spelled out in the indenture.

Ms. McKiddy's complete testimony reveals her belief that an "adequate" ROE is that return that is required by application of the DCF Method, *provided that* the results of this analysis satisfy certain checks on their reasonableness. In this case, Ms. McKiddy's tentative conclusion passed each of these tests, including the bond indenture coverage test, and therefore became her final conclusion.

Financial integrity

At pages 38-39 of its initial brief, Empire argues that Ms. McKiddy's recommended ROE "fails the basic measures of financial integrity." The Company never clearly identifies these "basic measures of financial integrity," though, and the Company's discussion of the subject is so vague as to almost defy response. It appears, however, that the Company's principal

complaints are that it has not been able to increase its dividend in recent years (Company Initial Brief, p. 39), and that the Company may not be able to "successfully borrow or raise equity capital in capital markets to sustain itself in the future" (testimony of Dr. Murry, Tr. 390, lines 10-17, quoted at Company Initial Brief, p. 38).

The Company also hints at the suggestion that it could become insolvent if the Commission adopts Ms. McKiddy's ROE. (testimony of Dr. Murry, Tr. 390, lines 18-23). But this is only a hint, and the Company offers no evidence to support such a claim – in fact, Dr. Murry himself said he did not intend to suggest that Empire was similar to the electric utilities in California that recently became insolvent. (Tr. 378, line 22 – Tr. 397, line 9).

Empire seems to attach significance to the fact that the Company has not been able to increase its dividend, but it has not explained why this is significant. Neither Dr. Murry nor the Company's counsel has cited any authority for the implicit proposition that the ability to increase the dividend is a "basic measure of financial integrity." The Commission has no duty to ensure that a company can increase its dividend, nor even to ensure that the company can pay any dividend at all. The fact that the Company has not increased its dividend does not tend to show that Ms. McKiddy's recommended ROE is inadequate.

The suggestion that Empire might not be able to "successfully borrow or raise equity capital" is no more persuasive, for the facts themselves belie the suggestion. First, the Company has offered no specific evidence that it is now, or will become, unable to attract capital. Second, as of the date of the evidentiary hearing in this case, Standard & Poor's still rated Empire's credit as "A-," which is higher than a "BBB" rating. (Tr. 394, line 18 – Tr. 395, line 2). Even a "BBB" rating is considered "investment grade," and companies that are so rated are deemed to be capable of attracting investment capital. (Tr. 394, lines 13-17; Tr. 396, lines 16-22; Tr. 398,

lines 5-7). Thus it is clear that Standard & Poor's believes that Empire can attract capital. Third, Empire has even demonstrated that it can attract capital, by issuing trust preferred stock ("TOPrS") in March 2001. (Gibson Rebuttal, Ex. 14, p. 3, lines 12-25). This occurred after the termination of the proposed merger with UtiliCorp, and at a time when Standard & Poor's was supposedly concerned about whether the Company would receive "adequate rate relief." The fact that Empire was able to issue these TOPrS under these circumstances confirms that it is, in fact, still able to attract capital.

Empire discussed Standard & Poor's reference to "adequate rate relief" at page 39 of its initial brief. In doing so, however, the Company misstated Ms. McKiddy's reaction to Standard & Poor's statement and demonstrated that it does not understand Ms. McKiddy's role in setting the Company's rates.

The Company stated that Ms. McKiddy "recognized the critical importance of significant rate relief to Empire." (Company Initial Brief, p. 39). In fact, Ms. McKiddy never said that Empire required "significant rate relief," or any rate relief at all, and she certainly did not say that significant rate relief was "critically important." It is not Ms. McKiddy's role, as a witness for the Staff, to recommend rate relief. Ms. McKiddy is a financial analyst[2] for the Staff, and her role is to recommend an appropriate return on equity for the company under consideration. Return on equity is a single issue, and it is just one of many that the Commission must evaluate when setting rates for a regulated utility. Ms. McKiddy took no position on what rate relief is needed.

[2] As the Company noted, at page 34 of its initial brief, Ms. McKiddy earned a B.S. in Business Administration from Columbia College in 1997. The Company failed to note that her emphasis during this course of study was in Finance. (McKiddy Direct, Ex. 61, p. 1, lines 20-21). Ms. McKiddy also received a Masters of Business Administration degree from William Woods University in 2000.

Finally, the Company incorrectly stated that Ms. McKiddy "did not accept the conclusions of Standard & Poor's concerning adequate rate relief." In fact, Standard & Poor's offered no opinion whatsoever regarding what constitutes "adequate rate relief," and it certainly did not offer an opinion regarding what ROE would be appropriate for Empire. (McKiddy Direct, Ex. 61, p. 17, lines 7-17). Ms. McKiddy did not reject Standard & Poor's conclusion on this matter, because there was no specific conclusion to accept or reject.

Stock price

In its initial brief, the Company complains that Ms. McKiddy made two critical errors in selecting the stock price to use for the term P_0 in the DCF Method equation. First, it faults Ms. McKiddy for using stock price data that is too old – because, the Company contends, the data reflected the prices at which the Company's stock traded in October, November and December 2000, prior to the termination of the UtiliCorp merger. (Company Initial Brief, p. 37). And second, it faults Ms. McKiddy for using stock price data that do not reflect a "current spot market price," as would be required by a *strict* application of the DCF Method. (Company Initial Brief, p. 38).

But the testimony of the Company's own witness, Dr. Murry, contains both of the same alleged flaws. All of the stock price data that Dr. Murry used in his application of the DCF Method were taken from trades that occurred in the first nine or ten months of 2000, at a time prior to the termination of the proposed merger with UtiliCorp. (Murry Direct, Ex. 13, p. 12, lines 20-21). In contrast, only about half of Ms. McKiddy's stock price data were taken from a time prior to the merger; the other half were taken from trades that occurred in calendar year 2001, after the termination of the merger. (McKiddy Direct, Ex. 61, p. 23, lines 16-19, and Sch. 14).

In addition, Dr. Murry's stock price data covered all of 2000, up until the time that he prepared his testimony – a period of about nine months. (Murry Direct, Ex. 13, p. 12, lines 20-21). In contrast, Ms. McKiddy used data from only about a six-month period, from October 2000 to March 2001. (McKiddy Direct, Ex. 61, p. 23, lines 16-19, and Sch. 14).

Ms. McKiddy thus used data that were not only more current, but were also collected over a shorter period of time. It seems a bit disingenuous for the Company to complain about Ms. McKiddy's failure to use a "current spot market price."

It is true that, at the time that she prepared her direct testimony (in March 2001), Ms. McKiddy had the advantage (or hindsight) of knowing that the proposed merger with UtiliCorp had failed, whereas, at the time he prepared his direct testimony (in October 2000), Dr. Murry did not have this knowledge. Thus, the Company might plausibly argue that Ms. McKiddy should have accounted for this significant change in the circumstances of the Company, as it affected the market price of the stock. But Dr. Murry never changed the stock price he used in his DCF Method calculations, even though he had the opportunity to do so when he filed his rebuttal and surrebuttal testimony. Instead of changing the stock price that Dr. Murry used in his own calculations, the Company chose to attack Ms. McKiddy's testimony and tried to force her to amend her own calculations, and to use stock prices and assumptions about growth that the Company accepted, but which Ms. McKiddy repeatedly rejected.

The Company introduced Exhibits 101 and 104[3] in an effort to prove that Ms. McKiddy's DCF calculations were in error, and that, properly done, those two exhibits would produce a

[3] Although the Company sought to portray these two exhibits as the testimony of Ms. McKiddy, they are not her testimony. In fact, the exhibits are identified in the transcript as "Company Changes to Direct Testimony of Roberta A. McKiddy page 24." (Tr. 623-624).

result more to the liking of the Company. In fact, however, the only thing that Empire proved is that if the input into an equation changes, the result will also change.

Ms. McKiddy determined the Company's stock price to be about $24 per share (McKiddy Direct, Ex. 61, Sch. 14[4]; see also Tr. 469, lines 9-18), and since the Company consistently pays annual dividends of $1.28 per share, she calculated the yield on the stock to be 5.50%. (McKiddy Direct, Ex. 61, p. 24, lines 7-13 and Sch. 14). She estimated *Empire's company-specific growth rate, g,* to be 3.00% to 4.00%. (McKiddy Direct, Ex. 61, p. 22, line 16 – p. 23, line 11). By plugging these figures into the DCF equation, Ms. McKiddy determined that the appropriate ROE should be within the range of 8.50% to 9.50%. (McKiddy Direct, Ex. 61, p. 24, lines 14-22).

At the evidentiary hearing, Empire counsel James C. Swearengen cross-examined Ms. McKiddy at great length, insisting that she *assume* – contrary to her testimony – that the stock price was not $24 per share, but $20 per share. Ms. McKiddy repeatedly refused to accept this premise. She did, however, ultimately acknowledge that if one changed P_0 (the stock price figure in the equation) – which Ms. McKiddy steadfastly maintained was improper – a different result is obtained. (Tr. 476, line 8 – Tr. 483, line 13; Tr. 492, line 5 – Tr. 493, line 5). The Company then proudly proclaimed, at page 38 of its initial brief, that Ms. McKiddy "conceded the resulting cost of equity range of 9.4% to 10.4% is correct and the Commission could rely on it." In fact, she conceded nothing of the sort.[5] The only thing she conceded was that Mr. Swearengen's math was correct.

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[4] Schedule 14 does not show the actual average stock price that Ms. McKiddy used. However, the effective average stock price may be found by reference to Column (3) of Schedule 14, which lists the average high / low stock price for each of the months studied. The average of the six figures in this column is $24.256, which produces the yield of 5.38% that is shown on Schedule 14.

[5] The actual colloquy on this subject, at Tr. 477 (the page cited by Company counsel in its initial brief) is as follows:

Footnote continued to next page.

Mr. Swearengen then insisted that Ms. McKiddy assume that the proper figure to use for growth (g) in the DCF equation was the growth rate for her nine comparable companies. Again, Ms. McKiddy refused to accept this premise, maintaining that the proper figure to use for g is the *company-specific* growth rate. She did, however, ultimately acknowledge that if one changed g (the growth rate in the equation) – which Ms. McKiddy testified was improper – a different result is obtained. (Tr. 536, line 12 – Tr. 538, line 10). The Company then proudly proclaimed, at page 38 of its initial brief, that "Ms. McKiddy's cost of equity for Empire would become 11.4% to 12.9%." But, again, Ms. McKiddy never conceded that this was an accurate calculation of Empire's cost of equity. Again, the only thing she conceded was that Mr. Swearengen's math was correct.

The Commission should reject this tinkering with Ms. McKiddy's testimony. She never testified that Mr. Swearengen's assumptions were correct or reasonable, and she never agreed with the conclusions that he tried to force upon her.

Riskiness of Empire stock

Empire's final criticism of Ms. McKiddy's testimony is the claim that she failed to state, in her direct testimony, the basis for her professional opinion that "the market views Empire as

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Q. Let me ask you, if someone used or applied the DCF model in this case the way I have described it, the way you have described it, the way it is shown on Exhibit 101, using the $20 stock price instead of the price you used, would the resulting cost of equity be correct?
A. Yes. The way you show it, this is correct.
Q. Could the Commission reasonably rely on it in determining a cost of equity for Empire in this case?
A. As shown, yes, but as I also qualified earlier, you need to true up the growth rate to give a more accurate picture before the Commission can make a proper recommendation.
Q. But the Commission could rely on Exhibit 101?
A. If it had all the terms trued up, it could.
Q. Well, I thought you said first that they could rely on this, and then you stated your preference that something else be done. But my question is, Exhibit 101 the way it is, could the Commission rely on this in determining a cost of equity?
A. I do not believe so because the growth rate has not been trued up as the stock price has.

Footnote continued to next page.

less risky than the industry due to its competitive rate structure and its strong service area." (Company Initial Brief, p. 43).

The Company is correct to say that Ms. McKiddy did not provide analytical support for her conclusion. (McKiddy Direct, Ex. 61, p. 34, lines 7-12). But it is important to place this observation in the proper perspective. Ms. McKiddy did not form her opinion about the proper ROE for Empire on the basis of this opinion. As noted above, at pp. 24-25 of this Reply Brief, she formed her initial opinion of the proper ROE by applying the DCF Method. She then checked the reasonableness of the resulting ROE range with four other analyses: first, by applying the risk premium method to Empire; second, by applying the CAPM method to Empire; third, by calculating Empire's resulting pre-tax interest coverage; and fourth, by studying comparable companies. The "unfounded risk opinion" that the Company criticizes at page 43 of its initial brief was offered as support for just one part of Ms. McKiddy's comparable company analysis, which was, in turn, just one of the four tests of reasonableness.

Finally, it is worth noting that although the Company criticized Ms. McKiddy for failing to provide any analytical support for this conclusion, the Company provided no analytical support in opposition to Ms. McKiddy's conclusion that the market views Empire as less risky than other companies in the industry.

Summary

The Company's criticism of Ms. McKiddy's "reliance on unprecedented bond indenture coverage test" is not justified, because it is based upon the assumption that Ms. McKiddy used this test as the sole or principal means of choosing the proper ROE. In fact, she used this test

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It is impossible to understand how Empire's counsel could interpret this to mean that Ms. McKiddy conceded that the Commission could rely on the cost of equity range shown on Ex. 101.

only as a check on the reasonableness of the results she obtained from her analysis using the DCF Method. (See pages 23-25, *supra*).

Empire's argument regarding financial integrity also misses the point, because the Commission has no obligation to ensure that the Company can increase its dividend, and because the Company clearly does have the ability to borrow money and issue stock. (See pages 25-28, *supra*).

Ms. McKiddy did not err in establishing Empire's stock price, for purposes of the DCF equation, at $24 per share. The Company's use of Exhibits 101 and 104 was convoluted, misleading, and just plain wrong, because it required Ms. McKiddy to draw conclusions on the basis of premises that she repeatedly and consistently refused to accept. Those two exhibits are nothing more than a meaningless mathematical exercise. (See pages 28-31, *supra*).

The Company's argument about the "unfounded risk opinion" is a minor criticism of a minor point in Ms. McKiddy's analysis, and is entitled to little weight. The Company does not even argue that Ms. McKiddy's opinion was wrong, but merely that it was unsupported. And it only pertains to one of several *checks on reasonableness,* and not to the underlying basis for Ms. McKiddy's recommendation. (See pages 31-32, *supra*).

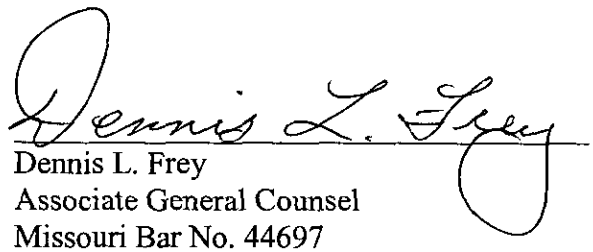
The Commission should reject each of the Company's arguments and allow Empire to earn a return on equity somewhere within the Staff's recommended range of 8.50% to 9.50%.

III. CONCLUSION

WHEREFORE, for the above-stated reasons and for the reasons stated in the Staff's initial brief, the Staff requests that the Commission adopt the Staff position on each and every issue presented in this case.

Respectfully submitted,

DANA K. JOYCE
General Counsel



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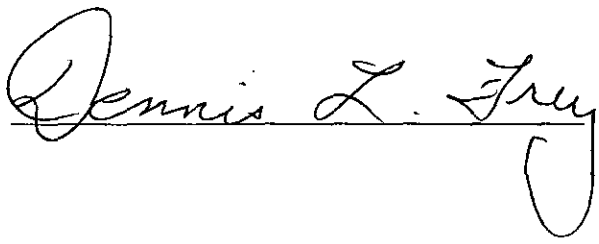
CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 3rd day of August 2001.



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