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MISSOURI PUBLIC SERVICE COMMISSION
REGULATORY REVIEW DIVISION
UTILITY SERVICES

SURREBUTTAL TESTIMONY

OF

JOHN A. ROBINETT

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2012-0345

Jefferson City, Missouri
February 2013

**** Denotes Highly Confidential Information ****

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1 **SURREBUTTAL TESTIMONY**

2 **OF**

3 **JOHN A. ROBINETT**

4 **THE EMPIRE DISTRICT ELECTRIC COMPANY**

5 **CASE NO. ER-2012-0345**

6 Q. Please state your name and business address.

7 A. John A. Robinett, P.O. Box 360, Jefferson City, Missouri 65102.

8 Q. By whom are you employed and in what capacity?

9 A. I am a Utility Engineering Specialist in the Engineering and Management
10 Services Unit of the Missouri Public Service Commission (Commission or PSC).

11 Q. Please describe your work and educational background.

12 A. A copy of my work and educational experience was provided in Appendix 1 of
13 Staff's Cost of Service Revenue Requirement Report.

14 Q. Are you the same John A. Robinett that contributed to the Staff Cost of Service
15 Report (COS) and Rebuttal testimony filed in this proceeding?

16 A. Yes, I am.

17 Q. How is your testimony organized?

18 A. I will address the rebuttal testimonies of Empire's Mr. Robert W. Sager and
19 Mr. Thomas J. Sullivan, including relevant factors regarding the retirement of the steel unit train
20 at Asbury.

21 **Surrebuttal of Mr. Robert W. Sager**

22 Q. In page 1, line 18 through page 2, line 4 Mr. Sager states that the lease proceeds
23 associated with the steel unit train was placed into account 151060 "lease of Railcars" and then

1 cleared monthly to fuel expense. Has Staff received evidence that these payments were used to
2 reduce fuel cost?

3 A. No. Currently Staff only has the statement from Mr. Sager that purports the
4 reduction of fuel costs. Staff is waiting for a response to outstanding data requests related to
5 accounting entries of the steel unit train lease proceeds.

6 Q. Did Empire contact FERC regarding whether they could sell the steel unit
7 train under the guidelines of it being an operating unit as described in Mr. Sager's testimony
8 in page 2, lines 10 through 12?

9 A. No. Empire's letter to FERC requests approval to make ledger entries to reflect
10 the sale of the steel unit train. In addition, FERC does not set or establish rates for Missouri
11 rate payers.

12 Q. On page 3, line 4, Mr. Sager states that Staff recommending placement of the
13 gains from the sale of the steel unit train into accumulated reserves comprises retroactive
14 ratemaking. Is Staff's recommended treatment retroactive ratemaking?

15 A. No. Staff's adjustment is to correct Empire's books. Requiring the Company to
16 properly record salvage on disposed plant in any future rate case regardless of when the salvage
17 sale occurs or is discovered to not have occurred is not retroactive rate making unless the
18 Commission ordered these funds to be recorded elsewhere.

19 Depreciation is the return of investment made by shareholders less net salvage on behalf
20 of providing service to ratepayers. Mr. Sager has not followed Commission guidance provided
21 in the Report and Order for Empire's rate case Case No. ER-2004-0570. The Company
22 specifically requested in this significant case, that depreciation rates include a component for net
23 salvage defined as: $\text{Net Salvage} = \text{Salvage Value} - \text{Cost of Removal}$. In this case the net salvage

1 of the steel unit train should result in an increase to the reserve for depreciation on behalf of
2 ratepayers in the non-jurisdictional amount of \$1,241,287 and not a gain to shareholders.

3 Empire argued and prevailed in Case No. ER-2004-0570, that a component for net
4 salvage should be reflected in the depreciation rates paid by Missouri customers, thus the salvage
5 value must be recorded in Empire's books¹. In the current instance where the salvage value of
6 the steel unit train is greater than any cost of removal and that positive salvage must be recorded
7 appropriately.

8 Q. Has Mr. Sager provided any evidence that the Commission has ordered the sales
9 proceeds from the sale of this steel unit train be recorded in any manner other than salvage?

10 A. No.

11 Q. Is Staff aware if this issue has been addressed and agreed upon in any of the cases
12 Mr. Sager cites?

13 A. No. Mr. Sager by his own admission states that the sale may have occurred in
14 time for the Case No. ER-2008-0093 rate case true up but the company does not believe an
15 adjustment was made. Staff's review of the Case No. ER-2010-0130 rate case did not find any
16 documentation showing the Commission addressed recording of the sale proceeds of this steel
17 unit train. Staff became aware of the Company's failure to record salvage to the plant account for
18 this steel unit train during the Case No. ER-2011-0004 rate case, and addressed this issue in the
19 Surrebuttal testimony of John Robinett. However, as that case was resolved by a "black box"
20 resolution, there was nothing in the Commission's Report and Order concerning this issue.

21 Q. Did Mr. Sager address the fact that Empire stopped recording depreciation of
22 the steel unit train without the Commission authorizing a change in depreciation rates in his
23 rebuttal testimony?

¹ See Schedule JAR(DEP) SUR-1, relevant sections of Empire's Initial Brief from Case No. ER-2004-0570.

1 A. No. Empire stopped recording depreciation accruals in April 2007 for this steel
2 unit train, while the steel unit train continued to be recorded as plant in service. Stopping
3 depreciation while an asset continues to be recorded as plant in service violates Commission
4 Orders that establishes depreciation rate schedules for specific plant accounts, as has been done
5 for Empire and which included the Asbury steel unit train.

6 Q. Did Mr. Sager attempt to address all of the concerns regarding the disposition of
7 the Asbury steel unit train that Staff raised in its COS Report?

8 A. No. Staff has three specific concerns regarding the Company's treatment and
9 booking of revenues associated with the disposition of the Asbury steel unit train while it was
10 still recorded as plant in service, was contributing to rate base, and depreciation expense was
11 being collected for it from Empire's Missouri regulated customers. Mr. Sager did not resolve
12 these concerns. Those three concerns are as follows:

- 13 1. the stopping of depreciation outside of an appropriate Commission order;
- 14 2. the application of the appropriate rules for guidance in the retirement of the steel
15 unit train with respect to recording sales proceeds and proper recording of
16 salvage; and
- 17 3. the leasing and booking of steel unit train lease proceeds.

18 Q. Please further explain these concerns.

19 A. As part of a review of the Company's accrual of reserves for depreciation of
20 assets Staff was able to observe that the Company discontinued depreciation of the Asbury
21 steel unit train beginning with April 2007 and ending November 2007 for a period of eight
22 months totaling a non-jurisdictional amount of \$248,137.18 in lost depreciation accrual. To be
23 clear, Empire was still collecting rates based on including depreciation expense on the steel unit

1 train, but Empire was not booking the collection of that depreciation expense in the
2 depreciation accrual.

3 Q. Did Staff question why Empire chose not to make the appropriate accruals to the
4 depreciation reserve as ordered by the Commission in the previous case?

5 A. Yes, Empire stated in DR 0240 and 0240.2 from Case No. ER-2011-0004 and
6 reaffirmed in DR 0094 for ER-2012-0345, that depreciation was stopped when the account was
7 fully depreciated. Even though depreciation was stopped by the Company on its books, rate
8 payers were still paying for the depreciation as a component of their existing rates.

9 Q. Is there a prior Empire case where a similar issue regarding collection of funds for
10 net salvage was addressed?

11 A. Yes. In Case No. ER-2004-0570 Empire explicitly sought Commission approval
12 to collect depreciation accruals for costs of removal that were expected to be incurred upon a
13 unit's retirement.

14 Q. Did Empire retire the steel unit train?

15 A. Yes. After a period of time, after approximately eight months in storage, the
16 Company declared the steel unit train was no longer being used and useful. Empire then
17 removed the steel unit train from the Company's Missouri regulated accounts and then sold the
18 steel unit train.

19 Q. Did ratepayers pay for the storage cost of the steel unit train for eight months?

20 A. Yes, approximately a non-jurisdictional amount of \$67,750.

21 Q. What is Staff's concern with the Company's selling of the steel unit train?

22 A. The staff has two significant concerns: (1) the manner in which the sale was done
23 by the Company which included ignoring Commission rules and (2) that ratepayers were harmed

1 by not receiving the non-jurisdictional amount of \$1,241,287.03 for salvage proceeds from the
2 sale of the Asbury steel unit train. Ratepayers were entitled to credit for the non-jurisdictional
3 amount of \$1,241,287.03 because that was the net salvage Empire experienced upon disposition
4 of the steel unit train.

5 Q. Does the Staff disagree that Empire properly reported the proceeds from the lease
6 of the steel unit train to offset Missouri regulated customer fuel cost?

7 A. Yes. Staff submitted data requests asking Empire to verify the detailed entries
8 supporting Mr. Sager's rebuttal testimony beginning at page 1, line 19 through page 2, line 4.
9 Empire's answer did not provide the requested information.

10 Q. Does Staff agree with the statements made by Mr. Sager at page 3, line 20
11 through page 4, line 3 concerning meetings between Staff and Empire regarding the new
12 property record system Power Plant?

13 A. Yes. Staff has met with Empire, since the last case regarding the new property
14 record system it. Not only has Staff met with Empire but Staff has visited with the other utilities
15 in the state that have either already implemented the software package or that are in the process
16 of implementing Power Plant. Based on these discussions it appears that on a going forward
17 basis the new software is able to meet Commission rule requirements for tracking assets from
18 work orders until they are placed in service and become part of the continuing property record.

19 **Surrebuttal of Mr. Thomas J. Sullivan**

20 Q. On page 2, lines 5 through 9 Mr. Sullivan states that "Staff's recommendations
21 regarding the depreciation rates for the production units fail to recognize the most current
22 information regarding the expected retirement dates of Asbury and Riverton plants and the most

1 current cost estimates for the Asbury mercury emissions equipment.” What are Staff’s concerns
2 with this statement?

3 A. Staff asked for Requests for Proposal (RFPs) and work orders relating to the
4 retirement of Riverton 7, 8, 9 and Asbury 2. The Company is either unwilling or unable to
5 provide specific documentation regarding these retirements. The only information Staff received
6 about these retirements is Mr. Sullivan’s statements that Empire states it is going to retire the
7 units. Empire has provided no proof in the form of RFPs and/or work orders documenting that
8 the retirements are eminent. As discussed below, even if this information was available, Empire
9 has sufficient depreciation reserves available to cover the cost of these retirements.

10 Q. Does Mr. Sullivan criticize Staff for failing to reflect in its recommended
11 depreciation rates equipment that has not yet be found to be fully operational and used
12 for service?

13 A. Yes. Mr. Sullivan recommends that Empire collect from rate payers, depreciation
14 expense for a mercury emissions control system at the Asbury plant that is currently under
15 construction and not providing service for ratepayers. Staff has, of course, excluded this
16 equipment that is not yet fully operational and used for service.

17 Q. Mr. Sullivan takes issue on page 2 lines 18 through 20 with Staff’s over accrual
18 claim in the direct testimony. Please explain Mr. Sullivan’s concern.

19 A. Mr. Sullivan appears to have misread the statements made in the depreciation
20 section of the COS Report. The report clearly stated that at the time of direct filing of the 2011
21 case based on the method Staff used, the reserves were *over* accrued on a total company basis.
22 Mr. Sullivan creates the perceived disparity by analysis of sub-accounting that is overly precise
23 and inappropriate given the guidance of FERC account 108.

1 Q. Does Staff disagree with the claims made by Mr. Sullivan on page 2, lines 3
2 and 4?

3 A. Yes. At page 2, lines 3 and 4, Mr. Sullivan claims that Staff mischaracterizes the
4 rates it recommended and gives a citation to the COS report at page 98, line 4. This is clearly a
5 wrong citation. Page 98 starting at line 3 through part of line 5 reads as follows: “These
6 production accounts are numbered Account 310, Land and Land Rights, through Account 349,
7 for which no designation currently exists. The second group of assets provided for in the USOA
8 is transmission.” Mr. Sullivan more than likely meant to refer to page 98, lines 23 through 28.
9 Staff performed the study for account 310 through 316 using a retirement date of 2030 based on
10 dollar weighted distribution for the production accounts due to the data being commingled for
11 Riverton, Asbury, and Iatan. This Study did not include Plum Point or Iatan 2 due to those
12 plants not being included in the data.

13 Q. Does Staff have any recommendations to alleviate the harm to ratepayers as a
14 result of Empire’s treatment and booking of revenues associated with the disposition of the
15 Asbury steel unit train?

16 A. Yes.

- 17 1. Empire should increase the accrued reserve for depreciation for account 312 by
18 the non-jurisdictional amount of \$248,137.18 to offset the early discontinuation of
19 depreciation of the Asbury steel unit train.
- 20 2. Empire should increase the reserve for depreciation for account 312 by the
21 non-jurisdictional amount of \$1,241,287.03 to record the positive net salvage
22 received upon sale of the Asbury steel unit train in 2007.

1 3. Empire should properly record lease payments of ** _____ **
2 (non-jurisdictional) received pursuant to the agreement with the railroad that
3 Empire would lease an aluminum coal train for coal transport for Empire's utility
4 operations while the railroad would lease the steel unit train from Empire for
5 other uses, for the period ** _____ ** through ** _____ **.

6 Q. Does this conclude your surrebuttal testimony?

7 A. Yes.

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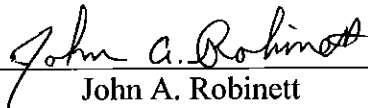
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric)
Company of Joplin, Missouri Tariffs) Case No. ER-2012-0345
Increasing Rates for Electric Service Provided)
to Customers in the Missouri Service Area of)
the Company)

AFFIDAVIT OF JOHN A. ROBINETT

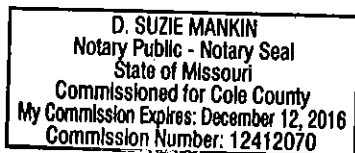
STATE OF MISSOURI)
)
COUNTY OF COLE) ss.

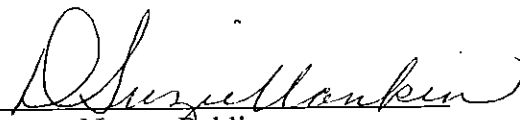
John A. Robinett, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 9 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.



John A. Robinett

Subscribed and sworn to before me this 4th day of February, 2013.





Notary Public

career and determined that Empire's proposed retirement dates produce reasonable life spans. (Tr. 1595)

Finally, the Commission should consider the consequences of adopting service lives based on Empire's life span approach versus lives determined by Staff's and Public Counsel's actuarial approach. If Empire's life spans are incorrect and the units remain in service longer than anticipated, ratepayers may have paid for the plant too quickly, but they will not have paid any more than they were required to pay because once an asset is fully depreciated, even though it is not retired, depreciation expense stops. (Tr. 1739, 1755) Secondly, the customer receives compensation for the depreciation expense they pay to the Company through an accrual to the reserve which is then deducted from rate base, thereby reducing the amount of return the customer is otherwise required to pay. (Tr. 1742-1743) On the other hand, if Staff and Public Counsel average service lives are incorrect, and the plant is retired sooner than their recommended service life, there will be an undepreciated and unrecovered amount of original cost associated with that plant for which the Company has not been compensated. And, given the recent experience in the MAWC rate case, it is not clear that the Company's investors will ever receive the full amount of their investment in plant given that scenario.

In light of the foregoing, the Commission should adopt the average service lives for production plant proposed by the Company and supported by its life span approach.

4. Net Salvage

a. Description of the Issue

When plant is removed from service, typically there is a cost to remove the plant and, in some instances, there is a salvage value associated with the retired plant. It is the difference between these two (i.e., salvage less cost of removal) that has generally been referred to as net salvage cost for

purposes of this issue. In many instances, costs of removal will exceed salvage and “negative” net salvage factors will be calculated. Net salvage costs can be broken down further into net salvage costs associated with the retirement of mass property and net salvage costs associated with the retirement of production plant. Further net salvage for production plant occurs in two forms: interim net salvage and terminal net salvage. Interim net salvage refers to the salvage and removal costs associated with interim retirements. Terminal net salvage refers to the ultimate dismantlement of plant facilities, which includes both salvage and removal costs. (Roff Direct, Exh. 18, p. 20) If Empire’s proposal to accrue net salvage as part of its depreciation rates is accepted, Empire’s depreciation expense and revenue requirement will increase by \$700,259 for terminal net salvage and by \$5,170,565 for mass property accounts over Staff’s and Public Counsel’s proposals. If accepted, Empire’s proposal for net salvage for interim retirements will actually decrease expense and revenue requirement by \$450,682 compared to Staff’s and Public Counsel’s proposal.

b. Empire’s Proposal to Accrue Net Salvage

In this case, Empire has proposed to accrue for future net salvage costs by calculating a net salvage factor from the historical records of the Company and including it in the development of its proposed depreciation rate. Staff and Public Counsel, on the other hand, have proposed to account for net salvage on a current or cash basis essentially by looking at the net salvage cost experienced by the Company in the last five years and developing an average expense based on that historical information. In Staff’s case, the average historical expense is then included in the cost of service as a separate, line-item expense amount. In Public Counsel’s case, the historical average cost is included as part of the depreciation expense.

This issue is not new. In Empire's 2001 rate case (Case No. ER-2001-299), Company and Staff essentially took the same positions that they are taking in this case. In the 2001 rate case, the Commission decided 3-1 (with Commissioner Murray dissenting) to adopt Staff's position on the issue. However, the Commission also stated that its "conclusion in this case should not be taken as a final endorsement of Staff approach. Both the approach adopted by Staff and by the Company have merit, and the Commission will use the one that fits the particular circumstances." *In re The Empire District Electric Company*, 10 MoPSC 3d. 463, at 479 (decided Sept. 10, 2001).

On January 11, 2005, the Commission issued its decision in a 1999 Laclede Gas Company rate case (which had been remanded by the Missouri Court of Appeals) that now appears to resolve many of the policy issues regarding the proper approach to net salvage costs. *In the Matter of Laclede Gas Company's Tariff to Revise Natural Gas Rate Schedules*, MoPSC Case No. GR-99-315. The Third Report and Order in the *Laclede case* is a decision in a rate case and not a decision in a generic or rulemaking context; nevertheless, a number of the Commission findings and conclusions in that case are equally applicable to the case at hand as will be discussed hereinafter.

There are a number of reasons why Empire's proposal to include future net salvage costs as a component of its depreciation rates is appropriate. First, Empire is properly entitled to recovery of these costs. Second, including net salvage as a component of the depreciation rate is required by regulatory and accounting rules. Third, such an accounting treatment appropriately allocates all components of cost over the useful life in a consistent manner. Fourth, treating net salvage cost as a component of depreciation rates results in intergenerational equity, such that no generation of customers is improperly charged. Fifth, such treatment is consistent with the way in which depreciation rates and depreciation expense are handled in the vast majority of jurisdictions. Finally,

including future net salvage costs as a component of depreciation rates and expense increases cash flow and improves certain financial ratios upon which credit ratings are based, thus enabling the Company to better meet its infrastructure and other public service obligations. (Roff Direct, Exh. 18, pp. 26-27; Knapp Rebuttal; Exh. 28, pp. 3-5, GAK-Exhibit 1)

The Company and its investors are entitled to recovery of both prudently incurred costs in the installation of plant as well as costs incurred in removing plant from service. No Party has disputed this concept (Public Counsel's position in the 2001 MAWC case notwithstanding). Moreover, recovery of future net salvage costs is consistent with industry standard and accepted definitions of depreciation. For example, NARUC defines depreciation as

. . . the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of utility plant in the course of service from causes that are known to be in current operation, against which the company is not protected by insurance, and the effect of which can be forecast with reasonable accuracy. Among the causes to be considered are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and the requirement of public authorities. (Roff Direct, Exh. DSR-1, App. B, p. 30)

“Service value” is then defined as “(t)he original cost of an asset less its estimated net salvage.” (Roff Direct, Exh. DSR-1, App. B, p. 36) These regulatory definitions clearly include net salvage as a component of depreciation. Indeed, this Commission has now found, in the *Laclede case*, that “the fundamental goal of depreciation accounting is to allocate the full costs of an asset, including its net salvage cost, over its economic or service life so that utility customers will be charged for the cost of the asset in proportion to the benefit they receive from its consumption.” (Third Report & Order, p. 9, emphasis added) Clearly, Empire and its investors are entitled to recovery of future net salvage costs as a component of depreciation rates.

The accrual for net salvage as part of the depreciation rate is also required by the rules of this Commission. 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) . . .” Further, Commission Rule 4 CSR 240-20.030(3)(H) specifically states that when implementing the FERC Uniform System of Accounts, “each electrical corporation subject to the Commission’s jurisdiction shall . . . charge original costs 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) In other words, the Commission’s own rules unequivocally indicate that net salvage will be part of the depreciation calculation.

The Commission’s power to establish depreciation accounts and rates is found in Section 393.240 RSMo 2000, which states, in relevant part:

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 accounts as the commission may prescribe.
(Emphasis supplied)

Thus, Section 393.240 RSMo 2000 provides that the Commission only has authority to require such depreciation rates as are consistent with its own rules. The Company’s proposal to accrue net salvage as a component of its depreciation rates is consistent with the Commission rules, and the Staff’s proposal to treat it as a line-item expense is not. Again, the Commission seems to have put this issue to rest in its recent *Third Report and Order* in the *Laclede case* by finding that the accrual method “is consistent with the requirements of the Uniform System of Accounts that this Commission has

adopted, and depreciation practices recognized and followed in all but a few regulatory jurisdictions in the United States.” (Third Report & Order, p. 9)

Accruing for future net salvage costs as part of the depreciation rate promotes intergenerational equity. Net salvage is an appropriate component of depreciation and inclusion into the development of an appropriate depreciation rate results in a fair and equitable allocation of these costs. From a ratemaking perspective, inclusion of net salvage and depreciation expense fulfills the regulatory precept of having customers pay their fair share of costs over the life of the property devoted to their service. By properly including net salvage in the development of a depreciation rate, the potential for intergenerational cross subsidy is eliminated.

As a matter of sound public policy, there is no reason to impose the cost of net salvage on future electric customers. This produces an economically inefficient allocation of resources across time to the detriment of all customers. (Roff Direct, Exh. 18, p. 11) In the recent *Laclede case*, Staff acknowledged that to address any intergenerational problem, customers benefitting from the use of an asset should pay for its costs of removal during the service life of the asset, not after it is retired from service. (Third Report & Order, p. 12) Accordingly, the Commission found that “the accrual method comes closer to matching the costs to the benefits derived, . . . [and] intergenerational equity will be promoted by the continued use of the accrual method.” (Third Report & Order, pp 12-13)

The accrual method also enjoys the support of the vast majority of regulatory jurisdictions. Mr. Roff was aware of only two other jurisdictions that have approved an approach similar to that taken by Staff and Public Counsel in this case. (Roff Rebuttal, Exh. 19, p. 30) Both Staff and Public Counsel witnesses were unable to name more than two jurisdictions, other than Missouri, that have approved their approach (Tr. 1816, 1945) and Public Counsel witness Majoros candidly admitted that

his approach had recently been rejected by the Indiana and Kentucky Utilities Commissions. (Tr. 1934, 1936) The record in this case is consistent with the Commission's finding in the recent *Laclede case*:

It is undisputed that using the accrual method for this purpose is supported by the overwhelming weight of authority on such matters. In both evidentiary hearings, Laclede and AmerenUE provided evidence showing the widespread support among depreciation professionals and authoritative texts for the traditional, or accrual, method of treating net salvage. (Third Report & Order, p. 8)

Finally, the inclusion of net salvage in development of a depreciation rate improves cash flow, and all other things being equal, improves certain financial ratios upon which a utility's credit rating is based and therefore reduces its cost of capital. Empire's business model is straight-forward: Cash to run the business is either provided by the customers through rates or the cash is obtained in the capital markets. When this model is working properly, customers pay for the cost of providing utility service, including an appropriate depreciation allowance, plus the opportunity for the owners of the business to earn a fair return on their investment. When out of balance and customers are not fully paying the cost of service, the Company is required to borrow more money to finance infrastructure requirements. This is the situation in which Empire finds itself. Annual capital expenditures (excluding new generation additions) have been in the \$40-45 million range in the last several years. This is a level of capital expenditures commonly referred to by the rating agencies as a "maintenance level" of expenditures, meaning this is the year-in/year-out level to fund the usual utility needs of providing safe and reliable service to customers. Contrast this maintenance level of expenditures to the annual depreciation allowance of around \$28 million, and it is easy to see that Empire is not even close to funding normal wear and tear replacements and new services without repeatedly going to the financial markets. (Knapp Rebuttal, Exh. 28, pp. 3-4)

A utility, such as Empire, suffering from a less than full recovery of cost will be assessed a higher cost of borrowing in the financial markets. This was very apparent when Standard & Poor's ("S&P"), in July of 2002, it lowered its credit rating for Empire to BBB from A-. S&P specifically cited Missouri's "low plant depreciation allowances" as one of three factors in the downgrade. (Knapp Rebuttal, Exh. 28, p. 4; GAK-Exh. 1) It is obvious that the credit rating agencies hold a negative view of Staff's and Public Counsel's depreciation methodologies. Staff's and Public Counsel's approach leads to depreciation rates that are significantly lower than levels allowed in other states.⁵ The unfortunate result of Staff's and Public Counsel's proposals is that infrastructure additions now, and in the future, will cost Empire more to finance than might have been the case. This is because the unreasonable deferral to some future period of net salvage costs of assets being consumed today increases the risk of recovery for the utility and certainly increases the costs of future customers. To the extent credit ratings are damaged, costs will be even higher. (Knapp Rebuttal, Exh. 28, pp. 5-6) Again, a majority of this Commission concurred with Empire's assessment of the impact of Staff's and Public Counsel's proposal on credit ratings when it stated in the *Laclede case*:

The Commission also finds that Staff's method significantly decreases the cash flows available to the utilities to meet their infrastructure and other public service obligations. This, in turn, has a negative financial impact on both the utility and its customers by requiring that such obligations be met with more expensive sources of external financings and by driving up the cost generally of obtaining money in the capital markets. (Third Report & Order, p. 14)

⁵ See Mr. Roff's comparative analysis attached to his Direct Testimony (Exh. 18) as Schedule DSR-4 and discussed previously.

c. The Reliability of Empire's Net Salvage Estimates

The only criticism that is leveled by Staff and Public Counsel against the Company's proposal to accrue for net salvage as part of the depreciation rate is the fact that the costs of future net salvage are speculative and therefore not known and measurable. However, neither Staff nor Public Counsel deny that Mr. Roff developed his net salvage factors in a manner that is consistent with industry practice and authoritative treatises. Specifically, for purposes of mass plant accounts, Mr. Roff examined historical retirement, salvage, and cost of removal activity for the period 1989 through 2003 for each asset category. Both salvage and cost of removal were divided by retirements on an annual basis to develop salvage and cost of removal percentages. A single net salvage percentage was developed for each asset category reflecting the history, trends, and Company expectations. (Roff Direct. Exh. 18, p. 28)

For purposes of production plant accounts, Mr. Roff determined net salvage for interim and terminal retirements. Interim net salvage factors were determined similar to the way in which net salvage factors for mass property accounts were developed. In essence, the interim net salvage factor was calculated by subtracting cost of removal from salvage and dividing by retirements. (Roff Direct, Exh. 18, p. 20) Because the Company has limited experience with the dismantlement of power plants, Mr. Roff determined his terminal net salvage factors by relying on the dismantlement estimates of other utilities. These estimates are contained in approximately 70 to 80 studies covering over 200 units throughout the United States. (Tr. 1602-1603) Recognition was given to the type of facility and its relative capacity. Mr. Roff has a collection of dismantlement estimates of other utilities. This information contains the company, plant/unit, capacity, study date, cost estimate, and dismantlement cost per unit of capacity (\$/kW). In general, the larger the facility, the lower the unit cost to

dismantle. A figure of \$50/kW was utilized to estimate the dismantlement cost for Empire's steam production units. A figure of \$13/kW was used for the other production units, with the exception of the State Line combined cycle unit. A figure of \$20/kW was utilized for the State Line unit. (Roff Direct, Exh. 18, pp. 20-21)

As a general matter, Mr. Roff has observed from his historical analysis that salvage is declining and cost of removal is increasing. He believes that there are two reasons for this occurrence. First, both salvage and cost of removal are a function of the age of property retired. Younger property is more valuable as it can be reused. In general, he has seen longer lives for most of the mass assets contained in the transmission and distribution plant functions. Older property retirements have less salvage value and cost more to remove relative to their original costs due to cost escalation over time. The second reason is that there are just more environmental requirements that impact the level of cost of removal. This creates an additional cost not reflected in the existing depreciation rates. (Roff Direct, Exh. 18, pp. 29-30)

Public Counsel witness Majoros claims that the results of Mr. Roff's salvage and cost of removal analyses are "so astronomical as to defy reason." (Majoros Direct, Exh. 89, p. 22) In fact, Mr. Roff's salvage factors are determined in a manner consistent with standard industry practices.⁶ Net salvage is defined by the National Association of Regulatory Utility Commissioners (NARUC) in its text, "*Public Utility Depreciation Practices*" (1996 edition) at page 18:

"Net salvage is expressed as a percentage of plant retired by dividing the dollars of net salvage by the dollars of original cost of plant retired."

⁶ Moreover, to the extent net salvage percentages exceeded 100%, Mr. Roff, for purposes of mitigating his recommendation in this case, has capped those percentages as 100%.

This is the exact way in which Mr. Roff has performed his net salvage analysis for every asset category in his study. The fact that the result of these calculations is a large ratio or percentage is no reason to dismiss the validity of the result. (Roff Rebuttal, Exh. 19, pp. 28-29) Moreover, this is the same type of analysis that Staff witness Gilbert performed prior to 1999 when Staff included net salvage as a component in the development of its proposed depreciation rates. (Tr. 1834, 1837-1838, 1858)⁷ Even Mr. Majoros admitted that Mr. Roff's net salvage study has been "traditionally used" and that Mr. Majoros has himself, in the past, performed this type of analysis. (Tr. 1946-1947)

Again, this Commission has had the opportunity to review this very issue and Staff and Public Counsel's contentions in the context of its recently issued *Third Report and Order* in the *Laclede case*. In that case, the Commission found that the net salvage percentage is "determined by dividing the net salvage experience for a period of time by the original cost of the property retired during that same period of time." (Third Report & Order, p. 8) This is exactly the same way in which Mr. Roff has calculated his net salvage percentages for purposes of his depreciation study. In the *Laclede case*, the Commission dismissed Staff's and Public Counsel's contention that such factors are not sufficiently reliable as they are estimates of future expenses to be incurred well in the future:

The Commission finds that no evidence or satisfactory explanation exists as to why it is inappropriate or unreasonable to use estimates for purposes of determining net salvage costs, but is appropriate to use them for deriving equity returns, allowances for pension costs, decommissioning costs, and the service lives used to allocate the recovery of up-front capital expenditures over many years. Given these considerations, the Commission finds that Laclede's net salvage estimates as derived under the accrual method are reasonable. (Third Report & Order, p. 12)

Such reasoning is equally applicable here and the record clearly reflects that Empire's net salvage estimates as derived under the accrual method are reasonable. In fact, to the extent Mr. Roff has

⁷ In that case, Mr. Gilbert calculated negative net salvage percentages as high as 410%. (Tr. 1863-1864)

voluntarily capped negative net salvage percentages at 100%, this further demonstrates the reasonableness of his estimates.

d. Safeguards in the Accrual Method

Finally, there are inherent safeguards in the depreciation process such that if current estimates of service lives and net salvage factors deviate from actual experience, those changes can be taken into consideration so that ratepayers and investors are not harmed and can be made whole. First, there is the fact that depreciation studies are periodically prepared and submitted to the Commission by the Company, usually in the context of a rate case or earnings investigation. In fact, Commission rules requires that, at a minimum, depreciation studies be performed no less frequently than every five years. (4 CSR 240-3.175(1)(B)2) (Tr. 1675; 1814) Second, through the ratemaking process, as a utility accrues depreciation expense, the depreciation reserve is credited accordingly. Therefore, if a utility company accrues more in depreciation expense than it actually incurs, the rate base is reduced and the customer receives the benefit of a lower rate base upon which it is required to pay a return. Conversely, if the accruals are less than actual costs, the reserve is less, rate base is increased and the company's investors earn a return on that increased rate base. (Tr. 1676; 1743)

By comparison, the expensing method advocated by Staff provides no way to track over- or under-accruals and account for such in future ratemaking cases. (Tr. 1744) These safeguards were also discussed by the Commission in the *Laclede case*.

Laclede's evidence shows that because the accrual method incorporates net salvage costs as a part of the depreciation rate, any difference between actual and estimated net salvage cost will be reflected in adjustments to the depreciation reserve. The depreciation reserve, in turn, acts as a kind of balancing account that tracks over- and under- accruals of net salvage costs. In this way, the depreciation rates can be subsequently adjusted to insure that the utility will not over- or under-collect such costs and that the ratepayer will not over- or under- pay for such costs. The

Commission's rule requiring the submission of depreciation studies no less frequently than every five years provides a mechanism for monitoring the depreciation reserve so that this balancing can occur . . .

The evidence also showed that any temporary difference between estimated and actual net salvage cost is reflected in the depreciation reserve that, in turn, is deducted from the utility's rate base pursuant to standard Commission practice. As a result, ratepayers are compensated at the utility's overall rate of return for the "use" of their money during those time when the utility's outlays for net salvage are less than what has been included in depreciation rates. In contrast, in the Staff's expense method, any difference between its estimates of net salvage costs and actual net salvage costs are either absorbed by the utility or borne by the customer. (Third Report & Order, pp. 13-14)

In the *Laclede case*, the Commission adopted a further safeguard and required Laclede to track and account for net salvage amounts received in rates separately from other components of depreciation expense. (Third Report & Order, p. 16) While this issue was not discussed during the instant hearing, Empire has no objection to this additional safeguard if the Commission believes it is appropriate for purposes of this case as well.

5. Conclusion

Empire has provided credible and complete evidence in this proceeding in support of its depreciation request. The requested depreciation expense level is fair and reasonable and is based upon sound and nearly universally accepted techniques. As such, Empire's request relative to depreciation expense in this proceeding should be granted.