BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the tariff filing of The Empire District Electric Company to implement a general rate increase for retail electric service provided to customers in its Missouri service area.	)))))	Case No. ER-2004-0570

RESPONSIVE BRIEF OF THE EMPIRE DISTRICT ELECTRIC COMPANY

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COMES NOW The Empire District Electric Company ("Empire" or "Company"), by counsel, and submits this responsive brief in support of its position on each contested issue and its rate increase request, Case No. ER-2004-0570, and in reply to the Initial Briefs of the other parties.[1]

I. Cost of Capital/Rate of Return

A. Introduction

The resolution of the rate of return issues, as well as the depreciation and fuel issues, are of critical importance to the financial health of Empire. The Company is at an extremely significant financial juncture in its corporate history. Empire's earnings must be increased to levels consistent with electric utility industry norms. The Company must have the ability to compete in the financial markets to meet its service requirements. Whatever return on equity ("ROE") the Commission authorizes in this case will have a significant impact on the Company's earnings, and will send a message to the investment community and impact the relationship of Empire with that community. "The cost of capital in this case is far more important than most; Empire's financial circumstances are sufficiently precarious that accurate measurement of the cost of capital in this case is critical." (Murry Direct, Exh. 11, p. 8) ". . . Empire's financial situation leaves no margin for error in this case." (Murry Direct, Exh. 11, p. 22) In other words, the Commission has before it serious issues that must be dealt with in a serious manner.

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[1] Cites to Staff's Initial Brief shall be to "Staff I.B., p. #." Cites to the Initial Brief of the Office of the Public Counsel shall be to "OPC I.B., p. #."

Unfortunately, the Commission Staff ("Staff") and the Office of the Public Counsel ("Public Counsel") do not appear to appreciate the gravity of this situation. This is apparent not only in their testimony filed in this proceeding, but also in their initial briefs filed herein.[2]

As the Commission is aware, the United States Supreme Court has held that the return authorized a utility by a regulatory body should be "commensurate with returns on investments in other enterprises having corresponding risks." In addition, the return should be "sufficient to assure confidence in the financial integrity of the enterprises, so as to maintain its credit and to attract capital." *See, Federal Power Commission v. Hope Natural Gas Company*, 320 US 591, 603 (1944); *see also, Bluefield Waterworks v. Public Service Commission,* 262 US 679 (1923).

While Staff and Public Counsel presumably agree that the standards of *Hope* and *Bluefield* must be followed, neither have made any real effort to apply the law to the facts involving Empire. Rather, both Staff and Public Counsel have taken essentially the same cavalier approach to rate of return that they followed in the recent MGE case,[3] reflecting a disdain for the law. In accordance with the Supreme Court decisions, this Commission must establish a rate of return for Empire's equity investors that is commensurate with the returns those investors could expect to achieve in investments in other enterprises having corresponding risks. (Murry Surrebuttal, Exh. 13, p. 9) Staff and Public Counsel, however, have ignored these judicial requirements and what is perhaps the most fundamental principle of regulatory finance in their direct testimonies and throughout this proceeding.

[2] The sharp tone of the rate of return portion of Staff's Initial Brief is especially disturbing and unproductive. The attempt to blame Empire's management for the Company's earnings difficulties is unwarranted and unsupported by the evidence. In fact, it is directly contradicted by the evidence.

[3] Case No. GR-2004-0209, *In the Matter of Missouri Gas Energy's Tariffs to Implement a General Rate Increase for Natural Gas Service*.

Evidence of adverse consequences from the Staff's approach already exists. In fact, the mere filing of the Staff's direct testimony with an "inordinately low" rate of return recommendation triggered a possible downgrade of Empire's rating by Standard and Poor's ("S&P"). (Murry Rebuttal, Exh. 12, p. 1) Furthermore, Staff's recommendation was so inadequate that it contributed to Empire being placed on S&P's CreditWatch. (*Id.*) These events in and of themselves firmly establish the fact that the investment community considered the Staff's proposal to fail to provide Empire with a rate of return commensurate with returns on investments in other enterprises having corresponding risks in violation of *Hope*.

Adoption of Staff's recommended return will result in financial ratios below S&P's published guidelines and medians, leading to a lowering of Empire's financial rating. (*Id.* at 2) Such a downgrade could in turn increase Empire's cost of debt and cost of equity and weaken Empire's ability to attract capital at a reasonable cost. (*Id.*) These are not the goals of the *Hope* and *Bluefield* standards.

In its Initial Brief, Staff quotes *Hope* regarding an authorized return as one being "sufficient to maintain [the company's] credit and to attract capital."[4] Knowledge of the law, however, is not enough, and neither Staff nor Public Counsel have followed this directive. ". . . Mr. Murray is recommending a return that will not support an investment grade bond rating, and this could be an explanation of why S&P would identify the Staff return recommendation as a problem in CreditWatch." (Murry Rebuttal, Exh. 12, p. 4) "Mr. Allen's recommended return on common equity also will produce a return that would not earn Empire an investment grade credit rating by these S&P standards." (Murry Rebuttal, Exh. 12, p. 16)

[4] Staff I.B., p. 3.

B. Empire's Dividend Policy is Appropriate

Further evidence of the Staff's cavalier approach is its criticism of Empire's dividend policy and the suggestion that the dividend should be cut.[5]

While it is true that over the last eleven years, Empire has paid out essentially all of its earnings as dividends, given the circumstances, this is a reasonable and prudent course of conduct designed to maintain the Company's investment standing. Staff witness Murray's claim that this dividend policy is causing Empire to have a higher cost of capital[6] is simply wrong and is a further example of his fundamental lack of understanding of regulatory finance.

Dr. Murry explained that the Staff is wrong in arguing that lower dividends, and thus lower payout ratios, will lower a utility's cost of capital. (Murry Surrebuttal, Exh. 13, p. 2) In Dr. Murry's words, Staff witness Murray's statement "shows a dangerous lack of understanding of the relationship between dividends, the cost of capital, and regulatory allowed returns." (Murry Rebuttal, Exh. 12, p. 7) The reality is that if a company is unable to earn its cost of capital because of high capital expenditures, fuel cost increases, or otherwise, an appropriate dividend may actually be greater than a company's earnings. To reduce that dividend would be a mistake and would result in a "penalty" from the financial community.

Dr. Murry explained the situation as follows:

> Over the period 1993-2004, Empire has paid out virtually all its earning as dividends in an effort to maintain its investment standing and has issued new equity to maintain its financial integrity. Empire's expected return on common equity for 2004 is 5.5 percent. **Contrary to Mr. Murray's assertion, the solution to Empire's dilemma is not to reduce dividends, which will decrease the market price and raise the cost of acquiring capital. The solution, as recognized by various market research**

[5] Staff I.B., p. 16.
[6] Murray Direct, Exh. 11, p. 22.

services, it to increase common stock earnings to levels consistent with electric utility industry norms.

(Murry Rebuttal, Exh. 12, pp. 8-9) (emphasis added)

Dr. Murry further explained the shortcomings with the Staff's position.

> Mr. Murray appears to be on a crusade to change utility industry dividend policy, or at least that of Empire, to suit his belief that lower dividends, and therefore lower payout ratios, will somehow lower a utility's cost of capital. His assertions regarding the relationship between dividend policies and the cost of capital are simply theoretically and factually wrong.

(Murry Surrebuttal, Exh. 13, p. 2)

Dr. Murry observed that Staff witness Murray is also wrong when he claims that Empire's dividend policy has caused the Company to issue more costly common equity. As explained by Dr. Murry:

> The dividends have been flat since 1993. The evidence is very clear. Empire's "erosion" in the "common equity balance" is the result of low common stock earnings, as I illustrated in my direct testimony, Schedule DAM-5.

(Murry Surrebuttal, Exh. 13, p. 4)

Dr. Murry characterized Empire's dividend policy as follows:

> Empire hardly could have a more conservative dividend policy. In light of this lengthy history of flat dividends, it is an incredible assertion that the dividend policy of Empire is not in line with the industry average. Other comparable electric utilities have had flat dividends over the past five years, but this apparently has been in order to conserve more cash. In the case of Empire, however, the dividend payout ratio is very high relative to the industry average because the earnings per share have declined. **Given this dividend history, the only rational conclusion one can draw from these data is that common stock earnings fall short of industry norms. This is in direct contradiction to Mr. Murray's conclusion that Empire's dividend is too high.** When placing Empire on CreditWatch with negative implications, Standard and Poor's noted in its September 28, 2004, report that Empire "suffers from relatively low allowed ROE's, receives low depreciation allowances, and lacks a fuel-adjustment clause to help shield the company from its markedly increased natural gas dependence." Contrary to Mr. Murray's recommendation, the

> answer to Empire's dilemma is to increase earnings-not cut the dividend. This can be achieved through adequate rate relief and increasing the opportunity to achieve allowed earnings by addressing the regulatory practices addressed by Standard and Poor's. (*Id.*) (emphasis added)

In the final analysis, the criteria regarding the level of dividends is whether or not the company in question is earning its required rate of return. A company such as Empire, should expect to earn its cost of capital. If Empire earns its cost of capital, it will follow that its dividends will be less than its earnings, which was the case when Empire initially set its current dividend. In order to remedy the problem which now exists, Empire's earnings must be increased so that they exceed the dividend level. Simply stated, there is no issue with respect to dividends. The issue is with respect to earnings.

C. Cost of Common Equity (What return on common equity recommendation is appropriate in estimating Empire's cost of common equity?)

Empire's ROE recommendation of 11.65 percent, if adopted by the Commission, will assist in satisfying the *Hope* and *Bluefield* standards. However, relying solely on a "mechanistic," company-specific discounted cash flow ("DCF") analysis, the approach followed by Staff and Public Counsel cost of capital witnesses, will not. The Staff and Public Counsel witnesses have not made any serious effort to comply with the law through an application of the *Hope* and *Bluefield* standards. Neither has changed its general approach to this subject since the ROE issue was last litigated in Case No. GR-2004-0209, *In the Matter of Missouri Gas Energy's Tariffs to Implement a General Rate Increase for Natural Gas Service*. Consequently, neither witness has produced what can fairly be characterized as the "true" cost of capital for Empire.

1. Staff's Recommendation

Staff witness Murray proposes a ROE range of 8.29 to 9.29 percent, with a midpoint of 8.79 percent. To arrive at his recommendation, Murray used a "company specific" DCF approach to determine the cost of common equity for Empire. (Murray Direct, Exh. 62, p. 26) No real financial integrity test was performed by the Staff witness. No professional judgment was exercised. His work product is simply a mechanical "vending machine" approach that perhaps anyone, with <u>any</u> level of education, training, and experience could perform. According to Dr. Murry, the analysis of the Staff witness "has a number of analytical and methodological problems that appear to have led to his unsubstantiated conclusions and flawed recommendations," and his testimony is "similar to testimony he has presented to this Commission over the last several years in other cases." (Murry Rebuttal, Exh. 12, p. 2) Dr. Murry explained that Staff witness Murray's "lengthy presentation of stale economic data is irrelevant and ignores the fact that the cost of capital is a function of expectations." (*Id.*)

In general, Dr. Murry found fault with the Staff witness' "inordinately low" recommended return. (Murry Rebuttal, Exh. 12, p. 1) Dr. Murry testified that Staff's recommendation is "so inadequate" that it contributed to Empire being placed on S&P's CreditWatch. (*Id.*) Adoption of Staff's recommended return will result in financial ratios below S&P's published guidelines and medians, leading to a lowering of Empire's financial rating. (*Id.* at 2) Such a downgrade could in turn increase Empire's cost of debt and cost of equity and weaken Empire's ability to attract capital at a reasonable cost. (*Id.*)

None of Dr. Murry's criticisms have been refuted by Staff's Initial Brief. Instead, in its Initial Brief, Staff sings the praises of the application of the DCF model, stating that the Staff witness utilized the DCF method as his "primary tool" because that is consistent with Commission precedent.[7] This, however, is not the issue. All agree that the DCF model is a useful tool. The issue is whether that tool is used properly and whether the results of a "company specific" DCF analysis, standing alone, satisfies the comparability requirements of the *Hope* and *Bluefield* decisions. Other tools, such as an analysis of comparable companies, should be used to check the result of a DCF analysis, and this is conceded by the Staff. (*Id.*) Contrary to this concession, however, Staff witness Murray failed to adjust the result of his "company specific" DCF analysis, and he ignored the earnings of comparable companies.

In its Initial Brief, Staff selectively quotes the *Hope* opinion, misinterpreting the significance of the decision. Staff has ignored the important "end result principle" set forth by the Supreme Court in *Hope*, which led to a more direct and practical interpretation of the methods of public utility regulation. Significantly, as Justice Douglas stated, "Under the statutory standard of 'just and reasonable' it is the result reached and not the method employed which is controlling. It is not the theory but the impact of the rate order which counts." *Hope*, 320 U.S. at 602.

Contrary to Staff's assertion that the DCF method is some how endorsed by *Hope*,[8] the opinion actually rejected the concept of formulistic ratemaking. Simply and mechanically applying a technique will not meet the standard of authorizing a return "sufficient to maintain [the company's] credit and to attract capital." Staff witness Murray failed to put the result of his DCF analysis in the perspective of the financial circumstances of Empire, and Staff witness Murray relied upon the result of his mechanical calculations even when that result failed to meet the most basic standards of

[7] Staff I.B., p. 6.
[8] Staff I.B., p. 4.

financial integrity and failed to show any semblance of qualified professional judgment. These failures are proof of Staff witness Murray's failure to satisfy the "end result principle" set forth by the Supreme Court in *Hope*.

Staff has ignored the evidence in this case that demonstrates Empire's precarious financial condition. For example, the earnings history of Empire showing an average of 7.66 percent over the past five years (Murry Direct, Exh. 11, p. 11); the expected earnings of only 5.5 percent for 2004 (Murry Rebuttal, Exh. 12, p. 8); and the failure of Empire to have earnings sufficient to raise dividends over the past ten years (Murry Direct, Exh. 11, p. 11). Additionally, although dividends have not increased, Staff appears to have ignored payout ratios of over 100%. (*Id.*, DAM-7) This ratio is proof of inadequate earnings – not of a dividend that is too high. Staff also ignored the many analysts' concerns which directly address the "end-result" of regulatory policies in Missouri,[9] and Moody's statement that Empire's cash flow from operations was "insufficient to cover capital expenditures" and that "regulatory lag" has created financing needs and resulted in a Moody's "negative outlook." (Murry Direct, Exh. 11, p. 27)

Further, Staff's Initial Brief does not even mention the failure of Staff and Public Counsel witnesses to address the issue of financial integrity requirements of their recommendations. This is the ultimate measure of the "end result principle" set forth by the Supreme Court in *Hope*. Staff has ignored the financial realities of Empire, has blindly adhered to mechanical calculations rather than exercising competent professional judgment, and has disregarded the financial integrity and adequacy of its end results. Instead of addressing these failures, Staff's Initial Brief, much like the testimony

[9] *See* Murry Rebuttal, Exh. 12, Schedule DAM-1, p. 2.

of Staff witness Murray, tediously labors through mechanical manipulations signifying virtually nothing.

2. Staff's Criticism of Empire

In an effort to hide from the facts with respect to the Company's inadequate earnings, Staff accuses the Company of poor management as a reason for Empire not earning its authorized rate of return.[10] This unwarranted charge is completely unfounded and directly contradicted by testimony from Staff's own witnesses. For example, when asked by Commissioner Appling if Empire is running an efficient organization, Staff witness John Cassidy testified that Empire has "done a very good job in hedging for natural gas. That policy has benefitted Empire's customers to date." (Tr. 631-632, 645) The Public Counsel did not disagree.

> Q. But are you familiar generally with the case that the Public Counsel's putting on in this proceeding?
>
> A. In general, yes.
>
> Q. And is Public Counsel putting on – making an allegation or putting on evidence that Empire has been imprudently managed?
>
> A. I don't believe so, but I'm not sure if that's –

(Tr. 1572-1528) In fact, there does not appear to be any testimony in the record regarding Empire engaging in "poor management." This last minute allegation, raised for the first time in the rate of return portion of Staff's Initial Brief, is a complete distortion of the record and should give the Commission sufficient grounds to seriously question any of Staff's claims.[11]

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[10] Staff I.B., pp. 16-17, 25.

[11] The Commission should contrast this portion of Staff's Initial Brief to the "matter of fact" discussion of the fuel issues.

a. Dr. Murry's Recommendation

Staff asserts that Dr. Murry's analyses resulted in a "breathtaking array of cost of common equity estimates, allegedly to Empire's liking."[12] Staff has missed the point of Dr. Murry's calculations. The information cited by Staff is the result of Dr. Murry's efforts to arrive at a reasonable rate of return for Empire in this proceeding. He did not undertake a "vending machine" approach and perform a simple, mechanical calculation without considering the financial realities of Empire and the earnings of comparable companies. Instead, Dr. Murry performed a detailed analysis, based on years of professional experience – both in the classroom and in front of various commissions.

Staff also points to Dr. Murry's use of Value Line's growth estimate. In its Initial Brief, Staff proposes that Dr. Murry should have ignored the Value Line earnings growth estimates.[13] To reach this conclusion, Staff would have to disregard Dr. Murry's explanation that the financial literature has uniformly recognized the superiority of Value Line's estimates as superior for a DCF analysis. Empire encourages this Commission not to make the same mistake. Dr. Murry provided ample documentation of Value Line's recognition in the financial literature. Staff's refusal to acknowledge this does not alter the facts.

Dr. Murry provided documentation of the superiority of Value Line's estimates in response to Data Request No. 2159, which was admitted into evidence as part of Dr. Murry's Surrebuttal Testimony, Exh. 13, Schedule DAM-3. Dr. Murry explained that analyst forecasts are superior

[12] Staff I.B., p. 10.
[13] Staff I.B., p. 12-15.

measures of growth for DCF analysts, and he provided, as one of the literature examples, a study by Robert E. Chatfield, Scott E. Hein, and R. Charles Moyer. These authors stated:

> The valuation tests of alternative forecasting techniques provided strong evidence that investors place the greatest weight on the forecasts provided by Value Line . . . This result may be explained by the broad availability of Value Line forecasts, and the fact that many earlier research studies have found Value Line to be more accurate than alternative forecasting methods. . . . These results suggest that investors and policymakers should rely upon analyst forecasts of earnings when looking for a proxy for the expected proxy growth rate in the DCF model of valuation.[14]

Contrary to Staff's assertion,[15] Staff witness Murray's manipulations of financial information did not produce a figure that is "far more accurate and better reflects investors' expectations of Empire's practical growth possibilities over the long term."

The argument that the growth rate measured by Value Line is too high because the earnings in the base year are low[16] is yet another illogical point made by Staff. The low base is an example of inordinately low earnings of Empire and high risks to investors. This is further evidence of Empire's financial condition and the need for adequate rate relief. If a regulatory body applies a lower growth rate to a lower net income, the utility will never be in a position to earn its authorized rate of return. Also, the higher growth rate includes in part a recovery from very low earnings. Analytically, this growth should be reflected in a DCF calculation. If investors expect this growth, they will discount it and consider it in the value paid for common stock. To ignore this growth in a DCF calculation is in error.

[14] Murry Surrebuttal, Exh. 13, Schedule DAM-3; "Long-term Earnings Forecasts in the Electric Utility Industry: Accuracy and Valuation Implications," *Financial Review*, Vol. 25, No. 3, Aug. 1990, pp. 421-439.

[15] Staff I.B., p. 17.

[16] Staff I.B., p. 16.

b. Dr. Vander Weide's Recommendation

Staff criticizes Dr. Vander Weide's recommendation by pointing to "unusual characteristics." Staff admits that Dr. Vander Weide's methodology cannot be disqualified for being "unique," but Staff asserts that he must "bear the burden of showing that his methods produce a reasonable result."[17] Through his testimony, Dr. Vander Weide did just that. Further, it is well accepted that the Commission is not bound by precedent or past practice. Is the Staff suggesting that once a method is used, it must always be used, and must always be used exclusively? This argument flies in the face of the *Hope* decision and the firmly established legal principle that it is the result reached and not the method that is critical.

Staff also attacks the group of comparable companies utilized by Dr. Vander Weide, alleging that many of these companies have little in common with Empire.[18] Empire does not have a lot in common with some in this group of 27, but Empire does access the same capital markets to compete for investors funds. In Staff's own Initial Brief,[19] it cites "That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Hope*, 320 U.S. at 603. If Empire's returns are very low as compared to others who are accessing the same capital markets, then how will Empire be able to attract capital?

In order to reduce the uncertainty of the estimate of the cost of equity for Empire, Dr. Vander Weide used a reasonably large sample of proxy companies, instead of applying cost of equity methods solely to Empire. (Vander Weide Direct, Exh. 14, p. 6) Dr. Vander Weide's selected proxy companies are similar in risk to Empire and serve as a "conservative proxy." (*Id.* at 5) Further, the

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[17] Staff I.B., p. 21.
[18] Staff I.B., pp. 20, 22-23.
[19] Staff I.B., p. 3.

selected group satisfies the standards of *Hope* and *Bluefield*, in that Dr. Vander Weide's calculations result in a recommendation that will provide Empire with an authorized return "commensurate with returns on investments in other enterprises having corresponding risks."

c. National Average for Return on Equity

Staff argues that the Commission has not historically looked to the returns allowed in other states to establish a return for a Missouri utility,[20] but suggests that this issue merits "special attention" because of the Commission's decision in the recent case of *In the Matter of Missouri Gas Energy's Tariffs to Implement a General Rate Increase for Natural Gas Service*, Case No. GR-2004-0209. Incredibly, however, Staff claims that in the MGE case, the Commission gave little weight to returns in other states and that there is "very little, if any, evidence concerning the average returns in other states" in the pending Empire case. The Staff needs to reread the MGE decision and the testimony in this case.

First, when addressing the issue in the MGE *Report and Order*, the Commission did look to the national average for return on equity. The Commission, recognizing the significance of the average allowed return, stated as follows:

> Obviously, despite the fact that all three experts are relying on essentially similar DCF models, there is a very wide range in recommended return on equity between MGE's witness and those of Staff and Public Counsel. However, **there is one more number that the Commission must consider in establishing an appropriate return on equity.** In a survey of regulatory decisions from around the country, as reported by Regulatory Research Associates, the average allowed return in the gas utility industry for 2002 and 2003 was 11%. For the first quarter of 2004, the average return on equity reported was 11.1%. That is the market in which Southern Union will be seeking to raise capital. (emphasis added)

[20] Staff I.B., p. 30.

The Commission then compared the national average with the recommendation of MGE. Although the Commission also pointed to testimony by Staff witness Murray and Public Counsel witness Allen as further support for its decision, the Commission used Allen's CAPM (not DCF) analysis and Murray's *corrected* DCF analysis.

Second, it is a gross distortion of the facts for Staff to state that the Commission found support for MGE's authorized ROE of 10.5 percent by looking to "the testimony of the Staff and Public Counsel witnesses, who both relied primarily upon the DCF Model."[21]

Third, the record in this case is clear regarding average returns in other states. According to the Regulatory Research Associates, the average allowed ROE for electric utilities in the first quarter of 2004 was 11 percent. (Murry Surrebuttal, Exh. 13, p. 9) In this regard, Staff's and Public Counsel's recommendations are far below industry averages, and adoption of the same by this Commission will cause investors in Empire to lose millions in revenues that investors in other companies of comparable risks will receive.

3. Public Counsel's Recommendation

Public Counsel witness Allen recommends an ROE between the mid-point and high-end of his recommended range of 8.96 to 9.41 percent. To arrive at his recommendation, Allen performed a DCF analysis and a CAPM analysis on Empire and a "comparable" group of publicly traded electric utility companies. (Allen Direct, Exh. 81, p. 4) To arrive at the growth component of his DCF model, Allen relied on the "br + sv" input. (Vander Weide Rebuttal, Exh. 15, p. 20) Dr. Vander Weide noted that this method is widely used for non-utility companies, but problems arise when it is applied to rate-regulated companies such as Empire. (*Id.* at 21) Dr. Vander Weide explained how use of the

[21] Staff I.B., p. 31.

"br + sv" component in the DCF model is circular. (*Id.*) And Dr. Murry explained that "the method requires an estimate of the return on equity before an analyst can even calculate the growth rate used to estimate the return on equity." (Murry Rebuttal, Exh. 13, p. 18)

Dr. Murry testified that Allen's recommended ROE is "insufficient to assure the financial integrity of Empire." (Murry Rebuttal, Exh. 12, p. 15) Like Dr. Vander Weide, Dr. Murry found fault with Allen's choice of "comparable" companies and pointed to Allen's "dubious methodology" in applying the DCF model. (*Id.*) Allen's recommended return is "out of line with the allowed returns for utilities that appear to be lower risk and in a stronger financial position than Empire." (Murry Surrebuttal, Exh. 13, p. 9)

None of these criticisms have been refuted by the Public Counsel's Initial Brief.

4. Public Counsel's Criticism of Empire

To begin, Public Counsel criticizes Empire for hiring outside consultants.[22] Beyond this nonsensical attack, Public Counsel points to reliance on a growth rate of six percent and a failure to perform a "company specific" DCF analysis.

a. Dr. Murry's Recommendation

Public Counsel criticizes Dr. Murry's use of a six percent growth rate in his DCF analysis. Public Counsel notes that the six percent growth rate is double the growth rate number improperly used by Public Counsel witness Allen.[23] As discussed above, the criticism of Dr. Murry's chosen growth rate is without merit. First, the six percent growth rate is from arguably the most reliable source, namely *Value Line*, for DCF analysis. (Murry Surrebuttal, Exh. 13, p. 10, Schedule DAM-3)

[22] *See* OPC I.B., p. 2.
[23] OPC I.B., p. 7.

One reason for Value Line's significance for measuring investor expectations is its wide dissemination and availability to knowledgeable investors. (*Id.*) Moreover, Dr. Murry did not rely on *Value Line* analysts alone.

> Q. Did you check any other analysts to see what their earnings forecasts were?
>
> A. Yes. I looked at Zacks and FirstCall/Thomson, two services I do not normally use in my discounted cash flow analysis. Zacks has forecasted earnings per share growth over the next five years of five percent for Empire and five percent for the electric utility industry. Likewise, FirstCall/Thomson, which Mr. Allen used in his direct testimony, has forecasted for the industry a 5.4 percent growth rate. These are in line with *Value Line.*

(Murry Surrebuttal, Exh. 13, pp. 10-11)

Second, in the face of reputable analysts sources, including ones that Public Counsel Allen used in preparing his direct testimony, Allen's opinion of what investors should expect Empire's earnings growth to be over the next five years is not probative and has no value for determining an appropriate authorized return in this proceeding. The claim in Public Counsel's Initial Brief – "It is clear that a 6% growth rate is unrealistic and drastically overstates investor expectations"[24] – simply does not square with the facts in the electric utility industry and the evidence in this case.

Public Counsel also attacks the size adjustment performed by Dr. Murry in one of his CAPM analyses.[25] However, because of a "small firm bias," the adjustment was necessary. As Dr. Murry pointed out in his direct testimony, ". . . for the past two decades the academic literature . . . has been replete with evidence showing this small firm bias." (Murry Direct, Exh. 11, p. 23-24) Ironically, Staff and Public Counsel witnesses used data from Ibbottson Associates in their own CAPM analyses and disregarded the "small firm bias" cautions that Ibbottson Associates set forth for users of their

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[24] OPC I.B., p. 8.
[25] OPC I.B., p. 10.

data in a CAPM analysis. In fact, Dr. Murry, quoting Ibbottson Associates, stated: "One of the most remarkable discoveries of modern finance is that of the relationship between firm size and return." (Murry Direct, Exh. 11, p. 24) In his testimony, Dr. Murry explained that he applied the adjustment recommended by Ibbottson Associates. Dr. Murry once stated that "Mr. Allen may wish that the small firm bias does not exist in his CAPM application, but wishing that a statistical bias does not exist, unfortunately, does not make it go away." (Murry Surrebuttal, Exh. 13, p. 13) The same could be said for the arguments made in Public Counsel's Initial Brief.

Lastly, Public Counsel points to Dr. Murry's total market return of 14.55% used in his second CAPM analysis."[26] Public Counsel's position regarding the methodology for estimating market return in this case is surprising. As Dr. Murry pointed out in his surrebuttal testimony, his methodology on this point is the same as the one used by Public Counsel witness Mark Burdette in the previous Empire rate case, Case No. ER-2002-424. (Murry Surrebuttal, Exh. 13, pp. 13-14) Dr. Murry has also noted that, in this case, Public Counsel witness Allen's recommendation for measuring market return would exclude small companies, such as Empire, from the estimation of the beta to use for setting the return for Empire. (*Id.* at 13)

b. Dr. Vander Weide's Recommendation

Public Counsel criticizes Dr. Vander Weide's decision not to perform a DCF analysis on Empire and to look to a group of proxy companies instead.[27] All of the reasons and justification behind Dr. Vander Weide's chosen methodology will not be rehashed here. It should be noted, however, that Public Counsel's criticism in this regard is surprising due to the conservative nature of

[26] OPC I.B., pp. 11-12.
[27] OPC I.B., pp. 12-14.

Dr. Vander Weide's chosen methodology. Considering Empire's financial circumstances, as recognized by financial analysts and established by the evidence in this proceeding, it is only logical that Empire's cost of common stock would be equal to or higher than the current electric utility industry average of 11 percent. (Murry Surrebuttal, Exh. 13, p. 9) Rather than viewing Dr. Vander Weide's methodology as deficient for using proxy companies to estimate the cost of capital for Empire, perhaps Public Counsel should have recognized it for what it is – a very conservative method. Empire's ROE recommendation of 11.65 percent, which resulted from averaging Dr. Murry's recommended allowed return and Dr. Vander Weide's conservative recommendation, is in fact a modest request given Empire's particular financial circumstances.

5. Expert Qualifications and Expert Testimony

The standard for the admission of expert testimony in civil cases is that set forth in section 490.065, RSMo.[28] Empire's cost of capital witnesses, Dr. Vander Weide and Dr. Murry, clearly satisfy these statutory requirements. However, Staff witness Murray and Public Counsel witness Allen do not possess the requisite education or expertise necessary in order to qualify as "experts" in this proceeding. Reliance on Allen's or Murray's testimony on cost of capital issues will thwart the Commission's ability to award Empire the opportunity to earn a fair and reasonable rate of return, and Empire encourages this Commission to look to the lack of experience and training on the part of these witnesses when determining how much credibility, if any, to attach to their testimony.

Staff is unable to challenge the expertise of Empire's cost of capital witnesses. Instead, Staff attempts to discredit these witnesses by claiming they exercised too much professional judgment.[29]

[28] *State Board of Registration for the Healing Arts v. McDonagh*, 123 S.W.3d 146 (Mo. banc 2003).
[29] Staff I.B., pp. 23-25.

Staff appears to lament Dr. Murry's and Dr. Vander Weide's use of professional judgment when assessing the unique financial condition of Empire and the business risks that the Company faces. (*Id.*) If the Commission were to rely on the recommendations of Dr. Murry or Dr. Vander Weide, Staff alleges that the Commission would not be relying upon facts and data and legitimate expert testimony, but would instead be relying upon the statement, "I'm a PhD with lots of experience; trust me". (*Id.* at 25) Such a statement – or anything to its effect – was not uttered in this proceeding, and, contrary to Staff's assertions, there does not appear to be a single point in the record of this proceeding where Empire's cost of capital witnesses were unable to explain a conclusion or provide adequate justification for their statements and positions. Staff's suggestions to the contrary are simply wrong.

Drs. Murry and Vander Weide did not inappropriately apply professional judgment in reaching a proper allowed return for Empire, as alleged by Staff. Instead, if the Commission relies on the recommendations of Drs. Murry and Vander Weide, the Commission will be relying upon two credentialed, nationally-recognized experts in the field who independently applied somewhat different methodologies but reached similar and complementary results.

In the recent MGE case, the Commission recognized the limited experience on the part of Staff's and Public Counsel's cost of capital witnesses. The shortcomings present in the work of those individuals continue today. In this case, the witnesses simply have one more case behind them. They continue to proffer the same mechanical calculations; they continue to ignore the particular financial realities of the regulated utility; and they continue to violate the standards of *Hope* and *Bluefield* by recommending an authorized return that is not "commensurate with returns on investments in other enterprises having corresponding risks" and will not be "sufficient to assure confidence in the financial integrity of the enterprises, so as to maintain its credit and to attract capital." Dr. Murry's and Dr. Vander Weide's independent, detailed analysis of market conditions, financial circumstances, and risks are a sharp contrast to the weaker, mechanical analyses of Staff witness Murray and Public Counsel witness Allen.

D. Capital Structure (What capital structure is appropriate for Empire?)

Empire witness Dr. Murry testified that the appropriate capital structure for Empire for purposes of this proceeding is the Company's pro forma capital structure as of December 31, 2003, consisting of long-term debt of $336,496,611 or 43.89 percent; trust preferred securities of $48,292,848 or 6.3 percent; and common stock equity of $381,935,258 or 49.81 percent of total capital. (Murry Direct, Exh. 11, pp. 6-7) Staff urges the use of Empire's June 30, 2004 consolidated capital structure, consisting of 49.14 percent common stock equity, 6.32 percent trust preferred stock, and 44.53 percent long-term debt. (Murray Direct, Exh. 62, p. 24) Public Counsel recommends that the Commission utilize Empire's "actual capital structure" as of June 30, 2004.[30]

E. Cost of Debt (What embedded cost of debt is appropriate for Empire?)

Empire's embedded cost of long-term debt is 7.25 percent, with a cost of trust-preferred securities of 8.93 percent. (Murry Direct, Exh. 11, p. 7) Staff asserts that the embedded cost of long-term debt for Empire was 7.22 percent as of June 30, 2004. (Murray Direct, Exh. 62, p. 25) Public Counsel witness Allen testified that the appropriate embedded cost rate for Empire's long-term debt as of June 30, 2004, was 7.23 percent. (Allen Direct, Exh. 81, p. 6)

[30] OPC I.B., p. 3.

F. Conclusion

In summary, Empire again encourages the Commission to apply the standards set by the Supreme Court in *Hope* and *Bluefield*, allow Empire to compete in the capital markets, make necessary capital investments, and continue providing high-quality electric service, and allow the Company the opportunity to earn an overall rate of return of 9.54 percent, as illustrated below.

	Ratio	Cost	Weighted Cost
Long Term Debt	43.89%	7.25%	3.18%
Trust Preferred Securities	6.30%	8.93%	0.56%
Common Equity	49.81%	11.65%	5.80%
Total	100.00%		
COST OF CAPITAL/RATE OF RETURN			9.54%

II. Depreciation Issues

A. General

Under the heading of "no good deed goes unpunished," Staff appears to criticize the Company's effort to mitigate the impact of its depreciation proposal by complaining that Empire waited "until very late in this case to disclose how it supports an annual depreciation expense of $10.2 million when its depreciation study reflected an annual increase of about $25.6 million." (Staff I.B., p. 35) First, this is not true. Empire clearly stated in its direct testimony, which was filed at the same time it filed tariffs initiating this case on April 30, 2004, that, in an effort to mitigate the impact of what it believed to be an appropriate depreciation accrual, it was only seeking an additional $10.2 million of depreciation expense for purposes of this case. (Gibson Direct, Exh. 1, p. 5) Mr. Roff, in his rebuttal testimony, clearly delineated the way in which Empire proposed to generate an additional $10.2 million in depreciation expense by: 1) using a whole life technique; 2) extending the estimated date of retirement for the Asbury plant from 2014 to 2020; and 3) limiting negative net salvage factors to no more than 100%. (Roff Rebuttal, Exh. 19, p. 35-36)

More importantly, however, Staff fails to realize that the reason the Company's depreciation study results in such a large increase in annual expense is because Empire's existing depreciation rates are woefully inadequate by any standard. By eliminating net salvage costs from its depreciation rates in Case No. ER-2001-299, Empire was put in a position, relative to the rest of the industry, of having substandard depreciation rates and accruals. This is clearly evident from the comparison performed by Mr. Roff of Empire's current depreciation accruals versus other similarly situated electric utilities. (Roff Direct, Exh. 18, Sch. DSR-4) Accordingly, had Empire not been starting from such a substandard position, relative to the industry, it might have been able to pursue the full amount of Mr.

Roff's recommended rates without risking rate shock for its customers. Under the circumstances, Empire's proposal to mitigate its request for increased depreciation rates and expense is clearly a reasonable and appropriate course of action – one that should be commended, not criticized.

In a similar vein, Public Counsel states that Empire's proposed depreciation rates are unreasonable "because they will produce excessive depreciation expense that will, in turn, be charged to ratepayers." (OPC I.B., p. 15) Public Counsel defines an excessive depreciation rate as one that "produces depreciation expense which is more than necessary to return a company's capital investment over the life of the asset." (OPC I.B., p. 16) Of course, the only way to determine whether depreciation expense has been excessive (or inadequate) is with the benefit of hindsight, and there is absolutely no evidence in the instant record to demonstrate that Empire's past depreciation rates have over-recovered its capital investment. In fact, the actual experience in Missouri is for companies to not only under-recover their investment in plant but to be denied recovery of their legitimate costs of removal.[31]

Again, given the fact that Empire's composite depreciation rate is approximately 2.27%, as compared to an industry average of 3.08%, the empirical evidence in this record clearly leads to the conclusion that Empire's existing rates are not excessive, but woefully inadequate. (Roff Direct, Exh. 18, Sch. DSR-4) Moreover, Empire's proposal to increase depreciation rates and expense by approximately $10.2 million a year will only produce a composite rate of 3.35% clearly within industry norms and far from "excessive." (Tr. 1771)

[31] *See Missouri-American Water Company*, Case No. WR-2000-281, 9 MoPSC 3rd 254 at 286 through 287.

Finally, in what can only be described as a fit of hyperbole, Public Counsel states "If any one of these issues is decided in the manner that Empire requests, the impact upon consumers will be dramatic for Empire's customers and detrimental to the economic development of Southwest Missouri." (OPC I.B., p. 1) Not only is there nothing in the record to support this claim, but the evidence actually demonstrates that it is past Commission decisions on rate of return and depreciation that have caused rating agencies to downgrade Empire's investment rating which in turn raises costs to all ratepayers.

B. Net Salvage

1. General

At the outset, it is significant to note that neither Staff's nor Public Counsel's Initial Brief acknowledge the Commission's recent decision in the *Laclede Gas Company* rate case[32] which squarely addresses the issue of whether future net salvage costs are an appropriate component of depreciation rates. In fact, in what can only be described as a case of denial, the Staff admonishes the Commission to "recognize that, if it were to adopt Mr. Roff's remaining life depreciation study, the Commission would effectively be overturning its decisions in Case Nos. ER-2001-299 and ER-2002-424. In each of those cases the Commission approved rates based on the treatment of net salvage as the Staff has presented it in this case." (Staff I.B., p. 36) Incredulously, Staff seems to be suggesting that the Commission decision in Empire's 2001 rate cases is not only precedent for purposes of this case, but an unwavering statement of policy that cannot be changed. First, Staff's position ignores the Commission's conclusion in Empire's 2001 rate case when it first adopted Staff's

[32] *In the matter of Laclede Gas Company's Tariff to Revise Natural Gas Rate Schedules,* MoPSC Case No. GR-99-315, Third Report & Order (issued January 11, 2005).

proposed depreciation rates.[33] In that case, the Commission clearly stated its unwillingness to announce a hard and fast policy by stating:

> ". . . the Commission's conclusion in this case should not be taken as a final endorsement of Staff's 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." (10 MoPSC 3rd 463, 479)

Second, Staff's position is contrary to well established law that prior Commission decisions on an issue are neither precedential nor binding.[34] Finally, if what Staff says is true, then Staff itself would have been precluded from deviating from the "traditional" method of determining depreciation which the Commission had adopted for Empire for many years prior to 2001.

Continuing its denial of *Laclede*, the Staff quotes from a 1934 Supreme Court case to argue that the definition of depreciation does not require that the cost of removing plant after it is retired be a part of the development of an appropriate depreciation rate. (Staff I.B., p. 37) First, the *Lindheimer* case cited by Staff has nothing to do with the development of an appropriate depreciation rate. Second, Staff's definition is completely contrary to authoritative definitions of depreciation which the Staff witness acknowledges includes the recovery of net salvage costs. (Tr. 1795-1796) More importantly, and more pertinently, this Commission in the *Laclede* case has found that the development of an appropriate depreciation rate should include an accrual for future net salvage costs.

> The Commission finds that the fundamental goal of depreciation accounting is to allocate the full cost of an asset, <u>including its net salvage cost</u>, over its economic or

[33] The 2002 rate case was settled and the Commission made no finding or conclusion about the appropriateness of Company's or Staff's proposed depreciation rates.

[34] *State ex rel. Capital City Water Company v. Missouri Public Service Commission,* 850 S.W.2d 903, 911 (Mo. App 1993).

> 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.[35]

Consequently, there should be absolutely no question that the development of an appropriate depreciation rate includes an accrual for future net salvage costs. The only issue to be determined is the appropriate amount of future net salvage costs. In that regard, Mr. Roff has developed a reasonable and reliable estimate for future net salvage cost consistent with traditional analysis. He has compared the actual cost of removal, less salvage, with the original cost of the plant that is being retired. Not only is this a traditional way in which to calculate negative net salvage factors, it is the way in which Staff witness Gilbert and Public Counsel witness Majoros have performed this calculation in the past and it is the way in which it was calculated in the recent *Laclede* decision.[36] In fact, Mr. Roff has taken his analysis one step further and limited the amount of negative net salvage to be included in Empire's proposed depreciation rates by capping the negative net salvage factor at 100% for those accounts where his study determined that negative net salvage values actually exceed 100%. Thus, by any standard, the future net salvage values utilized by Mr. Roff in developing his recommended depreciation rates for Empire are reasonable and should be adopted.

Finally, the Commission should disregard Staff's and Public Counsel's rank speculation that future net salvage costs recovered by the Company currently will not be available for their intended use in the future. For example, Staff speculates that "the ability of Empire to manipulate the date it actually incurs cost-of-removal expense and the date it realizes salvage value could easily lead to over-recovery of net salvage from present ratepayers, if Empire's approach is adopted." (Staff I.B., p. 38) First, there is absolutely no evidence that Empire (or any other Missouri utility) has

[35] Third Report & Order, p. 9. (emphasis added)
[36] Third Report & Order, p. 8, 10-12.

manipulated retirement dates and dates when removal costs are incurred. Second, and more importantly, the Company's estimates of future net salvage costs are based on actual net salvage costs incurred in relationship to the original cost of the plant retired. Accordingly, the date on which net salvage costs were incurred, whether immediately with the removal of plant or shortly thereafter, has absolutely no effect on the fact that removal costs were incurred and, in many instances, exceed the salvage value of the property retired. What makes Staff's and Public Counsel's speculation most disturbing is the fact that recent history shows it is not the ratepayers who have paid for cost of removal that was never incurred, but rather the utility company that has incurred the cost of removal without appropriate recovery from their ratepayers.[37]

2. Net Salvage Related to Power Production Plant Accounts

Empire readily acknowledges that it is unaware of any Commission decision allowing recovery of future net salvage costs for the retirement of power production plants (other than nuclear plants). That does not mean, however, that there are no removal costs associated with the retirement of non-nuclear power plants. While the experience in Missouri has been somewhat limited, there is a good deal of experience around the country regarding the retirement of power plants which range from plants that have been retired and put back in service, to plants that have been "greenfielded."

In the Comments of the National Association of State Utility Consumers Advocates (co-authored by Public Counsel witness Majoros), filed with the Federal Energy Regulatory Commission (FERC) in its Docket No. RM02-7-000, NASUCA presented a Summary of Status of Electric Generating Units (50 MW or greater) Retired Between 1982 through 2001. In that summary, NASUCA notes that a total of 143 plants have been retired, with 77 being retired in place; 33 being

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[37] 9 MoPSC 3rd at 286 through 287.

dismantled; and 6 being greenfielded. (Exh. 138, Attachment A) In addition, Mr. Roff has accumulated extensive data regarding cost estimates for the retirement of power production plants. These estimates cover approximately 200 units throughout the United States and represent 70 to 80 studies either prepared by utility companies or demolition contractors. (Tr. 1600-1603) Nothing in Staff's Initial Brief or the Initial Brief of Public Counsel challenges the validity of Empire's dismantlement cost estimates. The only criticism apparently leveled at these estimates is that they are "self-serving" because many of them were prepared by the utility company. The fact of the matter remains, however, that it does cost money to retire and dismantle a power plant and some amount of that cost should be reflected in current depreciation rates. Staff and Public Counsel would apparently wait until the plant is actually dismantled and then recover the cost of removal, after the fact, from future generations of ratepayers who may or may not have received service from their retired plant.[38] Clearly, costs of removal for power plants are a reality, and the Commission should allow the accrual of those costs in the development of an appropriate depreciation rate.

C. Average Service Lives – Power Production Plant

As explained in its Initial Brief, Empire developed its recommended depreciation rates for its power production plant accounts utilizing a life span analysis. Essentially, this requires the depreciation analyst to determine a final date of retirement for each of the units and develop a rate to recover the investment in those accounts (plus net salvage) over the anticipated remaining life of the power production plant. (Tr. 1728-1729) Staff and Public Counsel, on the other hand, utilize mortality data and through the application of Iowa Curves, attempt to develop average service lives

[38] Of course this assumes that Public Counsel does not play a game of regulatory "gotcha" by arguing that removal costs should not be recovered from future ratepayers because the power plant is no longer used and useful (as Public Counsel did in the 2001 MAWC rate case).

for Empire's power production plants. The problem with Staff's and Public Counsel's approach is that there is limited data upon which to perform this analysis. (Roff Rebuttal, Exh. 18; pp. 5-6)

Staff and Public Counsel criticize the Company's life span approach because it is dependent upon the accuracy of the final dates of retirement for each of the plants. Public Counsel states the retirement dates proposed by Empire may have been chosen for their effect on depreciation rates. (OPC I.B., p. 25) Nothing could be farther from the truth. As Mr. Roff testified, the estimated retirement dates were provided to him by Mr. Beecher after considerable discussion. (Tr. 1583, 1590) Staff also criticizes Company witness Roff for his "apparently lack of familiarity with Empire's generating units." (Staff I.B., p. 48) On the contrary, Mr. Roff has extensive knowledge of the Company's generating units, has made on-site reviews, and has had lengthy and thoughtful discussions with Company personnel regarding those units and their estimated dates of retirement. Empire's projected retirement and the resulting life span for each unit was consistent with Mr. Roff's experience in the field. (Tr. 1582-1583) Unlike Staff witness Macias, Mr. Roff has extensive experience in the development of appropriate depreciation rates for the utility industry. Nevertheless, the ultimate accuracy of a projection can only be determined with hindsight review, and neither Staff nor Public Counsel is more prescient in this regard than anyone else.

There is no evidence in this record that Empire has recovered depreciation expense for its power production plants from its ratepayers beyond the date when those units are retired from service. In fact, accounting procedures are in place to prevent that from happening. As Mr. Roff testified, when a unit is retired from service, depreciation expense on that unit ceases. (Tr. 1739, 1755) If anything, history has shown that Commission approved lives for production plants have been overly long. In the case of MAWC's Old Water Treatment Plant in St. Joseph, Missouri (which was over 100 years old when it was retired from service in 2000), the depreciation rates approved by the Commission were based on a service life that did not expire until 2028. (6 MoPSC 3rd 549, 554) Given this history, the Commission should adopt the lives recommended by Company witness Roff and ensure that full recovery of plant costs are achieved rather than the lives recommended by Staff and Public Counsel which could likely result in undepreciated investment. Also, given the fact that the power plants typically are in service for long periods of time and that rate cases are filed on a relatively frequent basis, if it appears that Company's estimated retirement dates are not materializing, there is always the opportunity to extend those lives in subsequent cases.

D. FAS 143/FERC Order 631

Public Counsel recommends that if the Commission adopts Empire's proposal to accrue for future net salvage costs as part of its depreciation rates, "that unbundled specific identifiable net salvage allowance be included as a component of depreciation expense and recorded in accumulated depreciation." (OPC I.B., p. 23) This recommendation is based upon Public Counsel witness Majoros' belief that this separate accounting is required by SFAS 143 and FERC Order 631. Mr. Majoros' belief, however, is misplaced. Empire is maintaining its financial records consistent with the requirements of SFAS 143 and FERC Order 631. (Tr. 1700) At page 28 of its 2003 Annual Report, Empire states:

> Upon adoption of this statement in the first quarter of 2003, we recorded a non-recurring discounted liability and a regulatory asset of approximately $630,000 because we expect to recover these costs of removal in electric rates. This liability will be accreted over the period up to the estimated settlement date. The balance at the end of 2003 was approximately $656,000. Also, we reclassified the accrued cost of dismantling and removing plant from service upon retirement, which is not considered an asset retirement obligation under FAS 143, from accumulated depreciation to a regulatory liability.

(Roff Rebuttal, Exh. 19, p. 14) In other words, Empire has reclassified to a regulatory liability an estimated amount of net salvage in accumulated depreciation that has not been spent. (Tr. 1715) This is all that FAS 143 and FERC Order 631 require. To the extent Public Counsel recommends something further under the guise that it is required by FAS 143 and FERC Order 631, Public Counsel's recommendation must be rejected.

Of significance is the fact that Public Counsel witness Majoros made a similar argument to the Kentucky Public Service Commission on behalf of the Kentucky Attorney General regarding the requirements of FAS 143 and FERC Order 631. In rejecting his argument, the Kentucky Commission found as follows:

> The Commission is especially concerned by the AG's interpretation of the provisions of FERC Order No. 631. As discussed above, FERC Order No. 631 generally adopted the provisions of SFAS No. 143. The AG's proposal to establish a net salvage allowance relates to non-ARO assets, those assets for which KU does not have a legal retirement obligation. Concerning the removal costs associated with these non-ARO assets, FERC Order No. 631 states:
>
>> 37. The purpose of this rule is to establish uniform accounting requirements for the recognition of liabilities for legal obligations associated with the retirement of tangible long-lived assets. <u>The accounting for removal costs that do not qualify as legal retirement obligations falls outside the scope of this rule</u>. The Commission is aware that there is an ongoing discussion in the accounting community as to whether the cost of removal should be considered as a component of depreciation. However, this issue is beyond the scope of this rule and we are not convinced that there is a need to fundamentally change accounting concepts at this time.
>>
>> 38. Instead we will require jurisdictional entities to maintain separate subsidiary records for cost of removal for non-legal retirement obligations that are included as specific identifiable allowances recorded in accumulated depreciation in order to separately identify such information to facilitate external reporting and for regulatory analysis, and rate setting purposes, (emphasis added)

> The language in FERC Order No. 631 clearly does not require the separation of the net salvage component from depreciation rates or the creation of a net salvage allowance as advocated by the AG. The requirement that separate subsidiary records be maintained is significantly different from requiring separation from depreciation rates.[39]

In this case, Empire is fully complying with the requirements of FAS 143 and FERC Order 631. Empire has also indicated its willingness to track and account for net salvage amounts received in rates separately from other components of depreciation. (Empire I.B., p. 46) Consequently, Public Counsel's recommendation to unbundle the net salvage component from the accumulated reserve is neither necessary nor required by FAS 143 or FERC Order 631.

E. Conclusion

Empire has demonstrated in its testimony and its Initial and Reply Briefs the propriety of its depreciation request and the sound basis underlying the results of its study. By comparison, Staff and Public Counsel have largely resorted to rhetoric, hyperbole, and speculation, and have presented no sound evidentiary basis for their positions. In sum, Empire has requested a fair and reasonable level of depreciation expense in this proceeding, and the Commission should approve Empire's proposed depreciation rates.

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[39] *In the matter of an Adjustment of the Electric Rates, Terms, and Conditions of Kentucky Utilities Company,* Case No. 2003-00434; 234 P.U.R. 4th 177; 2004 Ky. PUC LEXIS 623, *Order,* done June 30, 2004. (emphasis added)

III. Fuel and Purchased Power Expense / Interim Energy Charge ("IEC")

A. What is the appropriate level of total Company on-system fuel and purchased power expense, and what cost recovery method should be used in this case?

As the Staff correctly notes in its Initial Brief, it is undisputed that Empire is heavily dependent on natural gas to fuel its generation to serve its native load and that the market for natural gas is extremely volatile. (Staff I.B., p. 58). The evidence in this case also is undisputed that, even after the comprehensive audit and some nine months of proceedings, no party has raised any issues with respect to the prudence of Empire's fuel expenses or its fuel purchasing practices. In fact, Staff witness Cassidy has commended Empire for Empire's hedging program (Tr. 631), which is as a practical matter about the only real way Empire can attempt to mitigate against the volatility of a natural gas market over which Empire has no control.

The record and the parties' initial briefs demonstrates the fundamental fact that Empire has not been and currently is not recovering its prudently incurred fuel and purchased power expense in current rates. Last summer, the Commission was persuaded by the other parties that it should not provide Empire any rate relief until the conclusion of this general rate proceeding. It should be obvious to the Commission that Empire's customers have clearly benefitted from rates which were not then, and are not now, compensatory. All of the risk and burden of rising natural gas costs thus far wrongfully have fallen solely on the shoulders of Empire's shareholders. The Commission's decision in this case necessarily must be based on the record evidence presented, not speculations, theories or even data which might be found outside the record and which have not undergone review and cross examination by the parties.[40] The Commission now must set Empire's new rates, based on

[40] This is precisely the position taken by the Public Counsel and Intervenors Praxair/Explorer Pipeline during the on-the-record presentation last July and it is as true now as it was then.

the competent and substantial record evidence before it, in such a manner as to finally allow Empire the opportunity to recover its prudently incurred fuel and purchased power expenses. For the Commission to do anything less as a result of this long case would be both unlawful and would send a strong signal that Missouri's regulatory process is far out of balance and is not working.

1. The appropriate level of total Company on-system fuel and purchased power expense.

As confirmed again by the initial briefs of the other parties, the *only* total Company on-system fuel and purchased power expense figure proposed by any party for use under the traditional (i.e. non-IEC) method of setting rates which is supported by competent and substantial evidence on the record is the figure proposed by Empire ($137,548,710 for 5,092,000 MWh, more precisely 27.01 $/MWh, Beecher Surrebuttal, Exh. 7NP, p. 5).

Public Counsel in its Initial Brief continues to exclusively support the traditional approach, but again merely references the natural gas price number it offered in prefiled testimony rather than a total Company on-system fuel and purchased power expense figure represented in a dollars per megawatt or kilowatt hour figure. Neither Public Counsel's own witness (Tr. 758), nor the Staff's fuel run witness Mr. Bender (Tr. 797), supported in testimony the fuel run referenced in Public Counsel's Initial Brief, which supposedly provides the basis for Public Counsel's claim (which Public Counsel failed to present in any prefiled testimony) that Empire's fuel and purchased power requirement should be slightly over $126,000,000. While for some reason electing not to question Public Counsel's position head on, it is clear from Staff's arguments in its Initial Brief that even the Staff does *not* support Public Counsel's natural gas number of $4.68 $/MMBtu, upon which Public Counsel's overall fuel and purchased power proposal is based.

Intervenors Praxair/Explorer Pipelines' Initial Brief continues to reflect the fact that they have offered no record evidence and are not advocating any particular figure for Empire's fuel and purchased power costs under the traditional method (Tr. 905). What little argument was made dealt with the rate design of a proposed IEC mechanism which Praxair/Explorer claim in any event to be illegal without the consent of the parties. The Attorney General's office, which did not participate in the fuel portions of the hearing or offer any type of fuel related testimony or evidence, limited its input on the issue in its Initial Brief to simply arguing against the legality of an IEC. The Staff in its Initial Brief reaffirmed its position that it has not offered any evidence with respect to Empire's fuel and purchased power expense under the traditional method, electing instead to focus most if not all of its arguments to support its own proposed IEC mechanism.

Although Public Counsel continues to exclusively support the traditional approach, the record is clear. Public Counsel's proposal is based on a fuel run which is not supported by *any* witness and which wholly lacks a total expense number quantified as a rate per megawatt/kilowatt hour. It nevertheless purports to result in a total Company on-system fuel and purchased power requirement of just over $126,000,000, a number which was not presented in prefiled testimony, and supposedly based on a weighted natural gas price of 4.68 $/MMBtu.

As already discussed in Empire's Initial Brief, the record shows and the Commission necessarily should find that Public Counsel's weighted natural gas price of 4.68 $/MMBtu is unreasonably low. It is lower than Empire's current *hedged* gas price for 2005 (Tr. 570), at current prices it is simply not possible to bring Empire's total 2005 gas costs down to the level recommended by Public Counsel (Tr. 711), and Public Counsel's methodology relying so heavily as it does on historical prices for *unhedged* gas is seriously flawed. (*See*, Beecher Rebuttal, Exh. 6NP, pp. 11-12).

The Public Counsel would have the Commission set ongoing, future rates at a level that the record evidence shows will not provide Empire a realistic opportunity to cover its prudently incurred costs on a going forward basis.

Unlike Public Counsel, Empire has provided the Commission with a complete case under the traditional method. Empire's fuel run results in a requirement of approximately $137,500,000, based on a weighted (hedged and unhedged) natural gas price of 5.69 $/MMBtu, and resulting in a total on-system fuel and purchased power expense of 27.01 $/MWh. (Beecher Surrebuttal, Exh. 7NP, p. 5, Sch. BPB-8). The record evidence shows that in times of rising natural gas prices and market volatility, forecast prices--rather than purely historical prices--while inherently and admittedly subject to some level of uncertainty, are a more overall reasonable and accurate predictor of costs which will be incurred when rates from this case will be in effect, and that moreover, a blind reliance on only historical prices in such an environment could have disastrous financial results for Empire. (Beecher Rebuttal, Exh. 6NP, p. 12). Even Staff in its Initial Brief concurs with Empire witness Beecher's assessment that a $1.00 swing in natural gas prices can mean a loss in pre-tax earnings of approximately $10 million for Empire. (Staff I.B., p. 58).

In its Initial Brief Staff criticizes Empire's reliance on forecasted prices, specifically the use of NYMEX futures prices. This approach is completely contrary to what Staff counsel told the Commission during the July 27, 2004 hearing where Staff at that time touted its "innovative" past use of forecasted fuel during times of high inflation. (Tr. 382-383). Staff apparently has backtracked on its earlier position. Staff witness Cassidy, in response to Commissioner Clayton, deferred questions regarding NYMEX futures to Staff witness Choe (Tr. 624, *see also*, Tr. 620) although he did agree that the Energy Information Administration (EIA), which was relied on by the Staff, was not itself a gas market where actual gas could be purchased. (Tr. 613). He later testified that the EIA figures relied on by the Staff in this case were also forecasted figures rather than an actual price available for purchase (Tr. 645). EIA, of course, is merely a governmental research body that accumulates data and is not a real world player or participant in the market. (Staff I. B., p. 64).

In its Initial Brief, Staff relies heavily if not exclusively on Dr. Choe's testimony in criticizing Empire's use of NYMEX futures prices. Staff witness Choe, however, was forced to admit that based on his own prefiled testimony and schedules, Empire's use of year ahead futures prices actually resulted in a *conservative* prediction of gas costs when compared to actual spot prices. (Tr. 667-669) Upon further questioning by Commissioner Clayton, Staff witness Choe could not offer a better predictor of gas costs than the data and method offered by Empire (Tr. 670-671) and admitted that as Staff's sole expert on the issue he lacked the necessary expertise in forecasting future prices (Tr. 674-675). Staff witness Choe later testified that he had no recommendation as to what Empire should do with respect to purchasing natural gas solely on the spot market instead of hedging gas on NYMEX, but that he believed it was good for Empire to use NYMEX for its hedging practices. (Tr. 667-678) Accordingly, the record evidence hardly supports Staff's claim in its Initial Brief that Empire's reliance on NYMEX futures amounts to "folly".

2. What cost recovery method should be used in this case?

Empire continues to be hopeful that the parties will be able to reach an agreement with respect to the submission of a mutually agreeable IEC proposal for the Commission's consideration. In the event that such an agreement is not forthcoming, however, Empire offers the following.

Empire in good faith initially proposed an IEC mechanism as an alternative to the traditional method of addressing Empire's fuel and purchased power expense hoping that as the hearing progressed the other parties would recognize the equity, benefits and reasonableness of such a mechanism during times of volatile natural gas prices. Even at this late stage of the proceeding, however, the Public Counsel and Intervenors Praxair/Explorer Pipeline continue to argue in their respective Initial Briefs that despite an IEC's obvious benefit to their respective clients the Commission does not have the legal authority to implement an IEC absent unanimous consent of all the parties. The Attorney General's Office, who supposedly represents only the interests of the State's Department of Natural Resources, in its Initial Brief takes this one step further by implying that an IEC is simply unlawful—period. More importantly for the Commission and especially for Empire, it is clear from their respective initial briefs that **none of these parties have yet agreed to waive their right to appeal the issue should the Commission ultimately order an IEC mechanism in this case.**

Contrary to Staff's implication in its Initial Brief, Empire has not been inconsistent with respect to its position on an IEC; rather, Empire simply has been forced to realistically assess the choices the other parties have necessarily forced Empire to make as this case progressed. As stated in Empire's Initial Brief, under the circumstances here and now presented, **the Commission should consider adopting an IEC mechanism in this case only if the ongoing threat of litigation is removed by either the enactment of timely legislation or by consent of all the parties.** This is so even if Empire in large measure might agree with the Staff's legal analysis as to the lawfulness of an IEC, and the overall benefits of an IEC mechanism generally, as set forth in Staff's Initial Brief.

Aside from the obvious disagreements between Empire and the Staff as to the merits of their respective IEC proposals (IEC floor, ceiling, term), this ongoing threat of litigation makes an IEC wholly inappropriate at this time, but more especially so with respect to the particular IEC proposed by the Staff. Unlike the Staff, Empire does not have the luxury of viewing this threat of protracted litigation as an idle one. Empire cannot simply ignore the obvious consequences of litigation over a Commission-ordered IEC, because, for the Company, the issue is not a mere academic exercise. Empire cannot financially afford to run the risk that a party might take action in court to tie up **all** of Empire's fuel and purchased power revenues above the IEC "floor" pending what might easily be years of litigation. That the Staff in its Initial Brief gives short shrift to this serious practical problem flies in the face of Staff's oft-stated concern for Empire's financial health and its claimed concern for Empire's shareholders.

The Commission must understand that this litigation risk is especially devastating for Empire, particularly if the Commission adopts Staff's proposed IEC with its IEC floor of $110.8 million. **In effect, all the revenues above Staff's IEC floor of $110.8 million (a figure based on $3.20 MMBtu gas) might be subject to a court-ordered impoundment pending a lengthy appeal.** To see the magnitude of the problem in real world terms, the Commission need only look to Public Counsel's traditional proposal, under which even the Public Counsel would allow Empire's base or permanent rates (not subject to refund and court impoundment) to be set much higher at just over $126,000,000. On this basis alone, the Commission should reject Staff's proposed IEC as being unreasonable and unjust on its face.

While this serious problem is **somewhat** mitigated should the Commission adopt Empire's proposed IEC with a higher floor of $120 million, the practical and fundamental problem created by the other parties' threatened litigation unfortunately remains and creates a serious and unnecessary financial risk which should greatly concern the Commission, if not its Staff. Unless a settlement is somehow reached, or unless Senate Bill 124 is enacted, signed into law, and made effective prior to the Commission issuing a decision in this case, the Commission should decline to adopt an IEC mechanism as part of this proceeding.[41]

B. What natural gas price should be used in determining permanent rates?

The Staff's and Public Counsel's criticism in their respective Initial Briefs of Empire's use of NYMEX futures prices in determining the natural gas cost component of Empire's total Company on-system fuel and purchased power expense already has been discussed above. The Commission necessarily must determine, based on the evidentiary record, the total Company on-system fuel and purchased power expense quantified as a rate per megawatt or kilowatt hour through a fuel run (Tr. 545-546), not just pick some isolated natural gas cost number. No party, other than Empire, has provided the Commission with the requisite record evidence necessary to accomplish this fundamental and necessary regulatory task. Moreover, Public Counsel's witness admitted on the record that Empire would not be able to purchase unhedged 2005 gas at Public Counsel's recommended price of $4.68 MMBtu and that Empire's current hedged price is even higher than Public Counsel's recommended gas price. (Tr. 709-711) That Public Counsel witness Busch's predictions as to natural gas prices have historically been proven to be too low also is a matter of record. (Tr. 713-715)

The record further shows that the NYMEX futures prices, used by Empire and to a limited extent even by the Public Counsel, are the most appropriate to identify and forecast the natural gas

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[41] Given the above discussion, items number 3 and 4 of the Staff's Issues List relating to the IEC deserve no further comment here than that already provided in Empire's Initial Brief. Empire would also direct the Commission's attention to Empire's and the Staff's already filed objections to Public Counsel's/Praxair/Explorer Pipelines' various "Joint Recommendations" respecting the IEC. As to IEC rate design specifically, barring a settlement among the parties, nothing stated by the parties' in their respective initial briefs deserve further comment by Empire other than that which already has been addressed in Empire's Initial Brief and in Dr. Overcast's prefiled and hearing testimony. (Tr. 869-879)

component of Empire's overall fuel and purchased power cost. Unlike the EIA utilized by Staff in testimony and discussed by Staff in its Initial Brief, NYMEX provides a standard contract by which to hedge natural gas commodity risk and is commonly considered the most liquid price transparent pricing point for natural gas in the United States. (Beecher Direct, Exh. 5, p. 9) Staff in its Initial Brief criticizes Empire for updating during the course of the proceeding its NYMEX figures as of the dates Empire filed its various rounds of testimony. It is undisputed that the price of natural gas rose significantly from the date Empire first filed its direct testimony last April and it therefore was only appropriate for Empire to update its fuel and purchased power position accordingly at the time it filed its subsequent rounds of testimony.

Staff, on the other hand, touts its "consistency" of position throughout the case (Staff I. B., p. 66) despite the significant rise in natural gas prices from the date of direct testimony. Unlike Empire, Staff never attempted to update its numbers from Staff's original filing. In fairness, this is presumably due to the fact that for purposes of this case "the Staff elected not to recommend a price of natural gas that should be used in determining permanent rates" (Staff I.B., p. 65), preferring instead to try to account for the rise in gas prices during the course of this proceeding within the parameters of Staff's proposed IEC. Staff witness Cassidy presumably agrees with Empire that Empire should be allowed the opportunity to recover its prudently incurred fuel and purchased power costs in rates. (Tr. 611) However, the fact remains that Staff clearly refused to offer an opinion, let alone record evidence, as to a reasonable and specific natural gas price based on current market prices to be used in setting permanent rates in this proceeding. (Tr. 627-628, 641-642)

What is clear from the record is that Staff's IEC floor amount, namely $110.8 million at 3.20 $/MMBtu cost for gas (which Staff presumably considers to be Empire's base or permanent rate amount, Staff I. B., p. 62), was based solely on an historical 32-month period of November 2001 thru the end of Staff's update period of June 30, 2004. (Staff I. B., pp. 63-64) (Tr. 655) Given recent natural gas market prices, not only is Staff's 3.20 $/MMBtu figure unreasonable on its face for purposes of setting permanent rates, it is substantially lower than even the single point 4.68 $/MMBtu figure urged by Public Counsel. While here disguised under the umbrella of an "innovative" IEC mechanism, in reality Staff has, in practical effect, once again in this case come in *below* the Public Counsel on this issue, just as Staff did with respect to Staff's recommended rate of return. Staff's stated concern for balancing the interests of Empire's customers and shareholders, when exposed this practical reality, rings hollow and appears disingenuous.

Empire's single point natural gas number utilized on the date Empire's surrebuttal testimony was prepared was 6.79 $/MMBtu. This price was then weighted against Empire's actual 2005 hedged position, resulting in a combined price of 5.69 $/MMBtu, which was then used in Empire's fuel run to support Empire's total Company on-system fuel and purchased power expense of 27.01 $/MWh. It is this natural gas price component which should be used to set Empire's going forward, permanent rates so that Empire will have the opportunity to recover its prudently incurred fuel and purchased power costs. The evidentiary record in this case and fundamental ratemaking fairness demands no less.

IV. Conclusion

For all of the foregoing reasons, and for the reasons set forth in Empire's Initial Brief filed herein, Empire respectfully requests that the Commission adopt its position on each of the contested issues in this proceeding.

Respectfully Submitted,

/s/ James C. Swearengen

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the foregoing was served upon all attorneys of record for each of the parties to this action on the 4th day of February, 2005, by First Class United States Mail, postage prepaid, by hand-delivery, and/or by electronic transmission.

/s/ Diana C. Carter