Missouri Public Service Commission

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Missouri Public Service Commission

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

RE: Case No. ER-2001-299

Dear Mr. Roberts:

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

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

Thank you for your attention to this matter.

Sincerely yours,

Dennis L. Frey

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DLF:ccl
Enclosure
cc: Counsel of Record

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Empire District Electric Company's Tariff Sheets Designed to Implement a General Rate Increase for Retail Electric Service Provided to Customers in the Missouri Service Area of the Company	))))))	Case No. ER-2001-299

TRUE-UP REPLY BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION

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

I. INTRODUCTION

On August 30, 2001, the Staff filed its True-Up Initial Brief addressing the only two issue areas that were contested in the August 23, 2001 true-up hearing; namely: (1) property taxes and (2) capital structure/cost of capital, and in particular, the embedded cost of Trust-Originated Preferred Securities ("TOPrS"). This brief presents the Staff's reply to the true-up initial briefs of other parties, regarding these two issue areas.

II. PROPERTY TAXES

In several places in the Company's *Initial Brief*, Empire makes the point that the payment of property taxes is a legal obligation that cannot be avoided by the Company, and for which negative consequences will ensue if such payments are not made. This argument is totally irrelevant to the issue at hand. The Company presumably has many legal obligations; for

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example, to pay income taxes in 2002, and no party is proposing to go outside the operation of law date in this case to give Empire a projected 2002 level of federal and state income taxes on the basis that Empire will be legally obligated to pay some amount to those taxing authorities next year. That is because, as with property taxes, income tax expense applicable to the year 2002 is not known and measurable. The relevant test here for inclusion of items in revenue requirement by the Commission is the "known and measurable" test, not a "legal obligation" test.

The true-up items included property taxes only if applicable. Staff does not believe it is proper or appropriate to include property taxes related to the SLCC Unit that will not be assessed until January 1, 2002 (three months outside the operational law date and six months outside the true-up period of June 30, 2001) and not be actually paid for until December 31, 2002 (fifteen months outside the operational law date and eighteen months outside the true-up period of June 30, 2002).

Staff contends that the issue is not whether property taxes will have to be paid by Empire on plant investment that is assessed on January 1, 2002, but rather what amount will actually be owed by December 31, 2002. Staff agrees that property taxes will be paid in the future but does not agree with the Company as to what value should be placed on this future expenditure. Both the Empire and Staff witnesses have indicated that no one could know precisely what amount will actually be paid for the Company's plant additions. Therefore, the property taxes associated with this item do not meet the "known and measurable" standard that has been used consistently by the Commission over the years.

What the list of true-up items actually says is that property taxes would be trued-up **if applicable**. The Commission should consider that the *Order Setting Test Year, Setting True-Up Hearing and Adopting Procedural Schedule* issued January 4, 2001 explicitly provided that the parties agreed that "the proper test year is the twelve-month period ending December 31, 2000, updated for known and measurable changes through June 30, 2001". Clearly, an event that occurs outside of this true-up period by some eighteen months, such as property tax payments, cannot be thought of as meeting the "known and measurable" standard.

On pages 4 and 5 of its *Initial Brief*, Empire makes the claim that its shareholders will have to pay in 2002 for the additional property taxes associated with the SLCC unit if that amount is not given to the Company by the Commission in this case. There is no factual basis for this statement. If Empire earns a reasonable rate of return for calendar year 2002, taking into account its actual revenue, expense (including property taxes) and rate base levels for that period, then shareholders will not be responsible for these specific property taxes. But neither Staff or the Company is capable of foretelling what Empire's future earnings or returns will be, so the Commission should not accept the Company's implicit forecast of its earnings that is implicit in its position on property taxes; i.e., that it will incur no offsetting revenue requirement benefits in the future that may offset all or part of the additional property taxes associated with the SLCC Unit.

The Company also claims that both its and Staff's approach to property taxes use "estimates", and therefore the Commission presumably should not be averse to utilizing Empire's more far reaching estimate of future property taxes for rate purposes. Indeed, Staff's recommended allowance for property taxes in this case is an estimate, as are all ratemaking allowances since in reality rates are set prospectively. However, there is a crucial difference between Staff's estimate and the Company's estimate. First, Staff applied a property tax rate (based upon past Empire experience) to the assessed value of Empire's plant as of January 1, 2001 to determine its recommendation. The January 1, 2001 assessed value of plant is the basis for Empire's actual property tax expense booked during 2001; i.e., the true-up period for this case. In contrast, Empire's estimate is based upon applying a property tax rate to plant that will not be assessed until January of 2002, and for which the associated property tax expense will not even be booked by the Company until January 2002. So, Staff's estimate of property taxes is based upon known and measurable factors, and preserves appropriate matching of all revenue requirement elements. Empire's estimate of property taxes is neither known nor measurable, and has no relationship in time with other elements of the revenue requirement calculation. All of these estimates use information that occurs within the true-up period. For example, the customer growth adjustment uses customer levels as of June 30, 2001. It is therefore inappropriate for Empire to use them.

On pages 7 and 8 of its *Initial Brief*, Empire attempts to explain its proposal to apply a "net present value" factor to its recommended property tax allowance to prevent the inevitable over-recovery of this item in rates if their position is adopted. This matter was briefly addressed in Staff's *True-Up Initial Brief*. Empire has made no offer of evidence for this late statement of position. In fact, it was not until questions from the Commission during the evidentiary hearing that Empire's counsel even made an attempt to address the Commission's concern on over-collection of property taxes. There is no support in the record for the Company's position of using "net present value" calculations to mitigate the over-collection of property taxes that will occur using the Company's method. Indeed, Empire appears to be conceding the point that it will over-collect property tax costs from its customers under their approach, by bringing up at this late date the use of present value methods. To reiterate, the reasons for Staff's opposition to this approach using net present value techniques does nothing to mitigate the improper matching caused by use of 2002 property tax estimates for rate purposes along with 2001 levels of rate base, revenues and other items of expense.

Staff does concur with Empire's estimate of the Missouri jurisdictional value of this issue being approximately $884,000 in this case, as opposed to the $1,027,000 amount referenced in Staff's *True-Up Initial Brief*. It is the $884,000 amount that should be compared to Empire's current rate increase request of approximately $41 million in assessing the likelihood of Empire filing another rate proceeding should the Commission rule against it on this issue.

III. CAPITAL STRUCTURE/COST OF CAPITAL

Return on Equity and Use of Hypothetical Capital Structure

The Company has attempted, through its Initial True-Up Brief, to inject into the true-up phase of this case two issues that are not germane to the true-up process. Those two issues are the proper return on Empire's equity and whether the Commission should impute to Empire a hypothetical capital structure.

As the Staff noted at pages 8-9 of its Initial True-Up Brief, the purpose of the true-up is to update for "known and measurable changes." There was no "known and measurable change," during the true-up period, in the facts surrounding the question of whether it is appropriate to use a hypothetical capital structure in this case. There was no testimony concerning the use of a hypothetical capital structure, other than the Company's rehash of the same arguments that it had advanced in the main case, and there was no testimony at all, during true-up, about changes affecting the return on equity. In addition, return on equity was not identified, in the Commission's Order Setting Test Year, Setting True-Up Hearing and Adopting Procedural Schedule, as an issue that was subject to true-up.

The Company's arguments on these points should be ignored, and the Staff will not waste its time and the Commission's time by rearguing those issues.

Nonetheless, the Staff does feel compelled to correct one misstatement on this subject in the Company's Initial True-Up Brief. The Company stated, at page 9 of its brief, that: "The Staff argues that because the average common equity ratio for a group of electric utilities is 38%, this mandates a similar result for Empire." The Staff did not anywhere advance such an argument. What the Staff actually said was that the Company's capital structure consists of 37.76% common equity, and that this is not significantly different from the capital structures of other electric utilities, as reported in C. A. Turner Reports. (McKiddy True-Up Surrebuttal, Ex. 125, p.2, lines 1-9).

The Embedded Cost of the Company's Trust Preferred Stock

The Staff calculated the embedded cost of the Company's trust preferred stock ("TOPrS") by first subtracting the unamortized issuance expense of the stock from the amount outstanding, and then amortizing this issuance expense over the 30-year fixed life of the TOPrS.

Public Counsel claims that this calculation method results in "double counting," but it has never explained in detail how it reached the conclusion that "double counting" occurred. (OPC Initial True-Up Brief, p. 3). The Staff submits that there is no double counting at all, but that the Staff's method of calculating the embedded cost of TOPrS allows the Company to recover the issuance costs of the preferred stock just once – by spreading those costs out over the period of time from now until 2031, when the Company is obliged to redeem the TOPrS at their full face value.

Although OPC contends that the Staff's method of calculating embedded cost is not the proper way to determine the cost of equity, it does acknowledge that the Staff's method is the appropriate way to determine the cost of debt. (OPC Initial True-Up Brief, p. 3). If, as Public Counsel claims, the Staff's method does, in fact, result in "double counting," why would the OPC believe that the Staff's method would be an appropriate way to calculate the embedded cost of debt? Surely it is not because the OPC believes that "double counting" is OK, when one is calculating the embedded cost of debt. Is it? It does not make any logical sense to employ a method that involves "double counting" -- whether one is calculating the embedded cost of *either* debt *or* equity. The Staff's method of calculating the cost of TOPrS is not "double counting" at all, and it is proper.

The OPC argues that because the Commission ruled, in an MGE case (Case No. GR-96-285), that TOPrS would be considered as equity in that case (for a limited purpose), they must also be considered as equity for all regulatory purposes in all subsequent cases. (OPC Initial True-Up Brief, pp. 1-3). OPC also suggests that the only thing that is consistent about the Staff's positions in the MGE case and in this case is a desire to always give consumers the "short end of the stick." (OPC Initial True-Up Brief, pp. 2-3). Neither argument has merit.

All parties agree that TOPrS are a hybrid, possessing characteristics of both equity and debt. (See discussion in Staff's Initial True-Up Brief, pp. 11-12). The characteristics of such securities may vary from case to case. Accordingly, they must be evaluated on a case-by-case basis, to determine whether they are debt or equity. The MGE case occurred several years ago, and it involved a different company and different facts. It would be particularly unwise to lay down a rule, in this case, that TOPrS must therefore be considered as equity for all regulatory purposes.

As all parties noted in their initial true-up briefs in this case, what the Commission actually decided in the MGE case was that TOPrS were to be regarded as equity for the limited purpose of determining whether MGE satisfied a financial benchmark regarding its capital structure. The Commission did not directly address the question of how to calculate MGE's embedded cost of preferred stock in that case.

The Commission did, however, state in its *Report and Order* in the MGE case, that: "MGE, Staff and OPC agree that the appropriate cost of preferred stock for purposes of this rate case is 10 percent." *Missouri Gas Energy,* 5 M.P.S.C. 3d 437,467. It would appear, then, that the method that all parties used to calculate the embedded cost of preferred stock in the MGE case was satisfactory to the Staff.

OPC's own witness in the present case, Mark Burdette, stated that the Staff's methodology in the MGE case was the same as its methodology in the present case. He testified on redirect examination as follows:

> A: (by Mr. Burdette): Staff's recommendation in GR-96-285 was consistent – the methodology was consistent with the methodology in this case.
>
> Q: Okay. And that would be to treat TOPrS as debt?
>
> A: That would be to cost TOPrS by not only subtracting unamortized issuance expense from amount outstanding, but also to amortize the issuance expense over the life of the security.

(Tr. 1240, lines 1-9).

The Commission's *Report and Order* in Case No. GR-96-285 offers no support for OPC's claim that TOPrS should be treated as equity when calculating their embedded cost. All three witnesses on this subject – Ms. McKiddy, Mr. Gibson and Mr. Burdette – testified that TOPrS have more of the characteristics of debt than of equity. (See discussion in Staff's Initial True-Up Brief, pp. 11-12). There is no sound reason to calculate the embedded cost of TOPrS like one calculates the cost of equity; it should instead be calculated in the same manner as the embedded cost of debt is calculated. The Commission should therefore find that the embedded cost of the TOPrS is 8.88%, as Ms. McKiddy and Mr. Gibson have testified.

IV. CONCLUSION

WHEREFORE, for the above-stated reasons and for the reasons stated in the Staff's True-Up Initial Brief, filed August 30, 2001, the Staff requests that the Commission adopt the Staff position on the true-up issues presented in this case.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 4th day of September 2001.

Dennis L. Frey

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