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Exhibit No.:
Issues: Year 2000 Cost
Other Computer Costs
Decommissioning Deposits
Witness: Arlene S. Westerfield
Sponsoring Party: MoPSC Staff
Type of Exhibit: Surrebuttal Testimony
Case No.: EM-96-149

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

ARLENE S. WESTERFIELD

UNION ELECTRIC COMPANY

CASE NO. EM-96-149

Jefferson City, Missouri
April, 1999

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

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SURREBUTTAL TESTIMONY

OF

ARLENE S. WESTERFIELD

CASE NO. EM-96-149

UNION ELECTRIC COMPANY

Q. Please state your name and business address.

A. Arlene S. Westerfield, 815 Charter Commons, Suite 100B, Chesterfield, Missouri 63017.

Q. Are you the same Arlene S. Westerfield who has previously filed direct testimony in this case?

A. Yes, I am.

Q. What is the purpose of this surrebuttal testimony?

A. The purpose of this surrebuttal testimony is to respond to the rebuttal testimony of witnesses Warner L. Baxter and Gary Weiss of Union Electric Company (UE or Company) and Benjamin A. McKnight of Arthur Andersen LLP. UE is sponsoring Mr. McKnight's rebuttal testimony. This surrebuttal testimony relates to the issues of Year 2000 Costs (Y2K), Other Computer Costs (CSS, EMPRV and AMRAPS) and Decommissioning Trust Fund Deposits as they relate to the third sharing period credit calculation for the Experimental Alternative Regulatory Plan (EARP or Plan).

The Company filed its rebuttal testimony on Friday April 2, 1999. On Tuesday April 6, 1999, the Staff submitted several data requests to the Company

asking for information in support of their rebuttal filing. Upon receipt of this additional information from the Company, the Staff may need to file supplemental surrebuttal testimony. The Staff will seek to do so as soon as possible after it receives responses to its outstanding data requests.

YEAR 2000 COSTS

Q. What are the major differences on this issue between the Staff and UE?

A. There are several major differences:

1. The Staff disagrees with the Company's contention that the Staff must adhere to the Emerging Issues Task Force (EITF) Statement No. 96-14 as it relates to this issue. (Baxter page 11, line 4)

2. The Staff disagrees that the Federal Energy Regulatory Commission Uniform System of Accounts (FERC USOA) requires Year 2000 costs to be expensed. (Baxter page 11, line 10)

3. The Staff disagrees that Y2K is somehow a garden-variety type of maintenance that does not rise to an extraordinary level as characterized by the Company. (Baxter page 12, line 4 and page 12, line 10) (McKnight page 11, line 21)

4. The Staff disagrees with Mr. Baxter's characterization that the name "Year 2000" is driving the Staff's proposed treatment of these costs. (Baxter page 13, line 17)

5. The Staff disagrees that Y2K is not a new category of cost as defined in the Stipulation and Agreement for Case No. ER-95-411. (Agreement) (Baxter page 14, line 14)

6. Staff believes the chart on page 14 of Mr. Baxter's rebuttal testimony showing prior year's computer maintenance costs is incomplete.

7. The Staff disagrees that Commission Orders subsequent to the Agreement are not relevant to this issue. (Baxter page 15, line 11)

8. The Staff disagrees with Mr. Baxter's characterization of my direct testimony on page 3, lines 8-9 and line 16 that there is a contradiction between "ongoing" and "non-recurring" as a description for Y2K. (Baxter page 17, line 19)

9. The Staff disagrees with Mr. Baxter's characterization of how Y2K deferrals will burden future customers. (Baxter page 18, line 4)

10. The Staff disagrees with Mr. Baxter's characterization of Y2K as being part of continuing computer maintenance expenses. (Baxter page 18, line 2)

11. The Staff disagrees with how the Company's characterizes the Staff not proposing an adjustment for Y2K costs during the first two sharing periods. (Baxter page 18, line 18)

12. The Staff disagrees that it is causing "squabbling" about this issue. (McKnight page 13)

13. Staff disagrees with UE's implications regarding Y2K prudence. (McKnight page 14, line 6)

I will address each of these items in the Company's rebuttal testimony in the order presented above.

Q. What is the Staff's issue relating to the relevance of the Y2K EITF?

A. As stated in my direct testimony, it has never been the Staff's nor the Commission's practice to let ratemaking matters be dictated by the accounting standards that constitute GAAP. Additionally, the Agreement does not in any way cite GAAP as being controlling, nor does it state that new GAAP pronouncements issued after the Agreement was signed are binding on the parties or the Commission. I previously discussed the relationship between GAAP and the Commission's ratemaking authority in my direct testimony in this proceeding.

Q. Doesn't EITF Abstract 96-14 (attached as Schedule 1) call for expensing of Y2K costs?

A. Yes, it does; however it also allows for the capitalization of some costs. The EITF Abstract indicates that "[t]his Issue is limited to the upgrading of existing internal-use software for the year 2000 and does not address purchases of hardware or software that replace existing software that is not year 2000 compliant."

Q. What is Staff's response when Mr. Baxter cites FERC USOA instructions for expensing computer maintenance costs?

A. Mr. Baxter fails to mention that the USOA also provides for the deferral of extraordinary costs. The Staff believes that material Y2K costs constitute an extraordinary item. As will be discussed later in my testimony, both Laclede Gas Company (Laclede) and Missouri Gas Energy (MGE) have requested the extraordinary treatment of deferring these costs. The Staff also believes that the EARP Agreement, dated June 12, 1995, could not be structured in advance to address a cost that was largely unknown at that time. Therefore, the Staff believes that Y2K should be considered a "new cost" category under the Agreement. These computer repair costs are occurring under a unique and radically different set of circumstances from computer maintenance activities that had occurred prior to the 1995 Agreement.

Q. Mr. Baxter, on page 12, line 4 of his rebuttal testimony says the UE work associated with the Y2K issue is nothing more than repairing existing software so that it may perform the functions it was originally intended to perform. He also says the approach is basically the same as performing any computer program maintenance. Does the Staff agree with this characterization?

A. No. Mr. Baxter implies that Y2K is a "garden-variety" maintenance expense. However, concerns exist nationally that there may be large-scale national disruptions of electric power, telephone service, banking and other essential services due to the Y2K changeover.

UE itself appears to view Y2K compliance with significant concern. UE participated in a Technical Conference, held on December 16, 1998, sponsored by the Commission where it presented a Year 2000 readiness disclosure called for by the United States Year 2000 Information and Readiness Disclosure Act. This presentation

(attached as Schedule 2) addressed many concerns. Also attached (Schedule 3) is the UE Year 2000 Statement prepared September 1998 by the Year 2000 Program Management Team. This was in response to the Commission Questionnaire on Y2K discussed in my direct testimony. Both documents indicate the concerns involved with the threat of a nationwide breakdown of essential services and specifically address how UE is preparing to avert massive computer failures.

UE's process of addressing the Y2K issue is not "business as usual" by any reasonable standard.

Q. Does UE belong to or have associations with organizations that are providing Y2K guidance and information?

A. Yes, it does. The following organizations are all providing Y2K guidance and information: Edison Electric Institute, Nuclear Energy Institute, Electric Power Research Institute and the North American Electric Reliability Council.

Q. Is the Y2K issue receiving attention from areas outside the electric industry?

A. Yes, it is. The Securities and Exchange Commission (SEC) has mandated disclosure requirements in business financial statements regarding Y2K costs. The financial reporting community developed an EITF Abstract, previously discussed, that specifically dealt with financial accounting concerns associated with Y2K costs.

Mr. Baxter and Mr. McKnight attempt to portray Y2K costs as being routine and ordinary. But, it is absolutely clear that the events giving rise to these costs have

received enormous amounts of attention in society as a whole, and in fact constitute an extraordinary event or occurrence.

Q. Mr. Baxter implies on page 13, line 14 the Staff is categorizing Y2K as a new category of costs only because of the name of the issue. Do you agree?

A. No. The Staff is not categorizing this as either "new" or "extraordinary" because of the name Y2K. The issue is that Y2K costs constitute extraordinary, non-recurring maintenance expenditures.

Q. Mr. Baxter states on page 14 of his rebuttal testimony that the Company has been incurring significant computer software maintenance costs over a long period of time. Does his chart on the same page support that statement?

A. Not necessarily. Mr. Baxter's chart is flawed in that it only contains computer software maintenance costs through June 1997. The costs for the current sharing period are not included. The Staff has asked that this chart be updated in Staff Data Request No. 94. Upon receipt of this additional information, the Staff will be able to more fully evaluate the chart.

Q. Mr. Baxter states on page 15, line 11 of his rebuttal testimony that "Statements made subsequent to this Agreement by the Commission in a case not directly involving Union Electric does not provide the Staff with any basis to propose adjustments to the Final Earnings Report under the terms of the Agreement." What is your response?

A. I disagree. Y2K costs are a category of cost that has not been included previously in ratemaking proceedings. The Staff must consider decisions made by the Commission respecting such matters. Further, the Agreement does not change the fact

under the Agreement. The Staff has submitted a data request to UE asking it to state its position on this question.

OTHER COMPUTER COSTS

Q. Please describe the major differences between the Staff and UE relating to other computer costs.

A. The major differences are:

1. The Staff disagrees that all computer software costs should be expensed because that is the Company policy. (Baxter page 21, line 14 and page 22, line 15)
2. The Staff disagrees that because expenditures have been addressed in general ratemaking proceedings they cannot be considered a new category of cost. (Baxter page 22, line 22)
3. The Staff disagrees that the significance of the amounts incurred is irrelevant to this issue. (Baxter page 25, line 6)
4. The Staff disagrees that it was aware of computer software development of the type incurred in the third sharing period prior to that sharing period and prior to the consummation of the Agreement. (Baxter page 25, line 11 and page 26, line 13)
5. The Staff believe the table on page 25 of Mr. Baxter's rebuttal testimony is incomplete.
6. The Staff disagrees with the relevance of UE's reference its new (1994) general ledger system in the Agreement. (Baxter page 26, line 8)

7. The Staff disagrees that future benefits of the computer projects are irrelevant to this issue. (Baxter page 26, line 18)

8. The Staff disagrees that UE must wait until the Company's rates are adjusted to reflect regulatory treatment of computer software costs by the Commission. (Baxter page 27, line 11)

9. The Staff disagrees with the Company's point regarding capitalization of software costs under the American Institute of Certified Public Accountants' Statement of Position No. 98-1 (SOP 98-1) and re-engineering costs under EITF Abstract No. 97-13. (McKnight page 18 and 19)

10. The Staff disagrees about the significance of the "in-service" date of the CSS system. (Baxter page 27, line 17)

11. The Staff disagrees with UE's claim that it is not important which customer classes benefit from the projects in question. (Baxter page 28, line 3)

12. The Staff disagrees with the Company's suggested five-year life for the computer systems. (Baxter page 28, line 10)

I will address each disagreement in the order presented here.

Q. Why do you disagree with the Company policy to expense all computer software costs?

A. The Company policy on expensing of computer software is unclear. In the attached Data Request No. 16 and Company response (Schedule 6), the Staff requested the following: "Provide all information available regarding company policy

relating to treatment of computer related items (hardware and software). Specifically detail what policy is followed and how it is determined what items will be expensed and what items will be capitalized." The Company responded that "Initial purchases and replacements are considered capital expenditures. Purchases of software and hardware enhancements are expensed as incurred. The design development and installation of information systems software are also expensed as incurred." Yet, as an attachment UE supplied a copy of an accounting policy, dated June 27, 1991, which deals solely with personal computer procedures. The Company's response to this data request also indicated that the determination between capital and expense is based upon the "Property Unit Catalog." This information seems to contradict Mr. Baxter's repeated assertion that all computer software costs are expensed as incurred.

The Staff believes there is a significant difference in expensing a new Customer Service System with the first phase costs alone valued at **_____** (See attached Schedule 7, Costs to Implement CSS) and the purchase of a personal computer. Not only the magnitude of the costs, but the nature of these projects which will provide benefits to future periods and future customers, clearly indicates to the Staff that at least some portion of the cost of these projects should be capitalized. This is why the Staff does not believe the Company it has explained thoroughly why none of these costs should be capitalized.

Q. Is there other evidence of long-term benefits to UE from installation of the new CSS?

A. Yes. **_____** (Attached as Schedule 11) **_____

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[redacted] **

Q. Is the Company's policy of expensing software costs consistent with GAAP?

A. Yes, with the caveat that GAAP in effect prior to SOP 98-1 would appear to allow either expensing or capitalization of software costs. (McKnight, page 16) Therefore, the Staff's position of capitalizing significant software costs is also consistent with GAAP. The Company's position on this issue is based on a belief that the Staff and Commission cannot challenge UE's choice as how to account for these costs.

Q. Mr. Baxter states on page 22, line 22 of his rebuttal testimony that because these expenditures have been addressed in several ratemaking proceedings they are therefore not a new category of costs. What is your response to this statement?

A. At the time of the filing of this testimony, the Staff is still waiting for a response to Staff Data Request No. 95, which asks the Company to provide a list of the ratemaking proceedings to which it is referring. Pending receipt of this additional information, the Staff is not aware of any past UE rate proceeding in which the

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Commission ruled in favor of expensing software costs. In any case, the Staff is proposing this adjustment on the grounds that UE has not provided a reasonable explanation for the increase in software costs in the third sharing period (i.e., expensing of capital assets).

Q. Mr. Baxter on page 25, line 6 of his rebuttal testimony thinks the significance of the software costs incurred in the third sharing period is irrelevant. He also states that Staff must have been aware that computer software development expenses of the Company were significant prior to the third sharing period. Do you agree?

A. The significance of the amounts is indeed relevant as can be seen in my prior reference to CSS **_____**. This issue came to the Staff's attention because of the magnitude of the amounts incurred and the fact that none of the amounts were capitalized though the new systems appeared to be in the nature of capital projects. Additionally, the reason the Staff is looking at these issues now is the very fact that they have increased in the third sharing period above the levels incurred in the first and second sharing periods. Another reason, as mentioned in my direct testimony, was review of Commission orders relative to these types of costs in several recent rate cases.

Q. Does the chart on page 25 indicate that there were significant computer software development expenses in the prior two sharing periods and periods prior to the Agreement?

A. The Staff has never disagreed with the Company that they have incurred ongoing computer software development expenses. Our issue with the

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Company is the significance of the projects under discussion in this credit period, with CSS being the largest. The Company itself classifies these items as major projects in its response to Staff Data Request No. 24, attached hereto as Schedule 8. Mr. Baxter's chart is incomplete in that it does not include the costs for the third sharing period. It is difficult to make a comparison of the extent of the increase for these items absent the expenses for the third period. We have submitted a data request to UE asking for the third sharing period information consistent with Mr. Baxter's chart.

Q. Mr. Baxter implies that Staff was aware of computer software development prior to the Agreement being entered into by his referring to Section 3.e.vi of the Agreement, which in turn refers to the installation of the Company's new general ledger system in 1994. What is your response?

A. I have reviewed this section of the Agreement, which deals with the reports and data that the Company must provide as part of the monitoring of the Plan. Section 3.e.vi refers to the current chart of accounts, which is part of data that must be provided by UE to the parties. This section reads in its entirety: "[c]urrent chart of accounts (revised/updated in 1994 when new general ledger system installed - 29 digit account numbers adopted." This reference to the new general ledger system obviously does not provide any information regarding the magnitude of the cost or whether this cost was expensed or capitalized, or otherwise provide guidance.

Q. Mr. Baxter also believes that it is irrelevant to the decision to expense software costs whether the costs will provide future benefits to UE or its customers. Do you agree with this statement?

A. No. Mr. Baxter seems to be saying that the Company can expense whatever it wants under the Agreement and the Commission and the Staff have preapproved such treatment. Clearly it is inappropriate for expenditures, such as capital assets, which will benefit future periods to be treated by the Company as current expenses.

Q. Mr. Baxter says that it is inappropriate for UE to change its accounting policy for these costs until the Company's rates are adjusted to reflect a corresponding change in regulatory treatment by the Commission. What is your response?

A. The Company has disclosed to the Commission, its outside auditors and the SEC that they will comply with SOP 98-1 on January 1, 1999. In fact, the Company response to the attached Staff Data Request No. 76 (Schedule 9) is, "[t]he Company intends to adopt SOP 98-1, on January 1, 1999, resulting in the capitalization of qualifying costs related to internal use software incurred after that date." It seems clear that UE in fact does intend to adopt SOP 98-1, whether there is a Commission order on software costs or not.

Q. UE states that SOP 98-1 is irrelevant to the third sharing period credit calculation because it is not effective until January 1, 1999. Are they correct?

A. Yes. However, paragraph 42 of SOP 98-1 indicates "Earlier application is encouraged in fiscal years for which annual financial statements have not been issued." Once again, it is purely UE's choice that it will not adopt SOP 98-1 earlier than 1999. In this regard, it should be noted that in 1998, Kansas City Power and Light Company adopted SOP 98-1 retroactive for the entire year.

Q. Mr. McKnight discusses SOP 98-1 on pages 18 and 19 of his rebuttal testimony. He specifically addresses accounting treatment of "re-engineering costs," stating they should continue to be expensed. What is your response?

A. Mr. McKnight says SOP 98-1 does not alter EITF Abstract No. 97-13, (Issue 97-13) which requires re-engineering costs to be expensed. He continues by saying that my proposed adjustments do not differentiate between costs that would be expensed vs. capitalized under both SOP 98-1 and EITF Abstract 97-13 (Issue 97-13). My proposed adjustments to the third sharing period did not differentiate this because the Staff does not believe any of the costs should be expensed and, in any case, the Company has never quantified how much of the software costs would continue to be expensed under SOP 98-1. To reiterate, from my direct testimony, however, the Staff's basis for this adjustment is not the issuance of SOP 98-1.

Mr. McKnight may not be aware that there is rate case precedent for capitalizing re-engineering costs in Missouri, such as the Commission Order in Case No. ER-97-394, et. al, Missouri Public Service.

Q. Do you have any further comments on re-engineering costs?

A. Yes. The Staff found the reference to re-engineering costs in Mr. McKnight's testimony to be particularly interesting, since UE made representations to the Staff in a prior meeting that strongly implied that UE was not incurring re-engineering costs. The Staff is investigating this apparent discrepancy through a data request.

Q. Mr. Baxter, on page 25, line 17 says that CSS was placed "in service" in December 1998. He says the in-service date does not affect the time of when these costs should be recorded as an expense. Do you agree?

A. Expenses by definition are booked as they are incurred. However, when regulators refer to "in-service" dates, it has always concerned capitalized assets, in the Staff's experience. Mr. Baxter seems to implicitly agree that CSS is a capital asset when he acknowledges that it was not "in service" until December 1998. (However, the Staff would note that December 1998 was still not within the third sharing period.)

Q. Mr. Baxter also mentions on page 28, line 3 that it is irrelevant what classes of customers are served by the CSS system. He indicates that it is irrelevant because this is not a typical ratemaking proceeding or rate design case. What is your response?

A. To repeat the relevant facts from my direct testimony, the CSS is not currently serving residential customers. In fact, to the Staff's knowledge, no decision has been made by UE yet as to whether it will ever serve residential customers. To suggest reducing residential customers credits for a cost that provides them no benefit whatsoever, as UE does, is truly outrageous.

Mr. Baxter again seems to be saying that the Company can treat any item it wants in any manner it desires under UE's interpretation of the Agreement and the Staff (and the Commission) cannot challenge the Company. The Staff believes that it is just for such issues that the parties to the Agreement are allowed to bring their differences before the Commission.

Q. Mr. Baxter on page 28, line 18 states he believes a five-year maximum life for these computer projects would be more appropriate than the ten-year life suggested by the Staff. If the Commission agrees with the Staff's position of capitalizing these project costs, what is your response?

A. I disagree with the proposed five-year life for these projects. It should be noted that the Commission ordered a ten-year life for MGE's computer hardware and software costs in Case No. GR-96-285. Ultimately, it is the Staff's understanding that the Company will work with the Commission's Depreciation Department to determine the appropriate depreciation rate for these costs once SOP 98-1 mandates capitalization of these costs for UE, in any case.

DECOMMISSIONING TRUST FUND DEPOSITS

Q. Please discuss the Staff's disagreement with the Company's rebuttal testimony on this issue.

1. The Staff disagrees that this is not a new category of cost. (Baxter page 46, line 20)
2. The Staff disagrees that the rate used in the Staff's adjustment is incorrect. (Baxter page 50, line 3)
3. The Staff disagrees that its calculation reflects more than one sharing period. (Baxter page 50, line 4)
4. The Company's Cash Working Capital (CWC) calculation is incomplete. (Weiss Schedule 5, page 1 of 2)

I will address each disagreement in the order presented above.

Q. Why does the Staff believe the decommissioning deposit amounts at issue should be considered a new category of cost under the Agreement?

A. The Staff believes that this is an example of an item that could not be reasonably anticipated by the parties when the Agreement was drafted. The fact that UE couldn't make deposits for an extended period of time certainly could not have been anticipated in the Agreement. The Staff believes this is an unprecedented circumstance and extraordinary in nature. Therefore, the Staff believes it meets the relevant criteria of being a new cost.

Q. The Company on page 46, line 19 argues that the Commission previously ruled that it can have the use of the decommissioning funds until they are deposited. Please comment.

A. The Staff does not disagree that the Company should have the use of these funds; however, we do believe that the impact of this extraordinary 'use' should be reflected in the credit calculation. The calculation as proposed by the Staff measures this impact. The Staff disagrees that this is a violation of the terms of the Agreement.

Q. Why do you disagree with the Company's preferred cost of money rate (Baxter page 50, line 3) selected for the calculation?

A. As mentioned in my direct testimony, the Staff selected the AFUDC rate because the Company had the additional money available to use for investment in construction. It is obvious from Mr. Baxter's testimony that because the AFUDC rate is higher than the short-term debt rate, the Company has used all of its short-term debt for construction.

Q. How do you reach the conclusion that the AFUDC rate is higher than the short-term debt rate?

A. This is based on the AFUDC formula contained in the USOA, wherein short-term debt is assumed to be the first source of funds for construction activity, with any additional investment assumed to come proportionately from long-term debt, preferred stock and common equity.

Q. Mr. Baxter states that "Ms. Westerfield's calculation of the proposed decommissioning trust fund adjustment includes imputed interest earned on funds associated with deposits which were to be made during the second sharing period (March 1997 and June 1997). Upon settlement of the credits associated with the second sharing period, the Staff relinquished their right to propose adjustments on these items during the third sharing period." Is he correct?

A. Absolutely not. The calculation of Staff's adjustment only considers impact of UE's use of the funds for those deposits outstanding during the third sharing period. To state this another way, the Company still had the funds collected in rates for the quarterly deposits (March 1997, June 1997, September 1997 and December 1997) available to them for most of in the third sharing period, and it was still in effect earning on these funds in the third period. The rates we calculated for purposes of the adjustment are only for interest applicable to the months of July 1997 through March 1998. The third period began in July 1997.

Q. Do you believe the Company's calculation of the cash working capital impact of the Staff's adjustment in Mr. Weiss' schedule is incomplete?

A. Yes. The Company has only included two foregone deposits in its calculations while the Staff believes it should consider each of the foregone deposits from the date the Company stopped making the payments.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Application of Union Electric Company For An Order Authorizing: (1) Certain Merger Transactions Involving Union Electric Company; (2) The Transfer of Certain Assets, Real Estate, Leased Property, Easements and Contractual Agreements to Central Illinois Public Service Company; And (3) In Connection Therewith, Certain Other Related Transactions	)	EM-96-149

AFFIDAVIT OF ARLENE S. WESTERFIELD

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Arlene S. Westerfield, is of lawful age, on her oath states: that she has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 23 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Arlene S. Westerfield
Arlene S. Westerfield

Subscribed and sworn to before me this 19th day of April, 1999.

TONI M. WILLMENO NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

Toni M. Willmeno
Notary Public, State of Missouri
County of Callaway
My Commission Expires June 24, 2000