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Missouri Public Service Commission

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Tariff to Revise Natural Gas Rate Schedules.	)))	Case No. GR-2002-356

AFFIDAVIT

STATE OF MISSOURI)
) SS.
CITY OF ST. LOUIS)

James A. Fallert, of lawful age, being first duly sworn, deposes and states:

1. My name is James A. Fallert. My business address is 720 Olive Street, St. Louis, Missouri 63101; and I am Controller of Laclede Gas Company.

2. Attached hereto and made part hereof for all purposes is my direct testimony, consisting of pages 1 to 37, inclusive; and Section C - Schedules 1, 2, 9, 11 to 13, 16 to 18 and 20 to 21.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded and the information contained in the attached schedules are true and correct to the best of my knowledge and belief.

Jas A. Fallert

James A. Fallert

Subscribed and sworn to before me this 24th day of January, 2002.

Kenneth M. Beerup Jr.

KENNETH M. BEERUP, JR.
Notary Public — Notary Seal
STATE OF MISSOURI
City of St. Louis
My Commission Expires: Dec. 19, 2003

Exhibit No.:	
Issue:	Test Year, Update, and True-Up Accounting Schedules SRP and CSRP Accounting Authority Orders
Witness:	James A. Fallert
Type of Exhibit:	Direct Testimony
Sponsoring Party:	Laclede Gas Company
Case No.:	GR-2002-356

LACLEDE GAS COMPANY

GR-2002-356

DIRECT TESTIMONY

OF

JAMES A. FALLERT

Direct Testimony of James A. Fallert

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DIRECT TESTIMONY OF JAMES A. FALLERT

General Information/Qualifications

Q. Please state your name and business address.

A. My name is James A. Fallert, and my business address is 720 Olive Street, St. Louis, Missouri 63101.

Q. What is your present position?

A. I am Controller for Laclede Gas Company ("Laclede" or "Company").

Q. Please state how long you have held your position and briefly describe your responsibilities.

A. I was appointed to my present position in February, 1998. In this position, I am directly responsible for the Company's customer accounting functions, and also participate in the preparation and review of financial statements, budgets, and financial plans.

Q. What is your educational background?

A. I graduated from Southeast Missouri State University in 1976 with the degree of Bachelor of Science in Business Administration, majoring in administrative management. In 1981, I received a Master's Degree in Business Administration from Saint Louis University.

Q. Will you briefly describe your experience with Laclede prior to becoming Controller?

A. I joined Laclede in July, 1976, and held various staff and supervisory positions in the Methods and Procedures Department, Internal Audit Department, and Budget Department until April, 1988, when I was promoted to the position of Manager of Budget and Financial Planning. I held this position until being promoted to Manager of Financial Services in February 1992. I was elected Controller effective February 1, 1998.

Q. Have you previously filed testimony before this Commission?

A. Yes, I have, in Case Nos. GR-90-120, GR-92-165, GR-94-220, GR-96-193, GR-98-374, GR-99-315, and GR-2001-629.

Purpose of Testimony

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to present evidence to the Commission covering the following:

1. Recommendations regarding test year, update, and true-up
2. Adjustments to Utility Operating Income
3. Wages and Salaries
4. Clearing Accounts
5. Non-Utility Allocations
6. Uncollectible Accounts
7. Emergency Cold Weather Rule
8. Benefit Plan Trustee Fees and 401(k) Expenses
9. Pension Expense and Assets

10. Incentive Compensation Plan

11. Post Retirement Benefits Other Than Pensions

12. Gas Safety and Copper Service Replacement Accounting Authority Orders

13. Gas Safety Replacement Programs

14. Taxes Other Than Income Taxes

15. Income Taxes

Q. Please list the schedules you are sponsoring.

A. The following schedules were prepared by me or under my supervision: Section C, TEST YEAR UTILITY OPERATING INCOME AND ADJUSTMENTS: Schedules 1, 2, 9, 11, 12, 13, 16, 17, 18, 20 and 21. These schedules contain the income statement as well as supporting detail for the wage and salary adjustment, pension adjustment, post retirement benefits other than pension expense, benefit plan trustee fees and 401(k) expenses, uncollectible accounts, non-utility allocations, amortization of deferrals made pursuant to the Gas Safety Replacement Program (SRP) and copper service replacement program (CSRP) accounting authority orders granted by the Commission, expenses associated with these programs, taxes other than income taxes, and income taxes. The income statement and adjustments are described later in my testimony.

I am also sponsoring several rate base items listed on Schedule A, including prepaid pension asset and SRP and CSRP Deferrals.

Test Year, Update, and True-Up

Q. What test period has Laclede used in this filing?

A. We have used the actual operating results as recorded on the books for the twelve months ended November 30, 2001, as a starting point. As is usually done in rate cases, we have made adjustments to this period to reflect normal operations. We have also "annualized" certain items. This means that we have made adjustments to treat the status at the end of the period as though it existed for twelve months. We have made other adjustments to provide for changes which have occurred since November 30, 2001 and to provide for reasonable changes which will be known and measurable by March 31, 2002. These adjustments to the test period reflect data that are more contemporaneous to the time when rates will go into effect.

Q. Why was the historical test year ending November 30, 2001 selected?

A. This period represented the most recent annual period for which actual booked results were available prior to this filing and which allowed sufficient time for preparation of the filing.

Q. Would it be appropriate for the Commission Staff to update the test period for this case?

A. I believe that the Staff should, as it has in the past, look at subsequent months to confirm the appropriateness of the Company's adjustment to the November 30, 2001 test year data. This is the same approach used in the Company's recent rate cases (Case No. GR-90-120, GR-92-165, GR-94-220, GR-96-193, GR-98-374, GR-99-315, and GR-2001-629).

Q. Please explain what information you believe Staff should review.

A. The Staff should look at the latest information available prior to its filing. Such information would most likely be available following the closing of March 31, 2002 business, depending upon the procedural schedule established in this case. The Company's filed case includes the estimated effect of a March 31 update.

Q. Is the Company requesting a true-up in this case?

A. Yes. Laclede requests a true-up through a date no earlier than July 31, 2002. It is essential that the most recent available information be included in the calculation of rates. Additionally, there are several significant events that will occur between the proposed update period of March 31, 2002 and July 31, 2002. These include but are not limited to changes in labor rates paid under the Company's union labor contracts, a possible change in the annual assessment paid to the Commission, changes in the annual contracts with health maintenance organizations, higher postage rates and annual calculations of FAS 87 pension expense.

Adjustments to Utility Operating Income

Q. Please explain what is contained in Schedule 1 of Section C.

A. This schedule shows the amounts recorded in the Company's books and records for the year ended November 30, 2001 for all the items of utility operating revenues and operating expenses as well as a final total for the Company's utility operating income for that period. The second column shows a summary of the normalization and annualization adjustments made to the actual test year results to arrive at the third column, which is the pro forma statement of operating income for the year ended November 30, 2001. The adjustments shown in the second column are listed and summarized on Pages 1 through 5 of Schedule 2 of this Section. Each of these adjustments is described by the sponsoring Company witness and most are detailed on Schedules 3 through 21.

Q. Please summarize the adjustments to utility operating expenses which you are sponsoring on Schedule 2 of Section C.

A. I am sponsoring adjustments to wages and salaries, clearing accounts, non-utility allocations, uncollectible accounts, benefit plan trustee fees, 401(k) expenses, pensions, post retirement benefits other than pensions, amortization of balances deferred pursuant to the SRP and CSRP accounting authorizations approved by the Commission in Case No. GR-2001-629, gas safety-related expenses, taxes other than income taxes, and income taxes.

Wages and Salaries

Q. Please explain the adjustment you are sponsoring related to the level of Laclede's wages and salaries.

A. Adjustment 5 on Schedule 2 of Section C is made to reflect known and measurable changes in the level of wages and salaries applicable to operation and maintenance expense. Detail for this adjustment is shown on Schedule 16 of Section C.

Q. Please explain how the adjustment to Laclede Division contract wages is calculated.

A. The Company's current labor contract with its Laclede Division union employees includes, among other changes, 2.75% annual increases in wage rates effective August 1, 2000, August 1, 2001, August 1, 2002, and August 1, 2003. Laclede Division contract wages charged to operation and maintenance were normalized to include the current labor contract provisions which were effective August 1, 2001, in order to present the full twelve-month impact of changes in those provisions. In addition, this adjustment increases wage expense for the effect on operation and maintenance expenses of the change in labor contract provisions which will occur on August 1, 2002, and also adjusts to the normal level of employees anticipated at March 31, 2002.

Q. Have you made any other adjustments to Laclede contract wages?

A. Yes. I have adjusted the percent of test year payroll allocated to operation and maintenance accounts to a five-year average.

Q. What is the purpose of this adjustment?

A. The operation and maintenance expense percentage of overall payroll expense tends to vary from period to period. I have used a five-year average for operations and maintenance expense in order to adjust the expense associated with manpower requirements to a normal level.

Q. Please explain the adjustment to Missouri Natural Division contract wages.

A. Missouri Natural Division contract wages charged to operation and maintenance were normalized to give effect to the wage increase for field unit workers of 2.75% effective April 15, 2001 in accordance with the current labor agreement. In addition, this adjustment increases wage expense for the effect on operation and maintenance expense of the increase in labor rates which will occur on April 15, 2002 under the provisions of the current labor contract. Additionally, the operation and maintenance percent was adjusted to a five-year average for the reasons discussed earlier in my testimony. Also, employees were adjusted to a normal level expected at March 31, 2002.

Q. Please explain the adjustment to management salaries.

A. Management salaries were adjusted to reflect anticipated salary levels at March 31, 2002. The operation and maintenance percent for management salaries was also adjusted to a five-year average.

Q. Have you made adjustments for fringe benefits as a result of the wage and salary adjustments discussed above?

A. Yes. The impact of the adjustments on costs which are directly related to wages and salaries has been included in the FICA tax adjustment and in the 401(k) adjustment included later in this testimony.

Clearing Accounts

Q. What is a clearing account?

A. A clearing account is used to apportion charges to operating and capital accounts which cannot practicably be charged directly to those accounts.

Q. Please provide an example.

A. One example is allowed time (i.e., holidays, vacation, sick time) for the Construction and Maintenance Department. Since employees of this department charge numerous accounts and work orders depending upon the type of work being performed, it is not practical to allocate allowed time directly to these accounts. Instead, allowed time is charged to a clearing account. The charges are subsequently apportioned out of the clearing account to the appropriate operating and capital accounts based on the amount of payroll directly charged to those accounts.

Q. How is the apportionment accomplished?

A. The allocation methodologies vary depending upon the type of charges involved. Apportionments out of the clearing accounts are made to equal charges into the accounts during each fiscal year period; but during the course of the fiscal year, the apportionments out of the clearing accounts often occur in different months than the charges into the accounts. Therefore, any 12 month period that is not a fiscal year may not include 12 months of charges.

Q. Please explain the adjustment that you have included in this case related to clearing accounts.

A. Charges into these clearing accounts exceeded the apportionment out of the accounts during the 12 months ended November 30, 2001 test period. Adjustment 6.e. increases test year expense to correct this imbalance and includes a full 12 months of clearing account charges in the test year.

Non-Utility Allocations

Q. Please describe the adjustments to non-utility allocations included in this case.

A. Adjustment 6.a., which is detailed on Schedule 17, normalizes the amount of expense allocated to the Company's non-utility affiliates and its merchandise operations in accordance with the principles outlined in the Cost Allocation Manual (CAM) submitted to the Commission Staff and Office of the Public Counsel on December 21, 2001. The adjustment to merchandise includes the removal from cost of service of the base salaries and associated expenses of Merchandise Sales Personnel.

Q. What types of expenses are included in these adjustments?

A. Items adjusted include salaries, benefits, supplies and expenses, rent, depreciation, insurance, annual report, and directors' fees.

Q. Have you included the impact of the pending acquisition by The Laclede Group of SM&P Resources, Inc.?

A. No. At this writing, this transaction has not yet closed, and the extent of services that may be provided to SM&P by Laclede personnel and assets is uncertain. In the event that the acquisition is completed, any such services will be accounted for in accordance with the principles in the CAM.

Q. Would you expect this acquisition to significantly impact Laclede Gas Company's costs?

A. No. Any costs incurred due to the need to provide services to SM&P would be allocated to SM&P in accordance with the CAM.

Uncollectible Accounts Expense

Q. Please describe your adjustment to uncollectible accounts expense.

A. I am sponsoring Adjustment 3.a. to Customer Accounts Expense, relating to Uncollectible Accounts Expense in the test period.

Q. Why is this adjustment necessary?

A. This adjustment reflects a normalized level of expense. Calculation of this amount is determined by multiplying the "percentage loss factor" times applicable normalized Company revenues. These calculations are shown on Schedule 9 to Section C.

Q. How was the percentage loss factor derived?

A. Uncollectible account write-offs for the five years ending November 30, 2001 were divided by net revenues for the five years ending on April 30, 2001. "Net revenues" are customer revenues less Transportation, Large Volume and Interruptible rate revenues, and less gross receipts tax expensed. This calculation results in the percentage loss factor shown on Schedule 9.

Q. Why are different time periods used for purposes of determining the uncollectible account and revenue amounts used in the calculation?

A. There is generally a seven-month lag between the revenue period when the customer is rendered service and the period when the customer's account will be written off. Uncollectible accounts written off for the year ending November are, therefore, compared with revenues for the year ending the prior April because such a seven-month lag period allows us to better compare write-offs with the revenue period that actually generated the write-off amount.

Q. Does this pro forma level of Uncollectible Accounts Expense include the effect resulting from higher revenues associated with this rate request?

A. Yes. The Company is entitled to recognition of the increased bad debt expense from higher revenues associated with this rate request.

Q. Are you aware of any other factors that could significantly affect Laclede's uncollectible accounts expense in the future?

A. In general, the Commission's rules regarding service disconnection and restoration are the most significant factors influencing uncollectible accounts. Other major factors include the economy in the service area, the collection policies of the Company, and the level of energy assistance (heat grant) payments. A major cut in grants, or a shortfall between the level of energy assistance available and the amount required by customers, would have a significant adverse impact on Laclede's uncollectible accounts.

Emergency Cold Weather Rule Amendment

Q. Please describe Laclede's position regarding the Emergency Cold Weather Rule Amendment ("Emergency Amendment") approved by the Commission in Case No. AX-2002-203.

A. Laclede Gas adopted the terms of the Emergency Amendment in the tariffs approved in its previous rate case (No. GR-2001-629). The Company implemented the provisions of these tariffs on November 20, 2001, and the tariffs formally became effective on December 1, 2001.

Q. What recovery mechanism for the cost of the rule was included in Case No. GR-2001-629?

A. The Stipulation & Agreement in Case No. GR-2001-629 included a methodology for the eventual determination of the cost of the Emergency Amendment upon its expiration on September 30, 2003. An annual amount of $750,000 for the recovery of these costs was included in rates effective December 1, 2001.

Q. What amount have you included in rates related to such recovery in this case?

A. Adjustment 3.a. in which I have normalized Uncollectible Expense, continues the $750,000 annual cost in rates in this case. However, I suggest a review of the status of customers who have received service pursuant to the rule at the end of the heating season, at which time any appropriate adjustments should be included in the update of this case. The final cost determination will still be made as of September 30, 2003.

Benefit Plan Trustee Fees and 401(k) Expenses

Q. Please continue your explanation of the adjustments you are sponsoring.

A. Adjustment 4.f., detailed on Schedule 13 of Section C, reflects increased trustee fees based on the increased value of the projected plan assets managed by the trustee at March 31, 2002, as well as increased 401(k) expenses.

Q. What adjustment have you made to 401(k) expenses?

A. Company contributions to 401(k) Wage and Salary Deferral Savings Plans have been normalized to reflect: (1) the adjusted wage and salary levels; and (2) the ½ percent increase in the Company matching contribution levels, effective April 15, 2001 for the Missouri Natural Division.

Pension Expense Overview

Q. What basis of accounting does Laclede use to determine pension expense?

A. Laclede calculates its pension expense on an accrual basis in accordance with Statement of Financial Accounting Standards No. 87 (FAS 87), "Employers' Accounting for Pensions," and Statement of Financial Accounting Standards No. 88 (FAS 88), "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination of Benefits." These standards were developed by the Financial Accounting Standards Board (FASB), which has responsibility for establishing Generally Accepted Accounting Principles (GAAP) to be followed by all companies that are publicly traded in the United States. Laclede was first required to adopt the provisions of these statements effective October 1, 1987.

Q. Please briefly describe the cost measurement objectives of FAS 87 and FAS 88.

A. One of the primary objectives of FAS 87 and FAS 88 is to ensure that pension cost is assigned to the time periods in which pension benefits are earned. Another objective of these statements is to provide a basis for ensuring comparability of reported pension cost between different companies, and consistency in amounts reported from period to period by an individual company.

Q. Please continue.

A. FAS 87 establishes the basic framework for calculating and accruing net pension cost. It attempts to recognize the compensation cost of an employee's pension benefits over the approximate working life of that employee. Pension cost is based on the valuation of two separate components: 1) plan liabilities for benefits earned by employees; and 2) qualified plan assets, if any, to pay such benefits. Changes in the value of pension liabilities are netted against changes in the value of plan assets to determine periodic net pension cost. Depending on the magnitude of the changes in these two components, total net pension cost may result in either expense or income to a company. FAS 87 also provides for systematic recognition (i.e., amortization) of gains and losses arising from differences between a plan's expected and actual experience.

FAS 88 is merely an extension of the FAS 87 measurement process. It generally requires immediate recognition of all or part of that portion of the

FAS 87 gains and losses that have not been recognized as of the date certain specific types of pension plan transactions or events occur. In Laclede's case, this could occur when lump-sum benefit payments are made to retirees in exchange for the full settlement of the Company's retirement obligation to them.

Pension Expense Accounting Policy

Q. What are the key pension policy considerations to be addressed in this case?

A. In past cases, the Commission has designated the FAS 87 accounting methodology to be followed by Laclede in recognizing unamortized gains and losses arising from differences between the pension plan's expected and actual experience.

Q. How does the current policy compare with that of Laclede's peers?

A. This policy can only be characterized as unusual and extreme and has exposed the Company to increased volatility relative to its peers.

Q. How unusual is this accounting policy?

A. I have been unable to identify any company in any industry outside of regulated utilities in the State of Missouri that follow this methodology.

Q. Please explain how the current policy developed.

A. Laclede's accounting policy has been changed numerous times in rate cases over the years, and each change has served to accelerate the recognition of gains or losses. Each of the changes was made in response to a Staff proposal to provide such accelerated treatment.

Q. What has been the impact of this acceleration on Laclede's financial results?

A. The current policy of acceleration has had several undesirable results:

1. Year-to-year volatility in pension expense has been increased to an unacceptable level, making recovery of appropriate costs in rates problematic since expense in any year can vary significantly from the level which has been included in the Company's rates due to the accelerated recognition of gains and losses inherent in the current accounting policy. Poor market returns on pension assets could easily force the Company to file a rate case solely to make up for reduced pension credits which can be generated by the inherent volatility built into the current policy. In fact, one of the primary reasons that Laclede filed this case so soon following the resolution of its previous case was concern over the impact on pension expense resulting from recent significant pension asset losses incurred in the equity markets.

2. The Company's cash flow has been severely restricted because such a significant portion of its income resulted from <u>non-cash</u> pension income. This hinders the Company's ability to meet its public utility obligations to its customers, such as investment in utility plant and procurement of reliable gas supplies, with cash income and instead requires the Company to borrow to meet these cash requirements.

3. The quality of the Company's earnings has been reduced significantly. This can result in lower credit protection measures and reduced interest

in the Company by investors as they become aware of this problem. This issue has received considerable attention in the financial press.

Q. How do you propose to remedy this situation?

A. I propose that the Commission order that Laclede's accounting policy revert to that originally implemented upon the adoption of FAS 87. This original policy was designed to mitigate the problems mentioned above and would do so now.

Q. Please contrast the proposed FAS 87 accounting policy to the policy currently in use.

A. The current policy calculates a five-year average of gain/loss balances, and then amortizes that average balance over five years. I mentioned earlier that this approach is both unusual and extreme. It is unusual in that, to my knowledge, there are no companies other than Missouri utilities regulated by this Commission which employ the five-year average of the gain/loss balance. It is extreme in that it uses a five-year amortization of the resulting average balance, which is an unusually short, and in my opinion inadequate, amortization period for this purpose. This short amortization period has been used to rapidly recognize pension gains which has resulted in a non-cash offset to revenue requirement. The short amortization period can also cause rapid recognition of market losses, which in turn has contributed to the need for the Company to file for increased rates in this case.

Q. Please continue.

A. The policy originally adopted by Laclede, and which I now propose implementing once again, includes several features which mitigate the problems caused by the current policy. Under this proposal, gains or losses are not recognized until they exceed 10% of the greater of the assets or liabilities in the pension plan, and asset gains or losses are recognized ratably over a five-year period. Once recognized, gains or losses would be amortized over the average remaining working service period of the participants in the plan (about 15 years). This is a more typical amortization period. This policy would recognize gains and losses in a much smoother and more orderly manner than the current policy.

Q. Has the Company considered other alternatives to the proposed changes in FAS 87 accounting policy?

A. Yes. Numerous discussions have been held, including discussions with Staff during the settlement negotiations of Case No. GR-2001-629. While the Company believes that the accounting policy proposed herein is preferable, Laclede is willing and eager to explore other solutions to the problems caused by the current policy.

Q. Please explain Laclede's policy regarding FAS 88.

A. As I mentioned earlier, FAS 88 is an extension of FAS 87 which, under certain circumstances, requires immediate recognition of gains or losses which otherwise would be amortized through the FAS 87 mechanism. FAS 88 requires such recognition in the event that lump-sum benefits paid to retirees exceed the sum of service and interest cost calculated under FAS 87.

Laclede's current policy, which was implemented as a result of the settlement of Case No. GR-2001-629, requires recognition only to the minimum extent required by FAS 88. This effectively sets FAS 88 income or expense at zero, since lump sum settlements are not expected to exceed the threshold required for recognition under FAS 88 (which is the sum of service and interest cost).

Q. Does this policy prevent ratepayers from realizing the benefit of any gains which would otherwise be amortized through FAS 88?

A. No, not at all. Unamortized gains and losses accumulated in the pension plans are amortized through both the FAS 87 and FAS 88 mechanisms. Eliminating the amortization of gains and losses through the FAS 88 mechanism simply means that those gains or losses are eventually amortized through the FAS 87 mechanism. In the long run, the pension expense recognized is the same under the new FAS 88 accounting policy as under the previous policy, but it is recognized in a much more orderly, less volatile, and consistent manner.

Q. What happens in the event that lump sum settlements in a year exceeded the sum of service and interest cost?

A. Under this unlikely circumstance, recognition of gains or losses pursuant to FAS 88 would be required. The Commission's order in Case No. GR-2001-629 established an accounting authority order allowing the Company to defer the difference between this recognized amount and the amount allowed in rates. This ensures that an unexpected FAS 88 recognition would not cause a significant over or under recovery of pension expense. I recommend that such order be continued in this case, and that the accounting policy regarding FAS 88 that was adopted in Case No. GR-2001-629 be continued.

Q. What would be your expectation regarding activity in this accounting authority order?

A. Activity in such AAO would be extraordinary and non-recurring.

Q. Please summarize your observations regarding the pension accounting policy currently followed by Laclede.

A. The policy regarding FAS 88 was significantly improved in the settlement of Case No. GR-2001-629. However, the larger portion of pension expense reflected in FAS 87 calculations remains a significant problem for Laclede. The accelerated recognition of gains or losses inherent in the current FAS 87 policy prescribed by the Commission is unusual in relation to policies followed by other companies both inside and outside of the utility industry. This policy has caused rapid recognition over the past several years of the unusually high gains earned by assets in Laclede's pension trusts during the bull market of the 1990s. As a result, pension cost included in rates has been in the form of significant pension <u>credits</u>, which have served to substantially reduce the Company's rates charged customers in the short term. These credits have generated a significant portion of the Company's earnings in recent years.

However, these are paper earnings only, which have forced the Company's borrowing requirements higher and higher.

At this point in time, many of the gains earned in the 1990s have been amortized, and the gain balances have been further reduced by the losses incurred as a result of the stock market's poor performance in 2000 and 2001. Laclede's pension costs are rising rapidly as a result of the past pension accounting policy. Following are Laclede's FAS 87 pension credits since the year prior to adoption of the current accounting policy, concluding with the estimated cost based on December 31, 2001 asset values included in this case:

Fiscal Year	Measurement Date	(Credit)
1998	6/30/97	$ (3,828,000)
1999	6/30/98	$(11,259,000)
2000	6/30/99	$ (9,070,000)
2001	6/30/00	$ (7,069,000)
2002	6/30/01	$ (4,940,000)
2003	*	$ (912,000)

*estimated, based on current accounting policy, December 31, 2001 asset values

The current accounting policy routinely produces year-to-year variations of millions of dollars in pension expense. In fact, the pension expense in this case reflects an increase over amounts in current rates of over $4 million primarily attributable to the manner in which pension expense is calculated under the current accounting policy, a change that occurred in only one year. The volatility and uncertainty caused by the current FAS 87 policy are contrary to the interests of the Company and its customers. The revised accounting policy proposed in my testimony should be adopted by the Commission in this case.

Calculation of Normalized Test Year Pension Expense

Q. How was the Company's normalized test year pension expense calculated for FAS 87?

A. The Company's normalized test year pension expense reflects FAS 87 pension cost calculated based on a measurement date of September 30, 2001, updated for December 31, 2001 asset values and the resulting June 30, 2002 amortizations. Adjustment 4.a. adjusts FAS 87 to normalized levels based on the current accounting policy. Adjustment 4.b. further adjusts FAS 87 expense to normalized levels based on the proposed accounting policy described above. These adjustments are further detailed on Schedule 11 of Section C.

Q. Please describe the normalization of test year expense for FAS 88.

A. Adjustment 4.c. adjusts FAS 88 expense to zero based on the current accounting policy.

Q. Should the pension adjustments described above be updated?

A. Yes. The next scheduled valuation of pension expense will be completed based on a June 30, 2002 measurement date and should be included in the true-up requested earlier in this testimony.

Prepaid Pension Asset

Q. You are also sponsoring the inclusion of the Company's net prepaid pension asset in rate base. Please describe what this amount represents.

A. In addition to accruing FAS 87 and FAS 88 pension cost, the Company must also fund the payment of such benefits. Sources of funding include: 1) cash contributions; and 2) changes in the market value of assets previously set aside for the payment of retirement benefits. Usually, there will be a timing difference between when pension expense (or income) is accrued and when cash contributions, if any, are required to fund benefits. To account for these timing differences, a company will record a prepaid asset or an accrued pension liability on its balance sheet for each of its pension arrangements.

At any point in time, the balance in the prepaid pension asset account represents the amount by which aggregate contributions and pension income booked since the adoption of FAS 87 and FAS 88 exceeds aggregate pension expense recognized during the same period. Correspondingly, accrued pension liabilities result when the opposite situation occurs.

Q. Why is it appropriate to include the net prepaid pension asset in rate base?

A. Over the years, the Company has recognized significant net pension plan gains through its FAS 87 and FAS 88 calculations. As a result, ratepayers during that period have benefited from the inclusion of lower pension costs (or higher credits) in rates. However, the recognition of these gains, which have resulted in the creation of the net prepaid pension asset, have not resulted in additional cash flow to the Company. This is because the gains that have been recognized relate to assets held under a pension trust arrangement. Such assets cannot be withdrawn without incurring severe penalties. The net effect of this treatment has been to lower the Company's revenue requirement and, therefore, its cash flows.

In consideration of the above, it is essential that the Company be provided with a return on its net prepaid pension asset in recognition of the fact that its investment in the asset has not been made with ratepayer provided funds, even while customers' rates have been reduced by the gains earned on those assets. This treatment is similar to the Commission's current treatment of deferred income taxes in rate base.

Q. How was the amount of the net prepaid pension asset included in rate base determined?

A. The prepaid pension asset included in rate base was calculated by netting estimated March 31, 2002 accrued pension liability balances against estimated March 31, 2002 prepaid pension asset balances, for all Company sponsored retirement plans. Balances for the SERP and Directors' Retirement Plans are only included for activity subsequent to December 27, 1999, since prior to that date recovery of expenses associated with these plans was on the basis of cash payments rather than FAS 87 and FAS 88, pursuant to Commission orders in previous rate cases. In rate case No. GR-99-315, cash payment basis recovery was discontinued, and replaced with recovery on a FAS 87/FAS 88 basis after December 27, 1999.

Q. What is the anticipated impact of the proposed changes in FAS 87 accounting policy on the prepaid pension asset?

A. Since the proposed changes result in pension expense rather than pension credits, they would be anticipated to have the effect of reducing the prepaid pension asset in the future (exclusive of the impact of any possible contributions).

Incentive Compensation Plan

Q. Please describe Laclede's Incentive Compensation Plan.

A. The Plan permits Laclede's Board of Directors to pay selected employees a portion of their salary and pension benefits in the form of share units. Employees who qualify receive quarterly payments which are the product of the share units and the Company's quarterly dividend paid on each common share of stock. Employees who meet certain criteria can continue to receive these payments after retirement. In addition, a deferred account is established for participating employees which accumulates the product of share units and retained earnings per share each year. The employee is paid the deferred amounts in retirement, if certain eligibility requirements are met.

Q. What are the eligibility requirements for employees to receive retirement benefits from the Plan?

A. No awardee whose employment with the Company is terminated, other than by retirement, disability, death or at his election following a hostile change in control, or who engages in any business which is competitive with the public utility business of the Company, is eligible to receive any payments under the Plan. All deferred compensation accrued prior to such termination or such competitive activity is forfeited.

Additionally, vesting requirements apply to new share units issued. Employees who are awarded new units must work a specified number of years depending upon their age in order to continue to receive the benefit of the share units after retirement.

Q. What is the purpose of Laclede's Incentive Compensation Plan?

A. The Plan provides Laclede's Board of Directors with a means of compensating selected executives in a manner which provides them an incentive to remain with the Company to retirement, and to keep working until normal retirement age rather than retiring early. The forfeiture and vesting provisions of the plan provide participants with a greater incentive to remain with Laclede than the alternative of straight salary and pension benefits. Additionally, the Plan provides participants with an incentive to maintain the Company on a financially sound basis since a portion of the participants' compensation is linked to the Company's financial results.

The Plan helps the Company attract and retain qualified key executives, without increasing the net cost to the Company, since such compensation would otherwise be paid in the form of ordinary salary and pension benefits in the absence of the Plan.

Q. Have you included adjustments to test year expenses related to the Plan?

A. Yes. The payments to current employees are normalized in the Wage and Salary adjustment sponsored earlier in my testimony. The retirement portions are normalized in my adjustment regarding pensions and postretirement benefits.

Postretirement Benefits Other Than Pensions

Q. Please explain your next adjustment related to the cost of postretirement benefits other than pensions.

A. Adjustments 4.d. and 4.e. on Schedule 2 of Section C, adjust test year expense to reflect the Company's expected cost of postretirement benefits other than pensions (OPEBs). Details of these adjustments are contained on Schedule 12 of Section C.

Q. Please describe the types of OPEBs provided by Laclede to its employees when they retire.

A. Laclede provides certain health and life benefits to eligible employees retiring from active service.

Q. What basis of accounting was used to determine the amount of postretirement benefit expense to include in cost of service?

A. As previously authorized by the Commission[1], postretirement benefit expense was calculated on an accrual basis in accordance with Statement of Financial Accounting Standards No. 106 (FAS 106), "Employers' Accounting for Postretirement Benefits Other Than Pensions." FAS 106 measures OPEB cost in much the same manner as pension cost is measured by FAS 87.

Q. Have previous Commission Report & Orders contained any other conditions or authorizations pertaining to FAS 106?

A. Yes they have. Beginning with the Commission's Report and Order in Case No. GR-94-220, and continuing in all the Company's general rate proceedings thereafter, the Company has been directed to fund its annual FAS 106 OPEB expense levels in accordance with the provisions of Section 386.315 (RSMo. 2000), which requires the use of an external funding mechanism.

Q. Is Laclede currently funding its accrued FAS 106 costs in an external trust, or other external funding arrangement?

A. Yes it is. Consistent with the Commission's previous orders and Section 386.315, the Company is currently contributing its annual FAS 106 cost levels into three external trust arrangements. Disbursements from these trusts can only be used for the payment of OPEB obligations.

Q. How was the amount of normalized OPEB expense to be included in the Company's cost of service determined?

[1] See Case Nos. GR-94-220, GR-96-193, GR-98-374, GR-99-315 and GR-2001-629.

A. Test year expense was adjusted to reflect the FAS 106 expense level for the fiscal year beginning October 1, 2000. As with the calculation of pension expense, FAS 106 cost was further adjusted based on the proposed change in accounting policy proposed therein.

Q. Should the OPEB adjustment be updated?

A. Yes. The actuarial calculations for the year beginning October 1, 2001 will be completed shortly and should be included in this case when available.

Accounting Authorizations

Q. Please explain the deferral related to the Gas Safety Replacement Program (SRP) and Copper Service Replacement Program (CSRP).

A. The Company incurs significant costs on projects related to these programs which are performed pursuant to the Commission's gas safety rules. Since the Commission rules mandate replacement of existing facilities at considerably higher cost than those currently on the Company's books, these projects increase expenses but have no effect on revenues. Given the mandated and extraordinary nature of these programs, the Commission has permitted deferral of these costs and recovery in subsequent rate cases in order to afford the Company the opportunity to earn the return authorized by the Commission.

Q. Have you included such recovery in the instant case?

A. Yes. Pursuant to the Commission's order in Case No. GR-2001-629, Laclede has deferred and booked to Account 182.3 the costs incurred for replacement of bare steel service lines and replacement and cathodic protection of bare steel and cast iron mains, as well as associated work on other facilities (SRP) and replacement of copper service lines (CSRP). Such costs include depreciation, property taxes, and carrying costs which would normally have been expensed beginning with the in-service date. Adjustment 6.b. on Schedule 2 of Section C includes recovery of costs deferred pursuant to authority granted in Case No. GR-2001-629 as estimated through March 31, 2002. Detail of these adjustments is included on Schedule 18 of Section C.

Q. Are you sponsoring any other adjustments related to these cost deferral mechanisms?

A. Yes. I have included the outstanding balance accrued pursuant to the authority granted in Case No. GR-2001-629 as well as the associated deferred taxes in rate base. Additionally, I have reduced revenues required by $157,000 to reflect imputed maintenance savings resulting from the Program, pursuant to the Stipulation and Agreement in Case No. GR-99-315.

Q. What amortization period have you used for recovery related to these mechanisms?

A. I have used a five-year amortization period.

Gas Safety Replacement Programs

Q. How should costs related to the Company's SRP and CSRP be handled in the future?

A. I propose that effective with the rates established in this case, the continuing costs which are scheduled to be incurred over the subsequent three years which are associated with the safety replacement programs be included in rates on an annualized basis. The Company has implemented a detailed program for the replacement of copper services, and continues its programs for replacement of bare steel services, cast iron mains, and bare steel mains. These programs are most appropriately dealt with in the ratemaking process, given their magnitude in cost and duration.

Q. Why is this proposal preferable to the Accounting Authority Order mechanism currently in place?

A. Replacement of facilities pursuant to the gas safety rules increases the Company's costs significantly, but has no impact on revenues since the new pipe serves the same function as the replaced facilities. To its credit, the Commission has partially offset this negative impact on the Company by permitting deferral of costs associated with continuation of the program for later recovery. While this mechanism provides some needed relief to the Company's book earnings, it provides no cash to the Company until years after the costs are incurred. For programs of the importance and magnitude of Laclede's SRP and CSRP, it is essential that the Company have available the cash resources needed to pay for the manpower, equipment, and materials required to accomplish the planned replacements. My proposal helps meet this need.

Q. Does this proposed adjustment compensate the Company for future increases in payroll costs?

A. No. The manpower needed to accomplish these programs is currently employed and working on the programs. The proposed adjustment simply includes the cost of the planned continuation of this work, which the Company is obligated to do.

Q. Are these costs known and measurable?

A. Yes. These costs are currently being incurred by the Company in the form of wages and salaries being paid to employees who are on the payroll today and are, therefore, known and measurable. Most of the costs of these programs consist of payroll costs and associated overheads.

Q. Are the details of the Company's safety replacement programs addressed by any other Company witness?

A. Yes, the specifics of these programs are discussed in the Testimony of Company Witness Craig R. Hoeferlin.

Q. Please describe the adjustments you are sponsoring related to gas safety replacement costs.

A. Adjustment 6.d. on Schedule 2 of Section C includes costs associated with continuation of the SRP and CSRP over the three years subsequent to the update period in this case. These costs include carrying costs on the average net plant investment, as well as associated depreciation and property taxes.

Q. Are there any other adjustments associated with the CSRP?

A. Yes. The Company performs annual inspections of copper services and also performs other inspections of copper services and buried fuel lines as part of its gas safety programs. These inspections are expense items under generally accepted accounting principles, and are, therefore, most appropriately recovered in current rates. These inspections are being charged to expense effective December 1, 2001 pursuant to the Commission's order in Case No. GR-2001-629. However, prior to December 1, 2001, these charges were deferred as part of the then effective Accounting Authority Order for later recovery. Since these charges were deferred during the test year in this case, it is necessary to make an adjustment to include them in cost of service. Adjustment 6.c. on Schedule 2 of Section C includes the cost of safety inspections in operating expense.

Taxes Other Than Income Taxes

Q. Please describe the adjustments you have made on Schedule 20.

A. Schedule 20 contains calculations and support for Adjustments 8.a., 8.b., 8.c., and 8.d. related to taxes other than income taxes set out on Schedule 2. Adjustment 8.a. calculates the adjustment of property taxes and manufacturers' license expense to reflect the increase in assessed value at January 1, 2002, and for the unrealized portion of such taxes applicable to net utility plant at March 31, 2002, at tax rates which were in effect during calendar year 2001.

Q. Please continue.

A. Adjustment 8.b. increases FICA expense to reflect the increased wage and salary level described earlier in my testimony and reflected on Schedule 16. Adjustment 8.c. adjusts Federal Unemployment Taxes for the taxable wages and tax rate effective January 1, 2002. Adjustment 8.d. reflects the increase in the City of St. Louis Payroll Expense Tax resulting from the wage and salary level changes described in Schedule 16.

Income Taxes

Q. Please describe Schedule 21.

A. Schedule 21 shows the calculations of the proper amount of income tax expense related to the adjusted Test Year and Pro Forma Utility Operating Income Statement. The resulting adjustment to income tax expense is included in Adjustment 9 on Schedule 2. Page 1 of Schedule 21 shows the differences in the recognition of revenue and expense for tax and book purposes, and the resulting calculation of taxable income.

Q. Do the pro forma adjustments listed on Schedule 2 of Section C also affect taxable income?

A. Yes. All of the pro forma adjustments affect taxable income, and consequently, they all affect either current or deferred income tax expense.

Q. Please continue.

A. Page 2 of Schedule 21 shows the calculation of the current, pro forma income tax expense. Finally, Page 3 of Schedule 21 shows the calculation of total income tax expense, including deferred income taxes and investment tax credit amortization. The pro forma investment tax credit amortization has been adjusted to match the lives used for calculating book depreciation as reflected in Adjustment 7.a.

Q. Are there any other items relevant to your testimony regarding the Company's calculation of pro forma income tax expense that you have not mentioned?

A. Yes. There are various items for which the timing of expense is different between financial reporting and tax reporting purposes. I have not included in the calculation of income tax expense on Schedule 21 the book to tax timing differences, known as Schedule M items, for which there is an equal and corresponding deferred tax offset unless the item appears in the determination of rate base. This treatment differs from calculations provided in previous rate filings, and is done in this case for the purpose of brevity only. The situation exists because income tax rates have not changed in recent years and the Company's deferred tax balances for the omitted items have been provided at rates equal to current income tax rates. The Company hereby reserves the right to include the omitted Schedule M items in future filings before the Commission should income tax rate changes result in deferred tax balances which are not provided at then current rates.

Q. Are you sponsoring any other adjustments to the income statement?

A. No, I have no other adjustments to propose at this time. However, I would note that because of rate impact considerations the Company has not made an additional adjustment to reflect the rate base and income effects of compliance with Commission Rule 4 CSR-240-10.020. Suffice it to say that such an adjustment provides additional support for the amount requested by the

Company in this case and alone would more than justify the level of rate relief requested herein.

Q. Does this conclude your testimony?

A. Yes it does.