

## MEMORANDUM

**TO:** Missouri Public Service Commission Official Case File  
File No. EU-2011-0387, The Empire District Electric Company

**FROM:** Amanda C. McMellen, Auditing Department  
Mark L. Oligschlaeger, Auditing Department  
Curt Wells, Energy Department

<u>/s/ Mark L. Oligschlaeger 08/17/11</u> Utility Services / Date	<u>/s/ Amanda C. McMellen 08/17/11</u> Utility Services / Date
<u>/s/ Curt Wells 08/17/11</u> Utility Operations / Date	<u>/s/ Sarah Kliethermes 08/17/11</u> Staff Counsel's Office / Date

**SUBJECT:** Staff Recommendation to approve in part and deny in part Empire's request for an Accounting Authority Order for certain accounting procedures for costs related to Joplin tornado on May 22, 2011.

**DATE:** August 18, 2011

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### **Authority Requested in Empire's Application**

On June 6, 2011, The Empire District Electric Company ("Empire") filed an Application for an Accounting Authority Order (AAO) requesting accounting treatment for what it characterized as extraordinary and unusual costs resulting from the Joplin tornado that occurred on May 22, 2011. Empire requests authority to defer these costs to Uniform System of Accounts (USOA) Account 182.3, Other Regulatory Assets, and amortize them over a five-year period commencing with the effective date of rates set in Empire's next general rate proceeding. Empire states in its application that it will incur approximately \$20 to \$30 million of incremental costs to rebuild and repair the damages to its system directly related to the tornado and severe weather. Empire states that it will seek recovery of these deferred amounts in future rate proceedings.

As part of its request, Empire seeks authority to defer certain incremental operations and maintenance (O&M) expenses it has incurred related to the tornado. These O&M expenses include labor and material costs to make repairs to its system in the immediate aftermath of the storm.

Empire also requests authority to defer the capital-related costs associated with new infrastructure placed into service as it rebuilds its system in the area affected by the tornado. Capital-related costs in this context refer to depreciation expense and carrying charges associated with capital expenditures once they are considered operational and used for service.

ATTACHMENT A

Empire states that the May 22, 2011 Joplin tornado damaged or destroyed an estimated 8,000 Empire customer locations. [Empire Application, page 4.] So, in addition to its requests for authority to defer the tornado-related O&M expenses and capital costs, Empire also requests authority to defer “the fixed cost components of the Company’s rates” resulting from what it alleges will be lower customer usage due to the tornado.

In summary, in this Application, Empire is seeking deferral treatment of:

- Incremental O&M costs incurred and to be incurred
- Incremental capital-related costs incurred and to be incurred
- Alleged financial impact of the tornado on sales (lost fixed cost recovery or “lost revenues”)

### **Background for AAO Deferral Requests**

In the past, the Missouri Public Service Commission (Commission) has granted authority for utilities to defer costs in a number of circumstances, almost always involving the occurrence of “extraordinary events” of various types. By allowing deferral of these costs, the Commission gave the utilities the opportunity to seek future recovery of the extraordinary costs in rate proceedings.

Some deferral requests pertain to incremental O&M expenses associated with extraordinary events or natural disasters. When granted, the expenses were booked as an asset on the company’s balance sheet, and subsequently amortized to expense on the income statement over a period of time, normally five years.

Other deferral requests pertain to incremental capital expenditures entered into by a utility as a result of an extraordinary event. When granted, the Commission authorized the company to defer the depreciation expense and carrying charges associated with the capital expenditures once it was considered operational and used for service. The normal accounting treatment associated with capital related deferrals ordered by the Commission is to amortize these costs to the utility’s income statement over ten years.

Commission Staff (Staff) has not found any prior instances where the Commission granted an AAO allowing deferral of the fixed cost components of the Company’s rates, or “lost revenues,” resulting from lower customer usage due to the extraordinary event or natural disaster.

### **Standard for Deferral Authorization**

In its Report and Order in Case Nos. EO-91-358 and EO-91-360, cases filed by Missouri Public Service, a division of UtiliCorp United, Inc. (now KCP&L Greater Missouri Operations Company) (“Order”), the Commission stated its criterion for deferral of costs incurred outside a rate case test year. The Commission has consistently used this same criterion since those cases. In that Order, the Commission stated:

The deferral of costs from one period to another period for the development of a revenue requirement violates the traditional method of setting rates.... Under historical test year ratemaking, costs are rarely considered from earlier than the test year to determine what is a reasonable revenue requirement for the future. Deferral of costs from one period to a subsequent rate case should be allowed only on a limited basis. [Order, pages 6-7.]

In the “Standards for Deferral” section of the Order, the Commission described the following criteria for allowing utility companies to defer costs incurred outside of a rate case test year as a regulatory asset:

1. Events occurring during a period that are extraordinary, unusual and unique, and not recurring<sup>1</sup>; and
2. The costs associated with the material event are material.

### **Application of Extraordinary and Material Standard to Empire’s Requests**

Staff concludes that the May 22, 2011, tornado was an extraordinary event for purposes of Empire’s requests to defer tornado-related O&M costs and related capital-related costs. Staff also concludes that the tornado was of a material nature for purposes of Empire’s requests to defer tornado-related O&M costs and tornado-related capital costs. The remainder of this section will consider only these items of relief requested in Empire’s Application. Staff will separately discuss Empire’s lost revenues request in the section “Authority to Defer Lost Revenues Should Not Be Granted.”

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<sup>1</sup> The Federal Energy Regulatory Commission (FERC) USOA defines the term “extraordinary items” in General Instruction No. 7. The FERC USOA for electric utilities reads as follows:

Extraordinary items. It is the intent that net income shall reflect all items of profit or loss during the period with the exception of prior period adjustments as described in paragraph 7.1 and long-term debt as described in paragraph 17 below. Those items related to the effects of events and transactions which have occurred during the current period and which are of unusual nature and infrequent occurrence shall be considered extraordinary items. Accordingly, they will be events and transactions of significant effect which are abnormal and significantly different from the ordinary and typical activities of the company, and which would not reasonably be expected to recur in the foreseeable future. (In determining significance, items should be considered individually and not be in the aggregate. However, the effects of a series of related transactions arising from a single specific and identifiable event or plan of action should be considered in the aggregate.) To be considered as extraordinary under the above guidelines, an item should be more than approximately 5 percent of income, computed before extraordinary items. Commission approval must be obtained to treat an item of less than 5 percent, as extraordinary.

Staff obtained from Empire, updated quantifications of its actual incurred tornado-related costs and estimated future costs associated with the May 22, 2011, tornado. Based upon data request responses received from Empire, through July 31, 2011, Empire has incurred approximately \$16.8 million in capital related costs and approximately \$1.3 million in additional O&M expenses associated with the tornado. Empire has further stated in a data request response that it expects the majority of the incremental tornado costs to be incurred within 12 weeks of the tornado's occurrence<sup>2</sup>, with the exception of costs to rebuild a substation destroyed in the storm.

Based solely upon the costs incurred by Empire through July 31, 2011, we estimate the deferral that would be booked by Empire if this Application is approved would be approximately \$1.3 million for O&M expenditures and \$1.4 million for capital related cost, for a total first year deferral amount of \$2.7 million. Based upon Empire's projection of total tornado-related costs, including projected costs past July 31, 2011, Staff estimates that the deferral to be booked by Empire if this Application is approved would be approximately \$1.825 million for O&M expenditures and \$1.95 million (annualized amount) for capital related costs, for a total annualized deferral of \$3.775 million. While O&M costs would be in essence deferred "once" as they are incurred, capital related costs would continue to be deferred until such time as those amounts are considered for rate treatment in future Empire rate proceedings.

Given the extent of damage relative to the size of Empire's system, the May 22, 2011 tornado was an extraordinary event. Further, from the evidence presented by Empire in its Application and obtained through later discovery, Staff has come to the conclusion that the required O&M expenditures and the capital-related costs associated with those expenditures have had and will have a material impact on Empire's financial position. For these reasons, Staff recommends that Empire's request to defer O&M expenses and related capital-related costs resulting from the tornado be granted subject to the conditions described in the "Staff Recommendation" section of this Memorandum. These conditions are summarized below.

### **The Carrying Charge Rate Should be Set Equal to the AFUDC Rate.**

When deferral of capital related expenses is allowed, current Commission practice is to set the carrying cost rate equal to the Company's ongoing Allowance for Funds Used During Construction (AFUDC) rate, as calculated in accordance with the Commission's USOA. The Staff recommends that this practice continue if authority to defer capital related costs is granted to Empire.

### **A Ten-Year Amortization Period Is Appropriate.**

Because a majority of the costs incurred to date and estimated to be incurred in the future by Empire related to the tornado are capital expenditures, Staff recommends that this deferral be treated in a similar fashion to prior capital expenditure deferrals. Past Commission practice has

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<sup>2</sup> Twelve weeks after the tornado was August 14, 2011.

been to utilize a ten-year period for purposes of amortizing capital expenditure deferrals. Empire requested a five-year amortization period, which has been more typically used for deferral of non-capital related extraordinary costs.

**Amortization of Deferrals Should Begin Reasonably Close in Time to Cost Incurrence.**

Empire's Application included the request that it begin to amortize any deferrals at the time rates go into effect in its next rate proceeding. Staff opposes this aspect of Empire's Application as being unreasonable. While granting of the deferral will allow Empire to avoid charging the majority of the financial impact of the tornado to expense in the year incurred (i.e., 2011), and instead spread that impact over subsequent years, it is not appropriate for a utility to "hoard" such deferrals for an extended period in its balance sheet and not charge any of the costs to expense until years after the precipitate cause of the deferred costs occurred. Staff has consistently recommended that amortizations to expense for deferred costs should begin shortly after the incremental costs associated with the extraordinary item have been incurred. In this case, Staff recommends that any deferral authorized by the Commission in this case should be amortized over 120 months (ten years), beginning January 2012.

**Any Deferral Order Should Have No Ratemaking Effect.**

In all past AAOs granted by the Commission that the Staff is aware of, the Commission included language in its orders making clear that the authorization was not determinative in any way on the question of future rate recovery of deferred costs. The Staff recommends that similar language is appropriate in any order related to this Application allowing Empire to defer costs.

**Any Insurance or Government Reimbursements Should Offset Deferral Amount.**

Empire has insurance to cover most of the cost to rebuild the substation that was destroyed. Therefore, only the payment of the deductible portion of the cost of rebuilding the substation should be included in the deferral amount. In addition, Staff recommends that any insurance or government proceeds applicable to incremental operation and maintenance expense or capital related costs be used to offset the total amount of deferred expense. It is not appropriate for Empire to have the opportunity to double-recover these costs.

**Empire Must Maintain Materials for the Subsequent Audit of Any Deferrals.**

Empire should maintain detailed supporting records, work papers, invoices and other documents to support the amount of costs deferred under any AAO, including any related deferred taxes recorded as a result of the cost deferral. Such records should include documentation of the controls in place to ensure all expenditures were reasonable and not utilized to take advantage of the situation, detailing of food and lodging costs, labor and material costs, procedures and verification for expense versus capitalization determinations, and determination of incremental levels of such costs versus normal ongoing levels of costs. Such

records should be made available for review by the Commission Staff, The Office of the Public Counsel, and other intervenors, pursuant to 4 CSR 240-2.085 and Section 386.480.

### **Authority to Defer Lost Revenues Should Not Be Granted**

In its Application, Empire seeks authority to defer the “loss of the fixed cost components of the Company’s rates...incurred by Empire and related to the events surrounding the May 22, 2011 tornado and severe weather...” Empire defines “the fixed cost components” discussed in its Application as “[f]iled tariff rates less the variable cost component of fuel and purchased power.” [Empire Application, page 4.]. Based on subsequent information from Empire, to clarify exactly what relief Empire seeks through this particular request: Empire is not seeking to defer certain “fixed costs” that would normally be included in its income statement. Instead, Empire seeks to defer the financial impact of not receiving a certain level of revenues from its customers that it assumes it would have received but for the tornado. In a data request response, Empire stated that its estimate of the amount of the lost revenues due to the tornado in 2011 is approximately \$4.4 million.

Empire’s request to defer and obtain the opportunity to seek subsequent recovery of lost revenues associated with an extraordinary event is unprecedented in this jurisdiction. Though many prior natural disasters in Missouri (for example floods, wind, and ice storms) resulted in a loss of customer load by the affected utility for a period of time, at no time in the past have these utilities included lost revenues (or “loss of fixed cost components of rates”) as a financial item for which deferral treatment was requested.<sup>3</sup>

Application of the standard outlined above for deferral of costs from one period to another period to Empire’s lost revenues request indicates that deferral of lost revenues is not appropriate. Notwithstanding Empire’s characterization of this aspect of its request as seeking to defer “the fixed cost component of its rates,” the information provided to Staff in this proceeding indicates that Empire has billed revenues sufficient to fully recover its fixed costs even after the tornado occurred<sup>4</sup>. Consequently, the impact of allowing Empire the relief it seeks by deferring “the fixed cost component of its rates” would be to provide Empire the opportunity to earn an increased level of return on equity (ROE), in subsequent periods to compensate it for the alleged decreased level of ROE it asserts it is currently earning due to the tornado. Staff asserts that the AAO mechanism should not be used simply to prop up a utility’s profit levels following an extraordinary event.

Further, there is a clear distinction between allowing deferral treatment of extraordinary expenditures incurred by a utility to make repairs and restore service following a disaster, and allowing deferral treatment of a certain level of revenues that is allegedly foregone due to a

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<sup>3</sup> Staff was unable to find a similar request for lost revenues in other states in a survey of cases for the last 25 years. Staff invites Empire to alert it and the Commission to any request it may have overlooked, or from a further time period.

<sup>4</sup> Staff does not concede that failure to fully recover fixed costs would constitute a lawful basis to authorize the deferral of lost revenues.

disaster. When considering the former category of financial impact associated with a disaster, it is vitally important and in the public interest for a public utility to make expenditures as necessary to repair damages to its system and restore service to customers as quickly as possible in an emergency situation following a natural disaster. Since this type of cost is not normally allowed in a utility's rates as part of ongoing expense, Staff believes, and the Commission has long held, that a utility should be allowed the opportunity to subsequently recover at least a portion of these unanticipated and extraordinary costs in its rates, through a "sharing" of these costs between customers and shareholders. "Lost revenues" are different from these extraordinary repair and restoration costs in that they are an estimation of "specific sales not made" due to the emergency event. It is not appropriate in this circumstance for regulation to offer a utility a financial guarantee of receipt of all or part of assumed "normal" customer usage or sales and, further, Staff asserts that the return on equity allowance included in a utility's rates is intended to compensate a utility for the risk of any fluctuations in sales or revenues from the level previously assumed in setting that utility's rates.

Finally, as a practical matter, any recognition of lost revenues in an AAO deferral requires that some baseline estimation be made of what the utility's customers usage would have been absent the extraordinary event; i.e., a "what-if" scenario must be relied upon. In reality, there are a multitude of factors that affect a utility's sales levels at any point in time, and accordingly, any "lost revenues" deferral will necessarily be an estimate and not a verifiable and auditable financial quantification. As an example of potential inequities in allowing a utility to defer an estimated amount of "lost revenues" for potential later rate recovery, the quantifications provided by Empire in this case of its estimated "lost revenues" due to the tornado have not taken into account in any way the increased sales it has experienced this summer. In addition to the effect of increased usage by other customer locations offsetting ceased or decreased usage at other customer locations, the positive impact on revenues of warmer-than-normal weather acts as an offset against any negative impact on revenues associated with the tornado on Empire's system, all or in part. Usage information provided to Staff shows that for the May and June 2011 billing months, the usage has been slightly greater than the usage in the May and June 2010 billing months and greater than the annualized, normalized May and June billing months used in the recent rate case, Case No. ER-2011-0004. The revenue of the May 2011 billing month was higher than the revenues in the May 2010 billing month while the June 2011 billing month was approximately the same as the revenues in the June 2010 billing month and higher than the annualized, normalized revenues in the rate case. The revenues from both the May and June 2011 billing months were greater than the May and June revenues used in the rate case.

### **Staff Recommendation**

As described above, the Staff concludes that Empire's tornado-related O&M costs and related capital-related costs are extraordinary in nature and material. Therefore, the Staff recommends that the Commission accept Empire's AAO Application in part in this case.

Specifically, the Staff recommends that the Commission grant Empire's AAO request as described below:

That:

1. Empire be authorized to defer actual incremental O&M expenses associated with repair and restoration activities associated with the May 22, 2011, tornado, and depreciation and carrying charges equal to its ongoing AFUDC rates associated with tornado-related capital expenditures, to Account 182.3, Other Regulatory Assets.
2. Nothing in the Commission's order shall be considered a finding by the Commission of the reasonableness of the costs and/or expenditures deferred, and the Commission reserves the right to consider the ratemaking treatment to be afforded all deferred costs and/or expenditures.
3. Any insurance claim proceeds or government payments or credits applicable to incremental operation and maintenance expense or capital expenditures shall be used to offset the total amount of costs to be deferred.
4. Empire is required to begin, as of January 1, 2012, ratably amortizing to expense, over a ten-year (120-month) period, the appropriate amount of all costs it is authorized to defer, which are directly related to the May 2011 tornado. Thus, the ten-year amortization period will conclude December 31, 2021.
5. Empire is to maintain detailed supporting records, work papers, invoices and other documents to support the amount of costs deferred under this AAO, including any related deferred taxes recorded as a result of the cost deferral. Such records shall be made available for review by the Commission Staff, The Office of the Public Counsel and other intervenors, pursuant to 4 CSR 240-2.085 and Section 386.480.
6. Empire's request for authority to defer the fixed cost components of the Company's rates resulting from sales lost due to the tornado be denied.



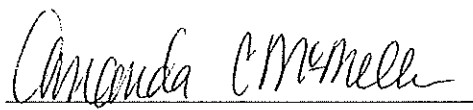
**BEFORE THE PUBLIC SERVICE COMMISSION**  
**OF THE STATE OF MISSOURI**

In the Matter of the Application of The Empire       )  
District Electric Company for the Issuance of an       )  
Accounting Authority Order Relating to its       )       File No. EU-2011-0387  
Electrical Operations and for a Contingent Waiver       )  
of the Notice Requirement of 4 CSR 240-4.020(2)       )

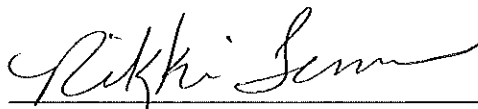
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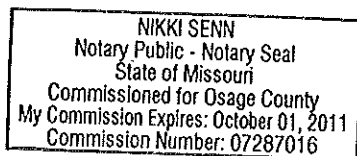
STATE OF MISSOURI       )  
  )  
COUNTY OF COLE       )       ss.

Amanda C. McMellen, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Recommendation in memorandum form, to be presented in the above case; that the information in the Staff Recommendation was developed by her; that she has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of her knowledge and belief.

  
Amanda C. McMellen

Subscribed and sworn to before me this 17<sup>th</sup> day of August, 2011.

  
Notary Public




**BEFORE THE PUBLIC SERVICE COMMISSION**  
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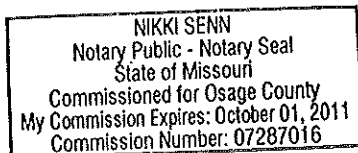
AFFIDAVIT OF MARK L. OLIGSCHLAEGER

STATE OF MISSOURI       )  
                                      )  
COUNTY OF COLE       )       ss.

Mark L. Oligschlaeger, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Recommendation in memorandum form, to be presented in the above case; that the information in the Staff Recommendation was developed by him; that he has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of his knowledge and belief.

  
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Mark L. Oligschlaeger

Subscribed and sworn to before me this 17<sup>th</sup> day of August, 2011.



  
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Notary Public


**BEFORE THE PUBLIC SERVICE COMMISSION**  
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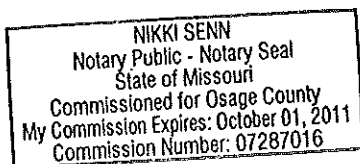
AFFIDAVIT OF CURT WELLS

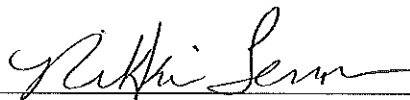
STATE OF MISSOURI       )  
                                      )  
COUNTY OF COLE       )       ss.

Curt Wells, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Recommendation in memorandum form, to be presented in the above case; that the information in the Staff Recommendation was developed by him; that he has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of his knowledge and belief.

  
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Curt Wells

Subscribed and sworn to before me this 17<sup>th</sup> day of August, 2011.



  
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Notary Public