EXHIBIT

Exhibit No.:	
Issue(s):	SFAS Pension Costs/ Patch Construction Costs/
Witness:	Ted Robertson
Type of Exhibit:	Rebuttal
Sponsoring Party:	Public Counsel
Case Number:	ER-2004-0570
Date Testimony Prepared:	November 4, 2004

REBUTTAL TESTIMONY

OF

TED ROBERTSON

Submitted on Behalf of
the Office of the Public Counsel

THE EMPIRE DISTRICT ELECTRIC COMPANY

Case No. ER-2004-0570

November 4, 2004

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

AFFIDAVIT OF TED ROBERTSON

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Ted Robertson, of lawful age and being first duly sworn, deposes and states:

1. My name is Ted Robertson. I am a Public Utility Accountant for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony consisting of pages 1 through 19.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

Ted Robertson, C.P.A.
Public Utility Accountant III

Subscribed and sworn to me this 4th day of November 2004.

KATHLEEN HARRISON
Notary Public - State of Missouri
County of Cole
My Commission Expires Jan. 31, 2006

Kathleen Harrison
Notary Public

My commission expires January 31, 2006.

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REBUTTAL TESTIMONY

OF

TED ROBERTSON

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2004-0570

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Ted Robertson, P. O. Box 2230, Jefferson City, Missouri 65102.

Q. ARE YOU THE SAME TED ROBERTSON THAT HAS PREVIOUSLY FILED DIRECT TESTIMONY IN THIS CASE?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of this rebuttal testimony is to address pension costs and costs associated with a construction company's failure to perform on its contract for work on the Energy Center 3 & 4 project.

SFAS 87 PENSION COSTS

Q. WHAT IS THE ISSUE?

A. On page 13 of my Direct Testimony in this case I indicated that the adjustments I've proposed regarding this issue were subject to modification pending the receipt

of additional information. Upon my review of the various data it is apparent that the Commission ordered a slightly different annual amortization level for the prepaid pension balance in Empire Case No. ER-02-424 than the amount that I calculated on my Direct Testimony Schedule TJR-2. Taking that fact into account along with a different electric company cost ratio adopted by the MPSC Staff in its Direct Testimony results in a difference of approximately $300,000 for rate base and $14,000 for the annual expense amortization. However, I believe that the Staff's calculation of the pension costs to be more in-line with the intentions of the Commission's prior order, and more accurate; thus, I recommend that the before jurisdictional allocated electric pension asset for rate base and the annual electric amortization expense as calculated the MPSC Staff witness, Mr. Doyle Gibbs, are the appropriate amounts to include in the determination of the Company's rates on a going forward basis.

Q. DO YOU ALSO AGREE WITH THE MPSC STAFF REGARDING THE DETERMINATION OF THE ACCUMULATED DEFERRED INCOME TAX OFFSET ASSOCIATED WITH THE PREPAID PENSION BALANCE?

A. Yes. It is my understanding that the Staff has imputed the associated deferred tax offset based on the current effective tax rate applied to the asset balance included in rate base. I believe that methodology is reasonable given that the Company's booked amount includes a mixing of the costs associated with the prepaid pension balance, and its continued use of SFAS 87 for book purposes.

PATCH CONSTRUCTION COSTS

Q. WHAT IS THE ISSUE?

A. The issue concerns whether or not Empire's Missouri rates should reflect a construction project cost overrun of approximately $3,648,717 related to its Energy Center Units 3 & 4 project.

Q. HOW DID THE COST OVERRUN OCCUR?

A. It's my understanding that on or about February 15, 2002, Empire and Patch Construction LLC ("Patch") entered into an engineering, procurement and construction agreement, the purpose of which was to have Patch engineer, procure and construct all facilities necessary to install two FT-8 TwinPak generators and associated balance of plant facilities to be located at 2537 Fir Road, Sarcoxie, Jasper County, Missouri. Patch subsequently failed to fulfill its contractual responsibilities and thus forced Empire to incur a significant cost overrun to complete the construction project.

Q. WHAT ARE THE CHARGES THAT THE COST OVERRUN REPRESENTS?

A. The amount of the original contract between Empire and Patch was $11,365,382. Additionally, approved change orders totaled $166,786.53. Empire and Patch subsequently added an addendum (i.e., Amendment-01) to the original contract. After Amendment-01 was finalized Empire began paying directly third party suppliers of labor, material, and services and paid Patch for its project related

payroll (prior to Amendment-01 Patch paid for all of these items and billed Empire based on a "percentage-complete" invoicing). In January of 2003, Empire's expenses related to the contract exceeded the base contract plus approved change order amount of $11,532,168.53 while construction was not complete and costs continued to be incurred. Empire began sending invoices to Patch on a weekly basis to be reimbursed for this contractual cost overrun (as per the terms of subsection 4 of Section A1.2 of Amendment-01). The total of these invoices reached $3,648,717.17 (meaning Empire's cost for services under the contract had reached $15,180,886.10) with no reimbursement received from Patch.

Q. WHEN WERE ENERGY CENTER UNITS 3 & 4 PLACED INTO COMMERCIAL SERVICE?

A. Company's response to OPC Data Request No. 1079 states that Energy Center Units 3 and 4 were placed into commercial operation on April 24, 2003 and April 25, 2003, respectively.

Q. HAS THE PROJECT'S $3.6 MILLION COST OVERRUN BEEN INCLUDED IN THE PLANT IN SERVICE OF THE COMPANY'S FILED CASE?

A. Yes. Company's response to OPC Data Request No. 1079 states that the $3,648,717 are costs Empire paid and invoiced to Patch. Empire is asking the Commission to include the $3,648,717 in the plant-in-service.

Q. PLEASE EXPLAIN WHY PUBLIC COUNSEL IS RECOMMENDING THAT THE COMMISSION NOT INCLUDE THE COST OVERRUN AMOUNT IN RATE BASE?

A. My position for recommending disallowance of the cost overrun is based upon the belief that Empire's management did not exercise sound business judgment in allowing Patch to forgo the purchase of a performance bond (which is essentially an insurance contract to protect the owner of the project should the construction contractor fail to fulfill the contract) that would have protected the Company from the additional costs it was forced to incur to complete the investment project. The position I have taken is based upon my knowledge of regulatory accounting concepts, procedures, and authoritative regulatory accounting literature. Regarding the prudent investment concept, Subsection 4.03(2) of the regulatory accounting guide, Accounting For Public Utilities, Hahne & Aliff, October 2003, states:

> "Prudent Investment" concept--Only plant prudently purchased or constructed is allowed in the rate base, or, to put it another way, any amounts determined to be acquired or constructed with either;
>
> (a) fraudulent intentions; or
>
> (b) in a manner that is obviously wasteful are excluded from the rate base.

Q. IS THE PUBLIC COUNSEL ALLEGING FRAUDULENT INTENTIONS ON THE PART OF EMPIRE ?

A. No.

Q. DOES THE PUBLIC COUNSEL BELIEVE THAT THE MANNER IN WHICH THE EMPIRE EXERCISED ITS DECISION-MAKING RESULTED IN ADDITIONAL PLANT INVESTMENT COSTS THAT WERE OBVIOUSLY WASTEFUL?

A. Yes. It is the Public Counsel's belief that Company's failure to enforce the original contract requirement for Patch to post a performance bond caused it to be "on the hook" for the financial responsibility to complete the project.

Q. PLEASE DESCRIBE THE BID AND SELECTION PROCESS THAT OCCURRED FOR THE PROJECT'S BALANCE OF PLANT AND INSTALLATION CONTRACTOR.

A. Company's response to MPSC Staff Data Request No. 423 included the document "Energy Center 3 & 4 FT8 Twin Pac Capacity Addition" which described the bidding process for the project. The document's Executive Summary states that once the supplier of the combustion turbine was chosen, the search for a balance - of-plant and installation contractor commenced. Requests for proposals were sent out with seven different contractors responding with interest in participating in the project. After all of the bids were evaluated, it was narrowed down to two

contractors, namely Patch, Inc. and Sega. These two contractors were interviewed and after further evaluation it was decided that Patch Inc. would serve as the balance-of-plant and installation contractor for the project. Beginning on page 4-1 of the document, progress on the bidding and selection process is further described:

> 4.0 Balance of Plant Contractor
>
> Once contracts were entered into with Pratt & Whitney for the purchase of FT8's, the next step was to find a balance of plant and installation contractor. Request for proposals (RFP's) were sent out on November 23, 2001 to several companies and a pre-bid meeting was held on November 29, 2001 with interested parties. Final bids for the project were submitted by December 20th by 7 different companies. The companies that submitted proposals were Black & Veatch, Bibb/Kiewit, Monsanto Enviro-Chem Systems, Alstom, Sega, Encompass, and Patch, Inc.
>
> The initial bids from the aforementioned bidders were evaluated by first evaluating what was included and not included in each bid. This evaluation process is summarized in Appendix B. Upon conclusion of this portion of the evaluation process, the FT8 Bid Analysis Team, comprised of Brad Beecher (Energy Supply Vic President), Joe Simmons (Energy Center Production Supervisor), Duane Zerr (Riverton Plant Manager), Bill Howell (State Line Combined Cycle Plant Manager), Blake Mertens (Energy Supply Staff Engineer), and Dale Jasumback (Energy Center Maintenance Foreman), met to eliminate several of the bids from consideration and decide upon two or three "finalists" that would be brought in for interviews/presentations.
>
> The bids were basically scored in three separate categories: cost, experience with the installation of FT8's, and overall intent or scope of the bid (how well did the bid meet the requirements of our RFP). The "Cost" category was slightly heavier weighted, four versus three, than the other two categories because it was felt that the other two categories in some ways were reflected in the "Cost"

category. The results of this scoring system are listed below in (Table 4-1).

Table 4-1 shows that even though Monsanto was the second lowest bidder from a cost perspective, it lacked greatly in the experience category and was only in the middle of the pack as far as meeting the expectation of Empire's RFP. Even though it appeared Patch was an overwhelming leader in the bid evaluation process, Empire felt that a final interview with the top two bidders, Patch and Sega, was warranted. After meeting with representatives with these two companies on the 16th and 17th of January, the Bid Analysis Team felt that both companies were capable of completing the project but because Patch's bid price was so much lower than Sega's (even though both bids did not account for all costs in the project), Patch was the clear cut choice to proceed into final contract negotiations with. On February 15th, 2002 Empire and Patch signed a contract for the installation of the FT8's and all balance of plant equipment for a price of $11,365,382.

Q. DID ANY OF THE SEVEN BIDDERS ANTICIPATE COSTS ASSOCIATED WITH A PERFORMANCE BOND FOR THE PROJECT?

A. Yes. As shown in Appendix B of the document I just described, five bidders (Patch, Sega, Bibb-Kiewit, Alstom, and Black & Veatch) recognized that the cost of a performance bond, while not actually included in the bids they provided, was a likelihood. Sega quoted the bond cost at 1.5 percent of its bid. Bibb-Kiewit stated the cost would be provided upon request. Alstom stated it could be included as an option. Niether Patch nor Black & Veatch quantified the cost of a performance bond but they both recognized its probability in their respective bids by stating that their bids did not include any costs associated with a bond.

Q. DID EMPIRE'S CONTRACT WITH PATCH SPECIFICALLY INCLUDE THE REQUIREMENT OF A PERFORMANCE BOND TO PROTECT THE COMPANY'S INTERESTS?

A. Yes, it did. Company's response to OPC Data Request No. 1084 states:

> As part of the final contract negotiations, one of the contract provisions was to procure a performance bond (see section 5.5 of original contract attached in DR 1081). Refer to MPSC Staff Data Request 355 for Empire's rationale concerning the performance bond.

Company's response to OPC Data Request No. 1081 provided an actual copy of the contract between Empire and Patch Construction LLC. Article 5.5 of that contract states the following regarding the purchase of a performance bond by Patch:

> Contractor shall procure a performance bond within twenty-one (21) business days after the execution of the Agreement and provide Owner evidence in the form of Exhibit G.

Q. SHOULD EMPIRE HAVE REQUIRED PATCH TO PRODUCE THE PERFORMANCE BOND WITHIN THE 21-DAY REQUIREMENT OF THE CONTRACT?

A. Yes. Pursuant to the terms of the contract, Patch had 21 days from the date of the contract in order to secure the performance bond. Empire's failure to confront

Patch's stalling and enforce the requirement did not represent sound business decision-making on its part. Public Counsel believes that Empire's inaction at this stage of the construction project is what ultimately led to it being forced to finance the cost overrun.

Q. IS IT POSSIBLE THAT THE COST OVERRUN WAS INCURRED BECAUSE THE PATCH BID WAS INTENTIONALLY UNDERSTATED WITH REGARD TO THE TRUE CONSTRUCTION COST OF THE PROJECT?

A. That is possible, but I have seen no data that would indicate that that is what actually occurred. In fact, the Sega bid, with which Empire compared the Patch bid, varied very little in amount from the $11,365,382 amended agreement price Empire and Patch ultimately settled on.

Q. DID EMPIRE AND PATCH SUBSEQUENTLY ENTER INTO AN AMEMNDMENT TO THE ORIGINAL CONTRACT THAT RELIEVED PATCH OF THE PERFORMANCE BOND REQUIREMENT?

A. Yes, approximately five months after the date of the original contract Empire and Patch entered into an addendum to the contract (i.e., Amendment-01). On or about July of 2002 Amendment-01 to the original contract between Empire and Patch Construction was finalized. Company has indicated that the amendment was necessary due to Patch's inability to procure a performance bond for the

project along with various schedule constraints. Company's response to MPSC Staff Data Request No. 355 states:

> In regards to the performance bond, Section 5.5 of the Original Contract between Empire and Patch required a performance bond be procured by Patch with 21 business days after the execution of the contract. Once the contract was signed, **Empire released Patch to begin engineering and other on-site worked almost immediately because of schedule constraints**. When Empire inquired about the performance bond, we were told, in one way or another, that "We are working on it", "We are close", etc. After a period of these "time-buying" responses, they came forward and told us they ultimately were not able to secure the performance bond. This inability to secure the performance bond, in-part, led to Contract Amendment-01 that is dated July 23, 2002.
>
> (Emphasis added by OPC.)

Q. WHAT DID EMPIRE GIVE UP AND WHAT DID IT RECEIVE WITH THE IMPLEMENTATION OF AMENDMENT-01?

A. In addition to tightening monitoring and control of Patch's construction costs/payments, Company essentially gained a "Guaranty Agreement" from Patch Construction LLC, Patch, Inc. and C. J. Patch III and Patricia Patch, the construction companies principles. In return Empire agreed the contractor shall not be required to provide the performance bond.

Q. WHAT IS A GUARANTY AGREEMENT?

A. In this instance, the Guaranty Agreement represents the "guarantee and promise" of the two Patch companies and their principals to fulfill the requirements of the original contract, and the subsequent Amendment-01 to the original contract. In essence, Empire's management gave up the requirement of a performance bond for nothing more than a "**promise to pay**" from the principals of the Patch companies.

Q. DID EMPIRE HAVE IN PLACE ANY OTHER INSURANCE IN PLACE TO PROTECT ITS INTERESTS IN THE EVENT THE PATCH COMPANIES/PRINCIPALS DID NOT FULFILL THEIR OBLIGATIONS?

A. No. Public Counsel Data Request No. 1078 asked Empire to please describe any insurance EDE has and/or had that would protect/reimburse it for Patch's failure to perform on its contract and, if applicable, identify all actual and expected proceeds from insurers relating to Patch issue. Company's response was:

No such insurance was in place.

(Emphasis added by OPC.)

Q. DID EMPIRE'S MANAGEMENT SEEK TO PROTECT EMPIRE WITH INSURANCE FOR OTHER ASPECTS OF THE PROJECT?

A. Yes, it did. In reviewing Company's budget for the project I noticed that $600,000 was listed as an item cost for project insurance. Company's response to

OPC Data Request No. 1083 stated that this insurance was property damage insurance (or "All Risk" builders risk coverage) for the project, but that it did not cover any performance guarantees for contractors. It added, builders risk coverage is intended to insure certain property exposures for a construction project's entirety as opposed to the performance of contractors.

Q. SHOULD EMPIRE HAVE PROTECTED ITS INTERESTS BY CONTINUING TO REQUIRE PRODUCTION OF THE PERFORMANCE BOND?

A. Yes, I believe that it should have.

Q. WERE THE ACTIONS TAKEN BY EMPIRE MANAGEMENT TO RELIEVE PATCH OF THE PERFORMANCE BOND REQUIREMENT BASED UPON SOUND JUDGMENT?

A. No. Public Counsel believes that the decision to relieve Patch of the performance bond requirement was inappropriate. The enforcement of the performance bond was meant to, and would have, protected the Company from the unfortunate events that have now occurred with regard to this construction project. Company has indicated that its reasoning for relieving Patch of the performance bond requirement was because Patch was incapable of purchasing the bond and time restraints regarding the implementation of additional electric plant limited its options. However, it is the Public Counsel's contention that Empire's

management has the responsibility to appropriately plan for and implement the operational needs of the Company.

It is management's responsibility to secure a contractor who can obtain adequate insurance in order to mitigate possible construction-related risk. The assurance of the performance bond should have been provided with the RFP response and implemented prior to commencing construction. I submit that any time restraints that may have occurred are a direct result of management's failure to plan appropriately for its operational needs. It is the Public Counsel's belief that the Company should never have allowed Patch to proceed with the project until the performance bond had been secured, and ultimately the result of that faulty decision-making is what required it to finance the cost overrun incurred. Therefore, the cost overrun was obviously a wasteful use of Company's assets and should not be included in rate base.

Q. DID EMPIRE FILE LITIGATION AGAINST PATCH IN ORDER TO RECOVER A PORTION OF THE COST OVERRUN?

A. Yes. According to the Company's response to OPC Data Request No. 1078, Empire did file litigation and won a judgment of $3 million plus attorney's fees of $25,000. However, according to the Company's response to OPC Data Request No. 1080, subsequent bankruptcy proceedings initiated by the Patch companies

and their principals effectively nullified the likelihood of Empire ever collecting on the judgment.

Q. WHAT IS EMPIRE'S RATIONALE FOR REQUESTING REIMBURSEMENT OF THE COST OVERRUN FROM ITS RATEPAYERS?

A. In its OPC Data Request No. 1080, the Public Counsel sought to understand the Company's rationale with regard to the position it has taken. Company's response to the data request included copies of the final decrees in the bankruptcy filings of Patch Construction, LLC; Patch, Inc.; C. J. Patch III and Patricia Patch relieving them of all debts. Empire also stated:

> **It is Empire's understanding that based on these documents Empire will not be receiving reimbursement for any of these construction costs.**

Since the Company gave no other support for its position, I am of the belief that it expects its ratepayers to reimburse it for the cost overrun because no other parties exist from which to recover the funds expended. Public Counsel believes that it is Empire's shareholders who should shoulder the responsibility for the cost overrun due to the failure of its management to exercise due diligence and appropriate care in protecting them from the adverse action that occurred.

Q. DID EMPIRE'S MANAGEMENT FAIL TO APPROPRIATELY FOLLOW ITS OWN GUIDELINES IN SECURING ITS INTERESTS AND THE INTERESTS OF ITS RATEPAYERS?

A. Yes. I believe that it did fail in its responsibility with regard to this issue. Had Empire stopped Patch after the 21-day deadline for the performance bond and instead chose another of the bidders for the project the likely increase in cost above that bid by Patch Construction would not have been that much different. As it now stands, the Company is seeking to recover from ratepayers a cost overrun in excess of $3.6 million that it should not have had to incur. In my opinion, the cost overrun was the wasteful result of Empire's management failure to protect the interests of the Company and its ratepayers.

Q. SHOULD EMPIRE'S RATEPAYERS BE FORCED TO ACT AS THE BACKUP SUPPLIER OF FUNDS FOR EMPIRE DUE TO EVENTS ASSOCIATED WITH INAPPROPRIATE ACTIONS TAKEN BY ITS MANAGEMENT?

A. No.

Q. IN YOUR DIRECT TESTIMONY YOU INDICATED THAT THERE ARE OTHER COSTS ASSOCIATED WITH THE COST OVERRUN AMOUNT THAT SHOULD BE ADJUSTED IN THIS RATEMAKING PROCEDURE. PLEASE DESCRIBE THOSE OTHER COSTS.

A. During the period calendar year 2003 through June 2004, Company recorded approximately $158,510 of depreciation expense on the cost overrun amount it included in its plant-in-service (source: OPC Data Request No. 1079). The expense was also booked in the accumulated depreciation reserve account (the common accounting entry for depreciation related costs is a debit to depreciation expense on the income statement and a credit to the accumulated depreciation expense reserve account on the balance sheet). Since the accumulated depreciation expense reserve account is utilized as an offset to the plant-in-service in the determination of the Company's rate base, it is only appropriate that the Commission not include in the setting of its future rates accumulated depreciation reserve related to the cost overrun amount. Therefore, Public Counsel recommends that the accumulated depreciation reserve be adjusted to remove the $158,510 from its balance in determining the rate base for this case.

Furthermore, Company's response to MPSC Staff Data Request No. 296 states that the Company incurred approximately $11,872 in legal costs during calendar year 2003 related to its litigation against Patch. Public Counsel recommends that these costs also be disallowed due to the fact that it is likely they would not have been incurred had the performance bond been in place.

SUMMARY

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS.

A. It is the Public Counsel's belief that, due to inappropriate decisions by Company managers along with an obvious failure of investment planning on Company's part, Empire incurred and booked to plant-in-service expenditures associated with a significant cost overrun at its Energy Center Units 3 & 4 construction project. The primary driver for the incurrence of the cost overrun by Empire was its failure to enforce the posting of a performance bond by the contracted construction company as dictated in the original contract between the two parties. The removal of the performance bond requirement in Amendment-01 ultimately forced Empire to wastefully assign over $3.6 million of its assets to complete the project. This management action failed to protect the best interests of Empire and its ratepayers.

Company now seeks to recover the investment associated with the cost overrun from its ratepayers because it cannot do so from the bankrupt Patch Construction LLC, the bankrupt Patch, Inc., or the bankrupt Patch principals that later provided a Guaranty Agreement (a simple "promise" to meet the obligations of the original and amended contract that was included in Amendment-01). Public Counsel believes that the cost overrun should never have been incurred by Empire. Had the performance bond been implemented as required in the original contract Empire and all its stakeholders would have been protected from the adverse financial harm that has now occurred. Therefore, I recommend that the total cost overrun amount, along with any related depreciation expense included in the

accumulated depreciation reserve account and various associated legal costs of the Patch litigation, be disallowed in the instant case as an imprudent expenditure of assets by Empire.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.