

Exhibit No. _____
Issue: Depreciation
Witness: M.J. Lyons
Type of Exhibit: Surrebuttal
Sponsoring Party: The Empire District Electric Company
Case No.: ER-2001-299
Date: May 3, 2001

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2001-299

SURREBUTTAL TESTIMONY OF

Martin J. Lyons, CPA

On Behalf of

The Empire District Electric Company

Jefferson City, Missouri

FILED
MAY 3 2001

Missouri Public
Service Commission

Surrebuttal Testimony

Martin J. Lyons

The Empire District Electric Company

Case No. ER-2001-299

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The Empire District Electric Company

I. Witness Introduction

1. Q. Please state your name and business address.

A. My name is Martin J. Lyons. My business address is 800 Market Street, St. Louis, Missouri 63101.

2. Q. By whom are you employed and in what capacity?

A. I am a partner in the Assurance/Business Advisory Services practice of PricewaterhouseCoopers LLP.

3. Q. Please describe your educational background and professional experience.

A. I received a Bachelors of Science in Business Administration with a major in Accountancy from St. Louis University in 1988. I received a Masters in Business Administration from Washington University in 1997. I am a certified public accountant and have worked in public accounting for thirteen years. I am a member of the American Institute of Certified Public Accountants and the Missouri Society of Certified Public accountants.

4. Q. What are your responsibilities as a partner in the Assurance/Business Advisory Services practice of PricewaterhouseCoopers LLP?

A. I am a member of the Global Utility Industry Services Group within the Assurance/Business Advisory Services practice of PricewaterhouseCoopers, LLP. As a partner in the Global Utility Industry Services Group I devote approximately seventy five percent of my time to supervising audits of, and consulting on accounting issues for, PricewaterhouseCoopers LLP utility clients.

1 5. Q. Have you participated in audits performed by PricewaterhouseCoopers LLP of
2 The Empire District Electric Company's financial statements?

3 A. I have participated in audits of The Empire District Electric Company's
4 ("Empire" or the "Company") financial statements since the December 31, 1997
5 financial statement audit. At December 31, 1997 and 1998, I was the senior
6 manager assigned to lead the audit of Empire's financial statements. At
7 December 31, 1999 and through the present, I have been the partner assigned
8 responsibility for providing ongoing accounting consultations to and supervising
9 audit services for the Company.

10 6. Q. Have you ever testified before the Missouri Public Service Commission?

11 A. No

12 7. Q. Have you ever testified before any other state regulatory commission?

13 B. Yes, the Illinois Commerce Commission.
14

15 **II. Purpose of Testimony**
16

17 8. Q. What is the purpose of your testimony in this proceeding?

18 A. The purpose of my rebuttal testimony is to respond to the testimony of Mr. Paul
19 W. Adam of the Missouri Public Service Commission Staff by presenting an
20 analysis of recent initiatives by the Financial Accounting Standards Board which I
21 believe demonstrate that accounting standards are evolving to (1) embrace a
22 concept that obligations associated with the retirement of long-lived assets are a
23 prerequisite for operating such assets and therefore should be considered a

1 component of such asset's historical cost, and (2) allocate such cost to expense
2 using a systematic and rational method which is no greater than that for which the
3 related asset is expected to provide benefit.

4 9. Q. What do you recommend to be the appropriate time period for costs associated
5 with asset retirements to be included in Empire's cost of service?

6 A. I recommend that asset retirement costs be included in the computation of
7 Empire's annual depreciation expense, reflecting the allocation of such cost over
8 the periods related assets are expected to provide benefit.

9 **III. Accounting for "Net Salvage"**

10
11 10. Q. Mr. Adams refers frequently in his direct testimony to net salvage. How do you
12 define net salvage?

13 A. Salvage value refers to the estimated dollar amount that would be received upon a
14 sale of property after the property has become unproductive. Net salvage is equal
15 to salvage value minus the cost of removing, dismantling, or demolishing the
16 unproductive asset. Net salvage may be a positive or a negative number.

17 11. Q. How does net salvage impact the computation of depreciation?

18 A. There are numerous methods of calculating depreciation allowances. For
19 illustration purposes let me describe how it impacts the straight-line method
20 which, in my experience, is the most commonly used method. Under the straight-
21 line method, the annual allowance for depreciation equals the difference or sum of
22 an asset's historical cost and the positive or negative net salvage value,
23 respectively, divided by the useful life. Using this method, the annual

1 depreciation expense generally remains constant over the life of an asset. A
2 positive net salvage value decreases the annual depreciation expense while a
3 negative net salvage increases the annual depreciation expense.

4 12. Q. You note that net salvage is equal to salvage value minus the cost of removing,
5 dismantling, or demolishing an unproductive asset. Can you describe recent
6 attention given to costs of removal, dismantling and demolishing by the account
7 profession?

8 A. Yes. Currently the Financial Accounting Standards Board ("FASB") has an
9 Exposure Draft outstanding entitled Accounting for Obligations Associated with
10 the Retirement of Long-Lived Assets ("ARO"). This FASB Exposure Draft
11 would apply to all entities that incur obligations that are associated with the
12 retirement of long lived assets. The FASB defines the term retirement in such
13 Exposure Draft as "the other-than-temporary removal of a long-lived asset from
14 service." In my opinion, obligations encompassed by this FASB Exposure Draft
15 include those associated with removal, dismantling and demolishing.

16 13. Q. What is the Financial Accounting Standards Board?

17 A. The FASB is a body composed of expert accountants that deliberates accounting
18 issues in public forums for the purpose of interpreting or establishing accounting
19 principles or describing existing accounting practices that are generally accepted.
20 Accounting principles officially established by the FASB are considered to be the
21 most authoritative principles generally accepted in the United States.

22 14. Q. Does an Exposure Draft represent or contain accounting principles officially
23 established by the FASB?

1 A. No, an Exposure Draft is a proposed "Statement of Financial Accounting
2 Standards" which is the title given to accounting principles officially established.

3 15. Q. What then does an Exposure Draft represent?

4 A. An Exposure Draft is the culmination of countless hours spent by expert
5 accountants discussing and debating a particular accounting project amongst
6 themselves and various experts from other fields. It is a written document setting
7 forth accounting principles proposed by the FASB to be made official pending
8 consideration of final public comment.

9 16. Q. Why was an accounting project dealing with obligations associated with the
10 retirement of long-lived assets needed?

11 A. Diversity in accounting practices had developed amongst companies in various
12 industries for recognizing obligations associated with the retirement of long-lived
13 assets in financial statements. Paragraph 1 of the ARO Exposure Draft states that:

14 "Some entities accrue those obligations ratably over the useful life of a
15 long-lived asset, either as a component of depreciation expense (and
16 accumulated depreciation) or as a liability. Other entities do not recognize
17 an obligation in the financial statements until an asset is physically
18 retired."

19 17. Q. What then is the major objective of the accounting project?

20 A. Paragraph 41 of the ARO Exposure Draft states the following:

21 "The major objective of the asset retirement obligations project is to
22 provide accounting requirements for the recognition and measurement of
23 liabilities associated with the retirement of long-lived assets. Another

1 objective is to provide accounting requirements with respect to the
2 recognition of asset retirement costs as well as guidance for the periodic
3 allocation of those costs to results of operations.”

4 18. Q. What preliminary conclusions has the FASB set forth in its Exposure Draft?

5 A. The FASB’s ARO Exposure Draft contains thirty-five paragraphs of proposed
6 “Standards of Financial Accounting and Reporting” which set out a great number
7 of conclusions and interpretive guidance. I believe the conclusions which are
8 most pertinent to this rebuttal testimony are the following:

9 “The retirement obligations included within the scope of this statement are
10 those that an entity cannot avoid as a result of the acquisition,
11 construction, or normal operation of a long-lived asset.”

12 “An entity shall recognize a liability for an asset retirement obligation in
13 the period in which all of the following conditions are met:

- 14 a. The obligation meets the definition of a liability in paragraph 35 of
15 FASB Concepts Statement No. 6, *Elements of Financial Statements*.
16 b. A future transfer of assets associated with the obligation is probable.
17 c. The amount of the liability can be reasonably estimated.”

18 “In assessing whether an asset retirement obligation meets the definition
19 of a liability, an entity shall determine if the three characteristics of a
20 liability in paragraph 36 of Concepts Statement 6 are met. Specifically, an
21 entity shall determine whether:

- 22 a. It has a present duty or responsibility to one or more other entities
23 that entails settlement by probable future transfer or use of assets.

1 b. It has little or no discretion to avoid a future transfer or use of assets.

2 c. An obligating event has already happened.”

3 “An entity shall recognize an obligation encompassed by paragraph 7(a)
4 (Obligations incurred upon acquisition, construction, or development of an
5 asset) as a liability when it initially recognizes the cost of the long-lived
6 asset. For obligations of that type, the acquisition, and not the operation,
7 of the asset creates the obligation. For example, the construction and
8 placement of an oil and gas production facility would typically be the
9 event that creates the obligation to dismantle and remove the facility. In
10 general, an obligation encompassed by paragraph 7(a) does not change
11 (even though the estimated amount of the obligation may change) with the
12 operation of the asset or the passage of time.

13 Upon initial recognition of a liability for an asset retirement obligation, an
14 entity shall capitalize an asset retirement cost by increasing the carrying
15 amount of the related long-lived asset by the same amount as that
16 recognized for the corresponding liability. An entity shall subsequently
17 allocate that asset retirement cost to expense using a systematic and
18 rational method over periods no longer than that for which the related
19 long-lived asset is expected to provide benefits. The objectives of the
20 requirements for capitalization and systematic and rational allocation to
21 expense are to obtain a measure of cost that reflects the entity’s total
22 investment in the long-lived asset and to allocate that cost to expense in

1 the period or periods during which the long-lived asset is expected to
2 provide benefits (emphasis added)."

3 19. Q. How will this FASB Exposure Draft impact Empire, if made official?

4 A. Empire management will need to assess whether it has asset retirement
5 obligations, including those associated with removal, dismantling and
6 demolishing, associated with its long-lived assets. Further, management will need
7 to determine whether such obligations meet the conditions for liability recognition
8 set forth in my answer to the previous question, or those included in the final
9 official pronouncement.

10 If management identifies obligations meeting the conditions for liability
11 recognition, Empire will be required to report a liability on its balance sheet
12 representing its cumulative obligations and increase its utility plant balance by an
13 equivalent amount, subject to adjustment for any depreciation of such amount
14 allocable to previous periods.

15 20. Q. How will the increase in Empire's utility plant balance impact depreciation
16 expense following adoption of this proposed standard?

17 A. Empire's total investment in utility plant, including its capitalized asset retirement
18 obligations, would be included in depreciation expense, thereby reducing
19 operating income, absent inclusion in rates, over the estimated useful lives of such
20 utility plant assets.

21 21. Q. Has a study been conducted to determine whether amounts of net salvage
22 proposed by Empire for inclusion in depreciation expense as part of this rate

1 proceeding will meet the conditions for liability recognition set forth in the FASB
2 Exposure Draft?

3 A. Not to my knowledge. However, it is my expectation that there would be
4 significant overlap.

5 22. Q. Absent such a study why is the FASB's Exposure Draft significant?

6 A. I believe it is significant because, having been released on February 22, 2000, it
7 represents evidence of the current thinking of experts on the subject of accounting
8 for asset retirement obligations. Their preliminary conclusions reflect a reasoning
9 that closure and removal costs are a prerequisite for operating a long-lived asset
10 and that the economic benefit of those costs lies in the productive asset that is
11 used in the entity's operations. As a result they conclude that such costs should
12 be capitalized and depreciated in order to achieve the objectives of (a) obtaining a
13 measure of cost that more closely reflects the entity's total investment in its assets
14 and (b) allocating that cost to the periods in which the related assets are expected
15 to provide benefits.

16 23. Q. Do you believe estimated net salvage should be included in the computation of
17 depreciation expense for rate-making purposes?

18 A. Assuming a goal of rate-making is to allocate and recover costs from rate payers
19 that benefit from such costs, I believe estimated net salvage should be included in
20 depreciation rates.

IV. Conclusions

24. Q. What is your overall conclusion?

A. I disagree with Mr. Adam's recommendation that Empire cease reflecting an allocation of estimated net salvage proceeds or expenses in its cost of service during the useful life of related assets as his recommendation appears contrary to the direction of generally accepted accounting standards.


25. Q. Does this conclude your prepared rebuttal?

A. Yes, it does.


AFFIDAVIT

STATE OF MISSOURI)
CITY) ss
COUNTY OF ST. LOUIS)

On the 1st day of May, 2001, before me appeared Martin J. Lyons, to me personally known, who, being by me first duly sworn, states that he is a Partner with the firm of PricewaterhouseCoopers LLP and that he has read the foregoing document and believes that the statements therein are true and correct to the best of his information, knowledge and belief.


(Name)

Subscribed and sworn to before me this 1st day of May, 2001.


(Name), Notary Public

My commission expires: _____

PATRICIA J. CUSUMANO
Notary Public - State of Missouri
City of St. Louis
My Commission Expires Aug 16, 2004