Exhibit No.:	
Issue:	Test Year and Update Accounting Schedules Gas Safety Accounting Authority Order
Witness:	James A. Fallert
Type of Exhibit:	Direct Testimony
Sponsoring Party:	Laclede Gas Company
Case No.:	GR-2001-629

LACLEDE GAS COMPANY

GR-2001-629

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 of Laclede Gas 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, and GR-99-315.

<u>Purpose of Testimony</u>

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 and update
2. Adjustments to Utility Operating Income
3. Wages and Salaries
4. Clearing Accounts
5. Merchandise Sales Personnel Salaries
6. Benefit Plan Trustee Fees and 401(k) Expenses
7. Pension Expense and Assets
8. Incentive Compensation Plan
9. Post Retirement Benefits Other Than Pensions

10. Gas Safety Accounting Authority Order

11. Gas Safety Replacement Program

12. Taxes Other Than Income Taxes

13. 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, 11, 12, 13, 15, 16, 17, 19 and 20. 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, amortization of deferrals made pursuant to the Gas Safety Replacement Program (SRP) accounting authority order granted by the Commission, expenses associated with the SRP, 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 Deferrals.

<u>Test Year and Update</u>

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 February 28, 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 February 28, 2001 and to provide for reasonable changes which will be known and measurable by July 31, 2001. 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 February 28, 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 February 28, 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 and GR-99-315).

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 July 31, 2001 business, depending upon the procedural schedule established in this case. The Company's filed case includes the estimated effect of a July 31 update.

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 February 28, 2001 for all the items of utility operating revenues and operating expenses and shows as a final total 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 February 28, 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 20.

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, merchandise sales personnel salaries, benefit plan trustee fees, 401(k) expenses, pensions, post retirement benefits other than pensions, amortization of balances deferred pursuant to the gas safety accounting authorization approved by the Commission in Case No. GR-99-315, 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 15 of Section C.

Q. Please explain how the adjustment to Laclede Division contract wages was 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, 2000, 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 of the impact of the change in labor contract provisions which will occur on August 1, 2001, and also adjusts to the normal level of employees anticipated at July 31, 2001.

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 was the purpose for this adjustment?

A. Operation and maintenance expense percent 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 2.5% effective April 15, 2000 in accordance with the labor agreement which was in place at the time. In addition, this adjustment increases wage expense for the effect on operation and maintenance expense of the increase in labor rates which occurred on April 15, 2001 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 July 31, 2001.

Q. Please explain the adjustment to management salaries.

A. Management salaries were adjusted to reflect anticipated salary levels at July 31, 2001. 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 February 28, 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.

<u>Merchandise Sales Personnel Salaries</u>

Q. Please explain your adjustment relating to Merchandise Sales personnel.

A. Adjustment 6.a., detailed on Schedule 16, removes from cost of service the base salaries and associated expenses of Merchandise Sales personnel.

<u>Benefit Plan Trustee Fees and 401(k) Expenses</u>

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

A. Adjustment 4.g., 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 July 31, 2001, 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 August 2000 for Laclede Division and April 2001 for the Missouri Natural Division.

Pension Expense Overview

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

A. Laclede calculated 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 occurs 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. How much pension expense did Laclede record on its books in Fiscal 2000?

A. The Company did not report pension expense during Fiscal 2000. Instead, the Company reported pension income in its 2000 10-K report to the Securities and Exchange Commission of $9,868,000 (which consisted of $7,620,000 of FAS 87 credits before transfers and $2,248,000 of FAS 88 credits).

Q. What portion of Laclede's income resulted from this pension income in 2000?

A. The $9,868,000 of pension income reported to the SEC was about 25% of Laclede's earnings before income taxes for the year.

Q. How does this compare with comparable gas distributors?

A. A study of the reported pension expense for the seven comparable gas distributors cited by Staff witness David Broadwater in Laclede's previous rate case (GR-99-315) for Fiscal 1999 indicates pension income averaging 1% of earnings before taxes. During this same Fiscal 1999 period, pension income was 30% of Laclede's earnings before taxes. During 2000, the comparable percent of pension income to earnings before taxes was 8% for the comparable companies compared with 25% for Laclede. It should be noted that two of Mr. Broadwater's comparable companies ceased to exist in 2000 as independent entities due to merger and, therefore, are not included in these numbers.

Q. Why is such a large portion of Laclede's earnings generated by pension income relative to its peers in the industry?

A. This results from the unusual and extreme accounting policy that is currently in effect for Laclede, and which sharply accelerates the recognition of gains and losses under FAS 87 and FAS 88. For instance, in 2000, Laclede recognized about 20% of the outstanding gains while the comparable companies recognized an average of only 3% of the gains. Clearly, the accounting policy currently followed by Laclede is out of step with industry practice.

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 is the impact of this acceleration on Laclede's financial results?

A. The current policy of acceleration has 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. This is a bona fide concern given recent significant pension asset losses incurred in the equity markets.

2. The Company's cash flow is severely restricted because such a significant portion of its income results from <u>non-cash</u> pension income. This hinders the Company's ability to meet its important obligations to

its customers, such as investment in utility plant and procurement of reliable gas supplies, from cash income and instead requires it to borrow to meet these cash requirements.

3. The quality of the Company's earnings is 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 balance, 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 could force the Company to file for increased rates.

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 four-year period. Once recognized, gains or losses would be amortized over the average remaining working service period of the participants in the plan. This policy would recognize gains and losses in a much smoother and more orderly manner than 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, but permits recognition of lesser amounts.

Laclede's current policy requires recognition under FAS 88 beginning with the first dollar of lump-sum settlements. Hence, the current policy results in considerably greater recognition of gains and losses than that required to be recognized under FAS 88.

Q. What is the impact of this accounting policy?

A. The current policy regarding FAS 88 further exacerbates the problems caused by the current FAS 87 policy. In fact, FAS 88 can generate even greater volatility, which is caused by significant year-to-year variations in lump sum payouts and unrecognized gain/loss balances. For instance, during the past five fiscal years, FAS 88 has generated annual pension credits as high as $4.9 million and as low as $1.6 million. Credits during fiscal 2001 are expected to be considerably less than $1.6 million.

Q. How can this problem be eliminated?

A. FAS 88 as it is applied to Laclede's pension plans by its nature produces varying and volatile results, and can result in wide swings between income and expense. I propose that the Commission implement a policy wherein Laclede would record the effect of lump sum settlements on its books only to the minimum extent allowed by FAS 88. This would effectively set 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. Would this change prevent ratepayers from realizing the benefit of any gains currently being amortized through FAS 88?

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

Q. What would happen 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. I suggest that the Commission establish an accounting authority order allowing the Company to defer the difference between this recognized amount and the amount allowed in rates. This would ensure that an unexpected FAS 88 recognition would not cause a significant over or under recovery of pension expense.

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 accelerated recognition of gains or losses inherent in the current 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 credits, which have served to substantially reduce the Company's rates 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 thus far in 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 effective June 30, 2001 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	$ (5,367,000)*

*estimated, based on current accounting policy.

The current accounting policy routinely produces year-to-year variations of millions of dollars in pension expense. In fact, the revenue requirement in this case reflects an increase over amounts in current rates of over $6 million attributable to pension expense as calculated under the current accounting policy. It is time for the Company and the Commission to get off of this roller coaster. The volatility and uncertainty caused by the current 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 effective for the fiscal year beginning October 1, 2000, and further adjusted for the expected gain or loss balance at a measurement date of June

30, 2001. Adjustment 4.a. adjusts FAS 87 to June 30, 2001 levels based on the current accounting policy. Adjustment 4.b. further adjusts FAS 87 expense to June 30, 2001 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. The factors which generate FAS 88 income or expense are unamortized gain or loss balances multiplied by lump sum pension payments to retirees as a percent of liabilities. The normalized test year pension expense reflects the unamortized gain or loss balance reflected in the FAS 87 calculations described above, times a five-year average of lump-sum payments made to retirees as a percent of liabilities. Adjustment 4.c. adjusts FAS 88 as described above based on the current accounting policy. Adjustment 4.d. further adjusts FAS 88 expense based on the proposed accounting policy discussed earlier in this testimony. These adjustments are further detailed on Schedule 11 of Section C.

Q. Should the pension adjustments described above be updated?

A. Yes. I have proposed an update in this case as of July 31, 2001. The next valuation of pension expense will be completed based on a June 30, 2001 measurement date and should be included in that update.

<u>Prepaid Pension Asset</u>

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 appropriate 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. 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 July 31, 2001 accrued pension liability balances against estimated July 31, 2001 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.

<u>Incentive Compensation Plan</u>

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.e. and 4.f. 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

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

expense levels in accordance with the provisions of Section 386.315 (RSMo. 1994), 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?

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.

<u>Gas Safety Accounting Authorization</u>

Q. Please explain the deferral related to the Gas Safety Replacement Program (SRP).

A. The Company incurs significant costs on projects related to this program 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 extraordinary nature of this program, 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-99-315, Laclede has deferred and booked to Account 182.3 the costs incurred for replacement of service lines and replacement and cathodic protection of bare steel and cast iron mains, as well as associated work on other facilities. Such costs include depreciation, property taxes, and carrying costs which would normally have been expensed beginning with the in-service date. Costs deferred also include inspection of copper service lines and customer-owned buried fuel lines pursuant to the Commission's order in Case No. GR-99-315. Adjustment 6.b. on Schedule 2 of Section C includes recovery of costs deferred pursuant to authority granted in Case No. GR-99-315 as estimated through July 31, 2001. Detail of these adjustments is included on Schedule 17 of Section C.

Q. Are you sponsoring any other adjustments related to the SRP cost deferral mechanism?

A. Yes. I have included the outstanding balance accrued pursuant to the authority granted in Case No. GR-99-315 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 the SRP mechanism?

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

<u>Gas Safety Replacement Program</u>

Q. How should costs related to the Company's SRP 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 gas safety replacement program be included in rates. The Company has recently 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 a program of the importance and magnitude of Laclede's SRP, 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 the SRP is currently employed and working on the program. 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 gas safety programs 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 gas safety replacement program?

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 program. These inspections are expense items under generally accepted accounting principles, and are, therefore, most appropriately recovered in current rates. However, pursuant to the accounting authority order currently in place, these charges were deferred during the test year for later recovery. I propose that, effective with the date of new rates resulting from this case, the known and measurable cost of these inspections which are being incurred today be included in current rates. Adjustment 6.c. on Schedule 2 of Section C includes the cost of safety inspections in operating expense.

<u>Taxes Other Than Income Taxes</u>

Q. Please describe the adjustments you have made on Schedule 19.

A. Schedule 19 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 actual increase in assessed value at January 1, 2001, and for the unrealized portion of such taxes applicable to net utility plant at July 31, 2001, at tax rates which were in effect during calendar year 2000.

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 15. Adjustment 8.c. adjusts Missouri Unemployment Taxes for the taxable wages and tax rate effective January 1, 2001. 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 15.

Income Taxes

Q. Please describe Schedule 20.

A. Schedule 20 shows the calculations of the proper amount of income tax expense related to the adjusted Test Year and Pro Forma Utility Operating Income Statement. Page 1 of Schedule 20 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 20 shows the calculation of the current, pro forma income tax expense. Finally, Page 3 of Schedule 20 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 20 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 the income statement.

Q. Does this conclude your testimony?

A. Yes it does.

FILED[3]
MAY 1 8 2001
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-2001-629

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 32, inclusive; and Section C - Schedules 1, 2, 11 to 13, 15 to 17 and 19 to 20.

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.

Jm A. Fallert
James A. Fallert

Subscribed and sworn to before me this 16th day of May, 2001.

Susan M. Kopp

SUSAN M. KOPP
Notary Public — Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: Dec. 19, 2003