Exhibit No.:	
Issues:	Staff Opportunism and Specific Proposed Adjustments – Advertising; Rate Case Expense; Dues and Donations; MoPSC Assessment; Venice Power Plant Adjustments; Automated Meter Reading Service Expense; Injuries and Damages; Legal Fees; Environmental Expense; Uncollectible Expense; and Territorial Agreements.
Witness:	Martin J. Lyons
Sponsoring Party:	Union Electric
Type of Exhibit:	Rebuttal Testimony
Case No.:	EC-2002-1
Date Testimony Prepared:	May 10, 2002

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EC-2002-1

REBUTTAL TESTIMONY

OF

MARTIN J. LYONS

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a AmerenUE

St. Louis, Missouri
May, 2002

Exhibit No. 138
Date 7/10/02 Case No. EC-2002-1
Reporter KEM

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REBUTTAL TESTIMONY

OF

MARTIN J. LYONS

MISSOURI PUBLIC SERVICE COMMISSION

Case No. EC-2002-1

I. BACKGROUND

Q. Please state your name and business address.

A. My name is Martin J. Lyons. My business address is One Ameren Plaza, 1901 Chouteau Avenue, St. Louis, Missouri, 63103.

Q. By whom are you employed and in what position?

A. In October 2001, I was named Controller of Ameren Corporation (Ameren). At that time I was also named Controller of Union Electric Company (UE), Central Illinois Public Service Company (CIPS) and AmerenEnergy Generating Company (AEG).

Q. Please describe your educational background.

A. In 1988, I received a Bachelor's of Science in Business Administration, with an Accountancy major, from Saint Louis University. In 1997, I received a Masters of Business Administration degree from Washington University.

Q. Do you have any professional designations?

A. I am a certified public accountant licensed to practice in Missouri. I am a member of the American Institute of Certified Public Accountants and the Missouri Society of Certified Public Accountants.

Q. Please describe your professional work experience.

A. In 1988, I joined Price Waterhouse (now PricewaterhouseCoopers LLP) and was admitted to the partnership in 1999. During my three years as a partner at PricewaterhouseCoopers, I devoted approximately seventy-five percent of my time to supervising audits of, and consulting on accounting issues for PricewaterhouseCoopers' utility clients. I routinely assisted utility clients with, among other things, accounting and financial reporting matters, utility rate filings, debt and equity offerings, merger and acquisition due diligence procedures and accounting issues raised by deregulation. I have also assisted utility clients with defending accounting principles before the Securities and Exchange Commission (SEC), Federal Energy Regulatory Commission (FERC) and various state regulatory agencies.

Q. While at PricewaterhouseCoopers, did you work with Ameren or any of its subsidiaries?

A. Yes, I did. During the one year immediately preceding my employment with Ameren, I served as the utility industry Technical Consulting Partner to PricewaterhouseCoopers' Ameren Corporation audit engagement team. In that capacity, I consulted with the PricewaterhouseCoopers audit team and with Ameren management relative to utility industry-specific accounting and regulatory matters. I reviewed financial statements and regulatory filings of Ameren and its subsidiaries for consistency with generally accepted accounting principles and with regulatory requirements.

Q. Please describe the duties and responsibilities of your current position.

A. As Controller, I manage the accounting, financial reporting and investor relations functions for Ameren, UE, CIPS and AEG. I am responsible for assuring that transactions are accounted for in accordance with generally accepted accounting principles and, when applicable, specific regulatory reporting requirements. Additionally, I am responsible for SEC, FERC, Missouri Public Service Commission and Illinois Commerce Commission regulatory reporting requirements.

Q. Have you previously testified before the Missouri Public Service Commission?

A. Yes, I have. In May 2001, I submitted testimony on behalf of The Empire District Electric Company in Case No. ER-2001-299.

II. OVERVIEW OF TESTIMONY

Q. What is the purpose for your testimony in this proceeding?

A. The purposes of my testimony are to rebut the accounting methods and procedures employed by the Staff to propose certain adjustments to AmerenUE's (the Company) June 30, 2001 test year amounts. In that context, my testimony addresses the propriety of the accrual basis of accounting as adopted and defined by Generally Accepted Accounting Principles; the Staff's use of inappropriate and misleading accounting methods; and the Staff's opportunistic use of arbitrary normalization methods, including the removal of one-time and non-recurring items, to the detriment of the Company. My testimony also rebuts specific adjustments proposed by Staff witnesses Paul R. Harrison, John P. Cassidy, Leasha S. Teel and Doyle L. Gibbs related to advertising, rate case expense, dues and donations, MoPSC assessment, Venice power plant adjustments, automated meter reading expense, injuries and damages, legal fees, environmental expense, uncollectible expense and territorial agreements. As part of my testimony, I have prepared an **Executive Summary** attached hereto as Appendix A.

III. STAFF OPPORTUNISM

Q. What do you mean by Staff opportunism?

A. In preparing our books, we adhere to universally recognized and accepted accounting principles and practices. We do so not only because we are required to do so by law, but also because doing so makes for sound and advantageous business practice. In crafting its submission, however, Staff has chosen to abandon these rules distilled by years of collected accounting expertise and practice. In their place, Staff has declined to offer any alternative system or practice of accounting. Moreover, Staff has failed even to explain its basis for so departing. Rather, Staff has simply deployed a collection of seemingly arbitrary, baseless, and often contradictory methodologies to undergird its adjustments to the Company's test year accounts. The only unifying principle apparent across Staff's adjustment methodologies is that each ultimately results in detriment to the Company. Staff appears to have picked and chosen accounting standards and normalization techniques to take advantage of opportunities to reduce the Company's revenue requirement. This rank opportunism is the only plausible explanation I can identify for Staff's conduct.

Staff's opportunism manifests itself in a variety of ways:

- Staff alternates (perhaps randomly) between the cash and accrual bases of accounting, and various forms of cost averaging techniques termed "normalizations," all departing from the Company's cost of service expenses under the accrual basis of accounting;
- Staff goes further and disallows entirely expenses that they dub "one-time and non-recurring," while failing to recognize that such costs occur year in and year

out in a variety of different areas of Company operations, and therefore becoming a baseline part of the Company's cost of service;

- Staff displays neither rhyme nor reason in determining which method of adjustment gets applied to each category of expenses;
- In departing from the Company's test year costs, Staff routinely fails to justify the basis for the need for an adjustment;
- Having departed without explanation, Staff then goes on to apply equally unjustified methodologies, that depart from any and all recognized systems of accounting;
- The bottom line of Staff's manipulations is that they are performing unjustified adjustments, based on unprincipled, vague and inconsistent methodologies, to deprive the Company any opportunity of recovering prudently incurred costs that benefited the ratepayers;
- In addition, the Staff apparently has a flexible view of the concept of a test year. In fact, Staff seems somewhat confused about exactly what constitutes a test year, and is opportunistic in the degree to which it finds itself unconstrained thereby.

Q. You referred to universally recognized and accepted accounting principles and practices. Please explain?

A. The accounting profession and the business community have long recognized the benefits of universal accounting principles. These rules are known as Generally Accepted Accounting Principles (GAAP). GAAP does not actually represent one set of accounting rules, but rather represents a hierarchy of accounting standards, principles, practices, and methodologies, which include the Statements of Financial Accounting Standards (FAS) issued by the Financial Accounting Standards Board (FASB),[1] Accounting Principles Board (APB) Opinions, American Institute of Certified Public Accountants (AICPA) Accounting Research Bulletins, and other published consensus positions developed by recognized accounting authorities. The GAAP hierarchy is officially recognized by the AICPA and the SEC as the preeminent accounting standard framework. Thus, GAAP represents the body of accounting standards promulgated by recognized standard-setting authorities, as applied in general practice by companies that prepare and use financial information. When I invoke GAAP, I mean to reference a recognized system of accounting that has adopted and defined and thereby embodies the accrual basis of accounting, which this Commission, along with FERC, expressly requires the Company to follow in financial reporting.

Q. Why would a Company choose to follow GAAP?

A. As I suggested above, a Company would follow GAAP for two reasons, one legal and one practical. As a legal matter, different companies are required to follow the accrual basis of accounting, and therefore GAAP, by a variety of regulatory agencies. In AmerenUE's case, the SEC, FERC and indeed the Missouri Public Service Commission all require the Company to report its books in accordance with the accrual basis of accounting, or GAAP.

But even absent the legal obligation to do so, companies will, and AmerenUE would, follow GAAP principles for sound business reasons. GAAP provides

[1] FASB has taken over the role of other previously recognized standard setters and is officially recognized by the American Institute of Certified Public Accountants (AICPA) and the SEC as the preeminent standard setting authority.

a consistent standard for accounting and financial reporting. That consistency allows the Company and users of its financial information to know, understand and predict the effects of events and transactions on the Company's financial position and the results of operations, even if the receipt or use of funds associated with such events or transactions are not expected to occur for some time. It permits the public to compare accounts across and between companies, and provides a sound basis for making loan, investment and other financial decisions. Without consistent application of a generally accepted accounting framework, the Company's financial information would be meaningless.

The fact that GAAP principles are adopted through an impartial process removed from the vagaries and influences of any particular entity means that the rules adopted are both more fair and comprehensive and also more reliable. Moreover, GAAP provides the informed reader with an extremely accurate snapshot of a company's financial state at any given time.

Q. Why Should the Commission View GAAP as Authoritative?

A. GAAP's value flows from the manner in which such standards are adopted. The FASB, for instance, sets standards through an open and fair rulemaking process. The FASB models its adoption process after the Federal Administrative Procedures Act. Proposed rules are publicly distributed for comment, during which time the FASB holds public meetings to generate additional input. After these comment periods, proposed rules are subject to further FASB deliberations and, in some instances, field trials. See http://accounting.rutgers.edu/raw/fasb/facts. The FASB adoption procedures are generally representative of the procedures used by all such standard setting bodies.

GAAP is thus created through a collaborative effort that invites for consideration the thoughts and views of both subject matter experts and relevant stakeholders. The FASB and other authoritative bodies issue authoritative pronouncements only after the thoughts and views of a diverse range of interested parties are fully considered through open deliberations. GAAP are efficacious as a direct result of the due process that creates them.

The Commission should favor GAAP not simply for how it is set, **but also because of how it is not set**. GAAP is emphatically not crafted in the heat of any particular rate case, litigation or other specific accounting event. It is, therefore, crafted in isolation from the results-driven incentives that infect a proceeding such as this rate case. Just as in litigation it is important to craft the procedural rules to be followed before a proceeding begins, and as in an election it is important to understand the procedures that will govern it in advance of voting day, it is important to establish the accounting rules that will govern a Company's reporting before the procedure begins. Only then can investors and regulators alike know that the accounts reported are fairly and accurately stated, and have not been opportunistically created to achieve a goal-driven result.

Q. In saying that the Commission should view GAAP as authoritative, do you mean to suggest that the Commission is bound by GAAP or should never deviate from it?

A. Absolutely not. My understanding is that the Commission is not bound to follow GAAP in all instances, and may depart from it. However, the Commission should do so only upon a reasoned and principled basis. As a matter of accounting principles, GAAP represents the accumulated wisdom of years of accounting practice, incorporates the interests and concerns of diverse stakeholders, and is adopted through an open, deliberative process. As such, it should be presumptively reasonable and accurate. Such rules should not be cast aside lightly. It is my understanding that the Commission is bound to render a decision based on substantial and competent evidence that is neither irrational nor arbitrary. Given their pedigree, GAAP principles are inherently substantial, and the antithesis of arbitrary and irrational accounting. In order to satisfy this burden, any system adopted in their stead must be equally reliable and well grounded.

Q. Does the Staff understand that the Commission is not bound by GAAP?

A. Yes. The Staff most definitely understands this principle. In fact, I would say that the Staff understands it a little too well. When pressed at deposition on the adjustments they have proposed, and the ways in which they depart from GAAP, a host of Staff witnesses ultimately fell back on the mantra that the Commission is not bound by GAAP, or that GAAP is not appropriate for regulatory procedures, but without further elaboration or basis. Staff apparently has taken the Commission's discretion to depart from GAAP and has turned it into a license to jettison overboard all relevant universally recognized accounting principles.

Q. Is the Company's financial information for the test year ended June 30, 2001 and the update period through September 30, 2001 stated in accordance with GAAP?

A. Yes, it is.

Q. You mentioned the accrual basis of accounting. Why does the Company follow this basis?

A. The accrual basis of accounting recognizes costs to the company as they are incurred and become both probable and estimable. It is required by the *Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act*. See 18 C.F.R. part. 101, *Gen. Instruct.* 11. As I mentioned above, as a Missouri electric utility, the PSC requires the Company to keep its books and records in accordance with the *Uniform System of Accounts*, see 4 C.S.R. 240-20.030(1), and therefore with accrual accounting.

The Company is also required to use accrual accounting as embodied by GAAP by the requirements of the SEC. See SEC Reg. S-X, Rule 4-01(a)(1). In fact, in SEC Reg. S-X, Rule 4-01 (a)(1) it is stated that "Financial Statements filed with the Commission which are not prepared in accordance with generally accepted accounting standards will be presumed to be misleading or inaccurate."

Moreover, the sound business rationales I discussed above further support accrual accounting.

Q. What benefits do you perceive in the accrual basis of accounting?

A. The accrual basis of accounting more accurately matches revenues with costs incurred to produce those revenues than any other accounting method of which I am familiar. The Financial Accounting Standards Board (FASB) summarizes accrual accounting, as is required by the *Uniform System of Accounts*, as follows:

> Information about enterprise earnings and its components measured by accrual accounting generally provides a better indication of enterprise performance than information about current cash receipts and payments. Accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for an enterprise in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which

> cash is received or paid by the enterprise. Accrual accounting is concerned with the process by which cash expended on resources and activities is returned as more (or perhaps less) cash to the enterprise, not just with the beginning and end of that process. It recognizes that the buying, producing, selling, and other operations of an enterprise during a period, as well as other events that affect enterprise performance, often do not coincide with the cash receipts and payments of the period.

FASB Concepts Statement No. 1, par. 44.

Q. What accounting standard does the Staff propose to use for this ratemaking proceeding?

A. It is difficult to tell precisely what standard Staff *is* following, but it is quite obviously *not* GAAP. The Staff proposes a smorgasbord of methodologies. In some instances, they use the Company's test year numbers, but in others modify those numbers by applying some "normalization" technique or adopting an average factoring in from a few to five or more years worth of data. In some situations the Staff proposes accrual basis accounting, but in others insists upon cash accounting. In some instances, Staff insists a cost be carved out of cost of service and be separately addressed by amortization, where in others it wholesale throws out a cost and refuses any recovery at all. The overriding problem with these varying approaches is that Staff repeatedly departs from GAAP-based treatment, does so without explaining why the test year number and the Company's figures are unreliable, without appealing to an alternate accounting principle, and does so in a manner seeming driven only by some desired outcome.

Q. Could you provide some examples of these varying and opportunistic accounting methodologies?

A. Each such questionable adjustment will be addressed specifically and in detail by the Company witness rebutting that adjustment. In my testimony I want to pull out a few examples to illustrate the general themes that permeate Staff's case. The following table illustrates specific instances where the Staff proposes departures from the Company's GAAP-basis financial information:

Area	Staff Witness	Staff's proposal
Injuries and damages	Gibbs	Cash basis
Environmental expense	Cassidy	Cash basis
Legal fees	Cassidy	Cash basis
Uncollectible expense	Gibbs	Cash basis
Y2K Computer Mod. expense	Harrison	6-year amortization
Venice Power Plant Adjustments	Harrison	Accrue gain contingency
OPEB and pension costs	Meyer	5-year amortization of 5-year average gain/loss account balance

Q. What explanation has the Staff provided for departing from the Company's GAAP basis financial information?

A. As Staff refuses to follow any specific accounting methodology, it has not provided a general rationale for departing from GAAP. Rather, the onus of providing such an explanation, if any, falls to the individual staff member. As the departures recommended differ from witness to witness and adjustment to adjustment, the explanations similarly differ from adjustment to adjustment, both in substance and sufficiency.

For example, attempting to explain his affinity for the cash basis, which he proposes for legal fees and environmental expense, Staff witness Cassidy explained his departure from GAAP as follows:

> When the accrual is materially and substantially in excess of the cash basis, I adopt the cash basis approach because of the large disparity that exists.

See *Cassidy April Depo*. 56:23-25; 57: 1.

Asked what he meant by "materially," Mr. Cassidy stated: "Substantially more than the cash basis." *Id.* 57:2-3. And in turn he defined "substantially more" as "Under materiality guideline," a wholly circular and unsatisfying answer. *Id.* 57:4-5. Finally, Mr. Cassidy offered up a ten percent guideline, but admitted to having made it up on the spot. *Id.* 57:7-10. When asked what he thought of this standard, Staff witness Gibbs summed it up well, stating "Not very much." *Gibbs April Depo*. 42:19-21.

Staff witness Harrison, on the other hand, proposed something approximating an accrual rule for accounts related to the Venice plant fire, a method he thought also appropriate for legal fees. *See Harrison April Depo*. 57:19-21; 60:16-20. Mr. Harrison believed himself to be following the Uniform System of Accounts, and therefore the accrual basis of accounting, in following this method. *Id.* 56:24-57:3. But in fact, the Uniform System of Accounts provides no specific recommendation on accounting for contingent insurance proceeds but instead relies on the application of GAAP, the most clarifying element of which is FAS No. 5, "Accounting for Contingencies."

Q. Why should the Commission be wary of Staff's departure from GAAP?

A. Whatever principles the Staff is following, if they may be called principles, it is clear that they are not any generally accepted or universally recognized method of accounting. It is therefore equally clear that Staff's methodologies have not been subject to any public comment period, have not taken into account the interests of diverse stakeholders, and generally have not been exposed to any due process of review. Rather, Staff's accounting methodologies are largely of their own creation. Indeed, various Staff witnesses have admitted that their only experience with regulatory accounting comes from what they learned "on the job" with the Commission. *See, e.g., Harrison April Depo.*: 18:19-19:2; *Cassidy April Depo.*: 20:20-21:2. The Staff's accounting approaches were not created in the impartial atmosphere of a standard setting process, nor through the course of the Commission's general rulemaking proceedings, open to public input, but rather have been forged in the heat of particular rate cases and litigation. They are thus irretrievably infected by the results-oriented pressures such situations create.

In short, the Staff's departure from GAAP, the generally accepted accounting standard, is arbitrary and without foundation. Furthermore, unlike the FASB's standard-setting process and those similar processes adopted by other recognized standard setting authorities, the Staff has not allowed the Company any opportunity to participate in their standard-setting process. Clearly absent an as-of-yet unprovided reasonable and compelling basis for doing so, the cumulative knowledge and wisdom gathered through the open and fair standard-setting processes that have forged GAAP should not be disregarded in favor of the Staff's arbitrary, foundationless choice of accounting standards.

Q. In addition to criticizing the Staff's failure to follow a recognized system of accounting, you have also questioned their specific adjustments. Could you comment further?

A. Yes. The questionable adjustments Staff makes loosely fall into three categories. The first consists of normalizations, largely comprising averaging methodologies. The second comprises Staff's inconsistent approach to accrual accounting. The third regards Staff's policy of identifying and eliminating entirely from test year cost of service all so-called "one-time, non-recurring" costs. In each area, the Staff jettisons GAAP principles in favor of some home-cooked methodology.

Q. You have criticized the Staff's various normalization techniques in general terms. What standard has the Staff used to normalize test year information?

A. Once again, it is very difficult to tell. Staff uses various normalization techniques ranging from averaging historical information over various periods to outright adjustment of the test year for items considered "non-recurring." Sometimes, Staff combines normalization techniques with departures from GAAP basis accounting that results in completely meaningless financial information. The following table illustrates specific instances where the Staff have normalized the Company's financial information:

Area	**Staff Witness**	**Normalization technique**
Callaway refueling fuel	Cassidy	Annualize 18-month refuel
Callaway refueling overtime	Gibbs	Three Refueling Average
Capacity purchase adjustment	Cassidy	Eliminate non-recurring
Midwest ISO exit fee	Cassidy	Eliminate non-recurring
Production cost model	Bender	5-year/6-year averages
Employee benefits	Gibbs	3-month annualization
Injuries and damages	Gibbs	5-year cash basis average
Tree trimming expense	Harrison	4-year average
Automated meter reading	Harrison	Eliminate non-recurring
OPEB & pension expense	Meyer	5-year average
Territorial agreements	Gibbs	Add-back territories
Materials and supplies	Harrison	13-month average
Prepayments	Harrison	13-month average
Fuel inventory	Harrison	13-month/5-year averages
Customer deposits	Harrison	13-month average

Q. What valid explanations have the Staff provided for their decisions to normalize and their choice of normalization techniques?

A. Once again, the specific techniques adopted vary from adjustment to adjustment, as do the sufficiency of their justification.

Staff generally fails to identify the need driving its adjustments, and fails to justify the methods adopted. This is not to say that Staff has failed to provide a basis for all of its adjustments. Some have been properly supported. For instance, Staff witness Cassidy proposes to annualize the costs of refueling the Callaway nuclear reactor. As the Company does so over an eighteen-month cycle, the Staff's rationale for including only two-thirds (i.e. twelve months' worth) of the test year expense in the cost of service seems eminently reasonable. Another example of where Staff provides legitimate reasoning for the need for an adjustment is tree trimming expense. Staff Witness Harrison correctly notes that the Company is switching from a five to seven year trimming cycle to a four-year cycle. Where the Company's practices have changed, an adjustment may well be appropriate. (Once again, though, the Company disputes the nature of the adjustment Mr. Harrison proposes). But most staff witnesses are not so reasoned. For instance, returning to the Callaway refueling, Staff witness Gibbs adjusts the overtime expense associated with the refueling, not by the same approach as Mr. Cassidy, but by averaging the overtime expense of the last three refuelings. Mr. Gibbs provides no basis for departing from the test year number, other than stating that the test year number is significantly higher than past refuelings. But that alone cannot provide a basis for departure, as he has wholly failed to inquire *why* the test year number was higher. Without ascertaining the reason for the purported abnormality, he cannot justify a normalization. He equally fails to provide any explanation as to why three refuelings is the appropriate number with which to "normalize." Similarly, Mr. Harrison proposes a complicated adjustment for coal fuel inventory. He proposes a methodology involving a five year average, but does so without first inquiring whether inventory levels five years ago bear any relevance to today's stockpiles (ignoring changes in burn rates, transportation costs, coal sources etc.). He simply fails to provide the necessity for an adjustment, or any basis for the adjustment adopted.

Similar problems can be seen elsewhere. Mr. Cassidy failed to perform any analysis of the Company's accruals before deciding that they warranted adjustment.

> Q. Do you think it is reasonable to [decide to make an adjustment] without looking at why the Company accrued what it accrued?
>
> A. Yes, because the cash basis provides an allowance and recovery of actual known and measurable costs. It's not based on estimates. It's not based on predictions that the accrual basis creates.
>
> Q. So it would – in your opinion it would be reasonable to do what you do, even if the Company had a sound basis for accruing what it accrued?
>
> A. Yes.

See Cassidy April Depo., p. 57, lns. 15-25.

Staff witness Gibbs also decided to normalize injuries and damages expense over a five-year period without performing any analysis of the propriety of the Company's accrual basis expense. *See Gibbs April Depo.*, p. 49, lns. 14-25, p. 50, lns. 1-10. That five-year average resulted in a larger proposed adjustment than if Mr. Gibbs had normalized using a three-year or four-year average.

In short, the Staff has neither offered valid explanations for why they chose to normalize the accounts as they did, nor suggested valid reasons supporting the techniques employed. When viewed in light of the clearly detrimental effects to the Company resulting from these normalization techniques, the only conclusion I can draw is that the Staff was opportunistically picking and choosing normalization techniques to the detriment of the Company.

Q. You mentioned the Staff's inconsistent approach to the accrual basis of accounting? What did you mean by this?

A. As I noted above, the Staff attempts to have its cake and eat it too, adopting accrual basis of accounting in a limited setting (the Venice fire) where it benefits Staff's apparent effort to cut the Company's rates, but otherwise adopting cash accounting.

Q. What deficiencies do you perceive in Staff's recommendation?

A. Staff's recommendation of the cash basis suffers from two key flaws: (1) it divorces costs from the ratepayers who benefited from the services that generated them; and (2) it recommends setting rates on a purely backwards looking, inductive basis, rather than a forward-looking basis more relevant to the period when rates will be in effect.

A utility such as AmerenUE frequently incurs costs, the cash impacts of which will not be borne by the Company for some years to come. For instance, environmental and legal liabilities may not be satisfied for up to and over five years. The accrual basis of accounting, embodied by GAAP, and indeed required by the Commission in its reporting requirements, requires the Company to record costs associated with legal and environmental obligations at the time they become probable and estimable. By booking costs in this manner, and including them in rates on an ongoing basis, the accrual basis recovers the costs incurred to provide current services from ratepayers in temporal proximity to the events that gave rise to those costs. The alternative – waiting until cash is rendered in satisfaction of obligations associated with such costs before including them in rates – requires rate payers years removed from related services to bear the costs incurred by them.

More importantly, as I will explain in more detail below in rebutting specific adjustments, the accrual basis of accounting requires some attempt at a forward looking estimation of anticipated cash flows associated with known liabilities (i.e. incurred costs). For instance, the Company's accrual for injuries and damages is based on estimates of legal liability made by those intimately familiar with the likely exposure in any given case. Staff's cash basis, on the other hand, merely adopts the expenses associated with services and liabilities long-since past, bearing no relation to current or future services.

The fundamental problem with the Staff-proposed cash basis is that it is effectively standardless. The USOA, which the Commission, along with FERC, requires the Company to follow, requires accrual accounting. The reason may well be that accrual accounting, as embodied by GAAP, provides systematic and rational guidelines for the recognition of costs. In summation, GAAP requires that a cost be recorded when an obligation has been incurred and the amount of funds required to satisfy such obligation is estimable and probable of being paid – no sooner and no later. The so-called cash basis of "accounting" has no such restrictions.

Rather, the cash basis is readily subject to self-interested manipulation. Were the Commission to adopt it, nothing would prevent a utility from cooking its books as surely as the sun rises and sets. Staff proposes, for instance, that the cash basis is appropriate for injuries and damages. Were that to be the rate-making treatment, nothing would prevent a company from settling a large numbers of cases in a given year – and promptly filing a rate case based on that test year. A company could similarly monkey with its books through creating pre-payments – having vendors bill in advance for services yet to be rendered; or it could manipulate its environmental expenses in a manner similar to injuries and damages. The simple fact is that unlike the USOA-mandated accrual basis, the cash basis is rife with opportunity for manipulation.

Q. What efforts has the Staff made to ascertain the reasonableness of the Company's accruals?

A. Absolutely none. Staff witnesses Cassidy and Gibbs both admitted they performed no analyses whatsoever of the bases for the Company's various accrual accounts. *See Cassidy April Depo.*57:15-25; *Gibbs April Depo.* 50:5-10. Thus again, they failed to establish the need for an adjustment to the test year costs, let alone the form of that adjustment.

Q. Mr. Cassidy justifies the cash basis by arguing that it provides "a determination of rates based on actual known and measurable costs on a going forward basis as opposed to the Company's accrual basis, which relies upon an estimate of what actual future payments and costs may be." What do you make of this justification?

A. Mr. Cassidy's attempted justification underscores the critical weakness in the Staff's position. While Staff's adjustment is indeed based on actual known and measurable cash flows – associated with costs long-since incurred in the provision of electric service - Staff makes no attempt to relate those cash flows to the costs of any future period. The simple fact is that ratepayers in 2004 will not be paying for the services provided during the test year, but for service rendered in 2004, and the costs upon which rates are set should more accurately reflect that period. As Mr. Meyer testifies, quoting the Commission, the purpose of a test year is to establish a "reasonably expected level of . . . expenses . . . during the future period during which the rates [set] will be in effect." *Meyer Direct Testimony*, p. 4. Mr. Cassidy's inductive-reasoning bound approach makes no attempt whatsoever to anticipate costs on a going-forward basis, but merely adopts cash flows related to some well-past events. When Mr. Cassidy accuses the Company's approach of being based on estimates, he fails to recognize that his own adjustment is similarly an attempt to estimate future costs, but one with no foundation in the current cost of providing electric service and no forward looking component. Accrual accounting, on the other hand, is inherently grounded upon a reasonable attempt to estimate probable cash flows to be paid in a future period, and to recognize those costs when they are incurred in the provision of electric service.

Q. Could you summarize your perspective on the Staff's approach to cash and accrual accounting?

A. Yes. As with the normalization techniques discussed above, and Staff's general refusal to follow any recognized system of accounting, I view Staff's frequent alternation between cash and accrual accounting as another example of rank and objectionable opportunism.

Q. Staff has routinely adjusts test year financial information by eliminating non-recurring costs. Do you agree with this practice?

A. No, I do not. In fact, this also smacks of opportunism.

Q. Could you please summarize your objections to this practice?

A. As an initial matter, Staff lacks any coherent or principled definition of what constitutes a one-time, non-recurring expense. At a certain level of disaggregation, any expense could be termed one-time and non-recurring: an individual's paycheck; the repair of any individual power plant; an individual train-load of coal. In fact, in the past, Staff has opportunistically manipulated the use of one-time, non-recurring exclusions to remove costs that recur with some frequency. In their testimony related to the previous test year ended June 30, 2000, the Staff identified and removed from test year uncollectible expense the $2.6 million effect on "net write-offs" of the Venture Stores and Laclede Steel bankruptcies. There is nothing unusual or non-recurring about customers declaring bankruptcy. Similarly, in the current test year, there is nothing non-recurring about infrastructure repairs and replacements (meter reading costs) and interstate organization-related costs (MISO exit fee).

By contrast, GAAP principles set out a clear and principled definition of what constitutes an "extraordinary" expense. Under the Uniform System of Accounts, extraordinary expenses are defined:

> 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 of 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... 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.

USOA, par. 15,017

Such costs should clearly be removed from the test year costs and revenues so as not to prejudice the numbers on a going-forward basis. (This is not to say that such costs should not be reimbursed).

Turning to the adjustments Staff makes, by categorically removing non-recurring costs from the test year, the Staff fails to recognize that non-recurring costs occur each and every year. In other words, there is a recurring level of non-recurring costs that should be factored into the test year. For example, in the third quarter 1998, the Company incurred a pre-tax charge of $18 million related to a targeted employee separation plan, which has reduced operating expenses by approximately that same amount during each year thereafter. As noted above, in their testimony related to the current test year ended June 30, 2001, the Staff identified and removed prudent non-recurring costs related to a capacity purchase ($1.8 million), the Midwest ISO withdrawal ($12.5 million) and automated meter reading costs ($0.9 million). If the Company is not allowed to recover any non-recurring costs in future rates, then those costs will never be recovered and the Company's investment-backed expectations will be frustrated.

Q. Does the Staff understand that non-recurring costs will never be recovered by the Company if they are removed from the test year?

A. The answer rather depends on which staff member one asks. Some understand the problem. Some do not. Some understand but do not care. For example, the following excerpt is taken from Staff witness Cassidy's April 11, 2002 deposition:

> Q. If a one-time, nonrecurring event was prudently incurred and it was used and useful for the ratepayers, based on what you said earlier, it is just that the ratepayers pay for it. Would you agree with that?
>
> A. Not if it's nonrecurring.
>
> Q. Even if it is -- it was a prudent expense and it was beneficial, used and useful, for the ratepayers?
>
> A. An expense can be prudently incurred and used and useful for the ratepayers but can still be nonrecurring. It can be something that's not an ongoing, recurring expense.
>
> Q. And simply the fact that it's nonrecurring means the ratepayers shouldn't have to pay for it?
>
> A. It's not reasonable to have ratepayers pay for something that's not going to happen again.
>
> *Cassidy Depo*. p. 46, lns. 2-18.

Staff witness Harrison also appears confused as to whether the Company ever recovers prudently incurred non-recurring costs:

> Q. ...In any given test year, there are going to be one-time, nonrecurring costs, aren't there?
>
> A. I would say there's always that possibility.
>
> Q. Do you think that it is appropriate for ratepayers to pay for resources that benefit them?
>
> A. Yes.
>
> Q. Does the Staff have a general practice of excluding one-time, nonrecurring costs?
>
> A. Yes, they do.

Q. If a one-time, nonrecurring cost benefits ratepayers, when do they pay for it?

A. It's figured into the test year. The purpose for our test year now and the adjustments is on a going-forward basis, not for -- we don't go back and -- and take that amount back out. It's included in the expenses for that, but it's taken out as far as on a going-forward basis, year after year after year.

Harrison Depo. p. 108, lns. 2-17.

Q. If the Company is not allowed to recover prudently incurred non-recurring costs from ratepayers, what effects does that have on the Company?

A. Staff's adjustments are, at a basic level, a refusal to permit the Company to pass along prudently incurred costs that benefited the ratepayers. The refusal to permit recovery of such costs undermines the very business model the Company and Commission are supposed to share – one based on just and reasonable rates. Staff's approach moreover, will frustrate the Company's investment-backed expectations, and will deter the Company from making prudent expenditures that enhance the Company's provision of safe and adequate service. The Company makes investment decisions based on cost-benefit analyses, within the confines of its obligation to serve. When investing or otherwise expending funds in furtherance of the Company's obligation to provide safe and adequate service, the Company expects that such expenditures will be recovered through rates. If the Company is not allowed to recover prudently incurred non-recurring costs, then its investment-backed expectations are frustrated. The failure to allow the Company to recover all prudently incurred costs will deter the Company from expending funds that enhance the provision of safe and adequate service and promote organizational efficiency.

Q. What is the end result of Staff's opportunism?

A. By adjusting the Company's books in the various manners they do, the Staff effectively threatens the Company's long-term financial health. In repeatedly failing to justify their departure from the Company's test year costs, the Staff repeatedly fails to analyze the actual bases for those costs. It is precisely to avoid problematic adjustments such as these that, as I understand, Missouri courts have adopted the prudent management rule, whereby before adjusting a cost, the Commission must first demonstrate that an expense or investment that benefited ratepayers was not prudently incurred before disallowing or adjusting it. That rule is explained in greater detail elsewhere. But the Staff's unprincipled departure from the Company's test year accounts here, without demonstrating that those accounts are somehow suspect, and then adjusting those costs without justifying the form of the adjustment, threatens the Company's financial position as it goes forward and continues to incur costs at test year levels if not higher.

IV. ADVERTISING

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. By way of adjustments S-14.3 and S-17.3, Staff witness Leasha Teel proposes to reduce test year advertising expense by a total of approximately $1.8 million. Ms. Teel reviewed the Company's advertisements noting approximately $9,504 of gas-related advertisements recorded in Missouri electric costs. Ms. Teel has appropriately disallowed 100% of that amount for purposes of this proceeding. Ms. Teel classified each of the Company's electric-related advertisements according to the five categories recognized under the KCPL Standard (general, safety, promotional, institutional or political). That standard defines each of those categories as follows:

General – informational advertising that is useful in the provision of adequate service;

Safety – advertising that conveys the way to safely use electricity and to avoid accidents;

Promotional – advertising used to encourage or promote the use of electricity;

Institutional – advertising used to improve the Company's public image; and

Political – advertising that is associated with political candidates or issues.

Cost of service (1) always includes general and safety ads, (2) never includes institutional or political ads and (3) includes the cost of promotional ads only to the extent the benefits of such ads exceed their costs. *See KCPL*, Report and Order, 28 Mo.P.S.C. 228, 269-71 (1986). Ms. Teel classified none of the Company's ads as "safety" or "promotional" but proposes to disallow approximately $1.69 million as "institutional" advertising. Ms. Teel attached Schedules 1, 2, 3 and 4 to her testimony documenting her assessment of each of the Company's advertisements.

Q. Do you agree that Ms. Teel has properly classified the Company's advertisements in accordance with the KCPL Standard?

A. No, I do not. Ms. Teel has incorrectly classified as "institutional" (and thereby disallowed) two groups of advertisements totaling $638,321. First, Ms. Teel has disallowed $285,781 related to the SmartLights – "Slide" television advertisement (*see* Schedule 4-3 to *Teel Direct Testimony*). Ms. Teel quotes in her testimony that the SmartLights program "provides funds to help qualified not-for-profit groups and communities buy energy efficient lighting." In classifying this advertisement as "institutional", Ms. Teel fails to recognize that the primary message of this ad is to encourage and facilitate the installation of public lighting, which promotes the use of electricity. Therefore, I believe the cost of this advertisement should be classified as promotional or general rather than institutional.

In *In Re Missouri Public Service, a division of Utilicorp United, Inc.*, the Commission stated that for promotional advertising costs to be included in cost of service, the benefits to ratepayers of such advertising costs must (1) exceed the cost of the ads and (2) result from the advertisements. 118 P.U.R.4th 215, 221 (1990). In other words, the advertisements must be causally connected to the benefits, and those benefits must outweigh the costs of the ads.

The SmartLights – "Slide" ad promotes the use of off-peak, nighttime lighting which helps the Company better utilize its installed generation capacity. For cost/benefit reasons, the Company does not specifically track increased revenue resulting from any of its SmartLights programs. However, the Company estimates that during calendar 2001 it granted approximately $148,000 toward specific lighting projects and estimates that the incremental off-peak electric revenues from those projects will approximate $26,000 annually. Clearly, those incremental off-peak revenues are causally connected to the SmartLights program. Furthermore, since the estimated, incremental off-peak electric revenues will allow the Company to recover its investment in less than six-years, the benefits of the SmartLights program exceed its costs. While the Company's estimates noted above relate to calendar year 2001, I have no reason to believe these relationships would be inconsistent with the test year.

The SmartLights – "Slide" ad might very well be classified as general based on other classifications made by Ms. Teel. Specifically, Ms. Teel classified the Company's SmartLights "Outfield", "Concert", "Night Vision" and "Pepper" radio advertisements (see Schedules 2-1, 4-16 and 4-17 to Ms. Teel's testimony) as general advertisements and thereby allowed 100% of those costs. The message and intent of those advertisements are the same as the message and intent of the SmartLights – "Slide" television ad in that they all encourage and facilitate the installation of public lighting and thereby promote the use of off-peak electricity. In the case of the SmartLights "Outfield", "Concert", "Night Vision" and "Pepper" ads, it appears as though Ms. Teel has come to the correct conclusion regarding the benefits to ratepayers. It is surprising that she has not come to the same conclusion with the SmartLights "Slide" advertisement.

Second, Ms. Teel has classified as institutional $352,540 related to the Jane and Fred/Direct Pay radio advertisement (see Schedules 2-1 and 4-18 to Ms. Teel's testimony). I believe this advertisement should be classified as general and fully included in cost of service because its primary messages are to provide information on becoming a direct pay customer, and to encourage the customer's switch thereto.

When customers become direct pay customers, the Company is better able to manage its collection of accounts receivable, thereby improving cash inflows to the Company and improving the Company's ability to deliver adequate service. Direct pay also reduces the Company's transaction costs. Adequate service clearly requires prompt and predictable cash collection and minimized transaction costs. Providing information to ratepayers about a service that so clearly helps the Company deliver adequate service fits the Jane and Fred/Direct Pay radio ad within the KCPL standard for general advertising.

Q. Do you have any further comments on Ms. Teel's testimony regarding advertising?

A. I would like to briefly summarize my understanding of this area. First, the KCPL Standard is a reasonable standard so long as it is fairly and consistently applied. The Company is not disputing the substantial majority of Ms. Teel's proposed adjustments. However, I do believe she has incorrectly applied the standard to the SmartLights – "Slide" and Jane and Fred/Direct Pay advertisements. These advertisements should not be classified as institutional because the primary message of each of these ads is not to enhance the Company's public image. In the SmartLights – "Slide" ad, the primary message is the promotion of off-peak electricity, which helps the Company better utilize its electric generation assets. In the Jane and Fred/Direct Pay ad, the primary message is to provide information that encourages customers to switch to direct pay, which minimizes transaction costs and improves the Company's ability to provide adequate service.

V. RATE CASE EXPENSE

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. Staff witness Leasha Teel is proposing to include in test year expense, and thereby allow the Company to recover *on an annual basis*, $300,000 of the Company's expenses incurred in connection with this rate case. Ms. Teel states that "[t]he Staff believes a level of $300,000 is a sufficient annual allowance for rate case expense."[2]

Q. Do you agree with Ms. Teel's proposed adjustment?

A. No, I do not. I disagree with Ms. Teel's proposed adjustment for the following two reasons. First, I disagree with Ms. Teel's exercise of discretion in this area. It is a generally accepted rule that known and measurable, reasonable, necessary and prudently incurred expenses should be allowed as rate case expense. The Company has the burden of substantiating its rate case expense, which it has done in its response to Data Request No. 17. Rate case expenses should not be disallowed unless the Staff can cite specific items that are unknown, not measurable, unreasonable, unnecessary or not prudently incurred. Absent such a showing, all rate case expense should be recovered. See Re Missouri American Water, Case Nos. WR-95-205, SR-95-206 (Mo.P.S.C. 1995).

Here, Ms. Teel has superimposed her own arbitrary judgment as to what a sufficient level of rate case expense recovery should be. She stated in her November deposition that she didn't remember how she calculated this number, adding that she talked with her supervisor to determine the number.[3] She stuck to the $300,000 figure in her second testimony, even though her workpapers demonstrated that UE's expenses for just the three months of the update period were in excess of $338,000.[4] When asked why she did not annualize the three-month expenses of $338,000, she merely responded that the Staff believed $300,000 is enough.[5] This determination is the epitome of arbitrariness. Nowhere has Ms. Teel set forth specific items that she considered

[2] *Teel Direct Testimony*, p. 6, lns. 8-9.
[3] *Teel Nov. Depo.*, p. 48, lns. 5-9; p. 49, lns. 12-19.
[4] *Teel April Depo.*, p. 43, ln. 24 through p. 44, ln. 8.
[5] *Teel April Depo.*, p. 44, ln. 17 through p. 45, ln. 12.

imprudent, unreasonable, not necessary, unknown or immeasurable. Absent such a showing, all of the Company's rate case expense should be recovered. I believe this to be yet another example of the Staff's use of improper and arbitrary adjustments to the detriment of the Company.

Second, Ms. Teel's adjustment fails to recognize the fact that the Company has been forced to defend two different test years. The Company incurred significant external expense preparing to defend the original June 30, 2000 test year. Failure to allow full recovery of rate case expense related to the June 30, 2000 test year would unfairly penalize the Company for the Staff's initial use of an improper test year. Since the test year was changed to June 30, 2001, the Company expects it will again incur significant expense to defend the new test year, bringing the estimated, expected total to at least $2.6 million. Allowing the recovery of just $300,000 per year stretches the Company's recovery over approximately nine years, an unfairly long period. I believe the cost of service should include $900,000 for rate case expense, which would allow the Company to recover its expected rate case expense over approximately three years.

VI. <u>DUES AND DONATIONS</u>

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. Staff witness Leasha Teel proposes to reduce test year dues and donations expense by approximately $616,000, arguing that certain expenditures of this sort "are not necessary for safe and adequate service, and provide no direct benefit to the ratepayers." Included in Ms. Teel's adjustment is $600,104 paid to the Edison Electric Institute (EEI).

Q. Do you agree with Staff witness Teel's proposed adjustment?

A. I recognize that the Commission has historically excluded dues and donations on the basis that they generally benefit shareholders rather than ratepayers. However, I strongly believe that dues paid to EEI should be fully included in cost of service. To a large extent they represent non-lobbying activities and provide significant benefits to ratepayers and therefore should be included in cost of service.

Q. What percentage of the EEI dues represents non-lobbying expense?

A. According to an "Audit Report of the Expenditures of The Edison Electric Institute" issued by the National Association of Regulatory Utility Commissioners (NARUC) in June, 2001, over 40% of EEI's expenses fall in the categories of "Utility Operations & Engineering" and "Finance, Legal, Planning and Customer Service." (See Schedule 1-2). The former category includes "information on utility operations and engineering issues," defined to mean "engineering and standards, fossil and synfuels, nuclear power and environment," and <u>not including</u> costs for activities related to legislative or regulatory advocacy or research. (Schedule 1-5) Ms. Teel conceded in her first deposition that these seemed to be expenditures that benefit ratepayers.[6] The second category includes the costs of "acquisition, compilation, categorization and dissemination of information useful in the improvement of the quality and value of service rendered to customers." (Schedule 1-6). Ms. Teel admitted that this too, seems to cover expenditures that benefit ratepayers.[7]

As NARUC is an impartial body whose membership includes all 50 state public service commissions, including this Commission, its determination should be

[6] *Teel Nov. Depo.*, p. 44, ln. 18 through p. 45, ln. 5.
[7] *Teel Nov. Depo.*, p. 45, lns. 11-18

conclusive of this matter. Forty percent of UE's EEI dues are $240,000, which should be included as legitimate, non-lobbying expenses that benefit ratepayers.

Q. Why do you think that EEI dues should be allowed when other dues and donations are generally disallowed?

A. Because the Company's membership in EEI <u>does</u> directly benefit ratepayers by allowing the Company to provide safer and more adequate service. I recognize that the Commission has historically disallowed EEI dues absent a showing of direct, quantified benefits allocated between ratepayers and shareholders. *See In Re: Kansas City Power & Light*, 75 P.U.R.4^{th} 1, 32 (1986). However, that decision was issued before NARUC audited EEI's expenses. Further, I strongly believe that the direct benefits to ratepayers resulting from the Company's EEI membership are implicit in the Company's history of safe and adequate service. Without the benefits of membership in EEI, the Company would be less able to provide safe and adequate service at a low cost because it would not have available to it the benefits of current industry information or would have to incur substantially more cost to gain the industry information available through EEI.

As noted in the Company's response to Data Request No. 9, the Company does not formally quantify or allocate the direct benefits of EEI dues. In fact, such benefits may not be quantifiable or allocable with any higher degree of certainty than quantifying the benefits of any individual employee, employee training program or other administrative activity. And the need to quantify the benefits is eliminated by NARUC's audit. In any event, ratepayers benefit from the Company's membership in EEI because EEI provides a network of electric industry expertise that the Company regularly draws upon. EEI membership allows the Company's employees to keep current on industry developments, allows the Company to participate in and reap the benefits of industry-specific surveys and other knowledge sharing mechanisms and, overall, reduces the cost to individual members of providing these benefits. Without such EEI benefits, the Company would either have to do without needed information and services or it would have to pay the entire cost of the needed information and services itself. Clearly, having to do without, or paying more for the information and services available through the Company's EEI membership, would detract from the Company's ability to provide ratepayers with safe and adequate service at a reasonable price.

Q. Are you personally aware of operational benefits provided by EEI?

A. Yes. In my previous positions at PricewaterhouseCoopers, I spoke from time to time at EEI property accounting and accounting managers' meetings on subjects such as financial reporting trends and techniques, new FASB and SEC accounting and reporting guidance and other subjects. As the Controller of AmerenUE I have required various members of my staff to attend EEI seminars on various matters including accounting for derivatives and hedging activities as well as accounting for certain costs and activities related to property plant and equipment, amongst other things. I personally will attend the June 2002 EEI Chief Accounting Officers Conference. At each of these conferences I can say from personal knowledge, and reports provided me by my staff, that the EEI professionals work hard to assemble accounting experts from the "Big 5" accounting firms, the FASB, the SEC and the FERC to impart invaluable knowledge and insight that helps AmerenUE comply with new accounting rules in a complete and efficient manner. Frankly, the types of benefits AmerenUE derives are identical to those which I imagine are derived by members of the regulatory community that attend NARUC Accounting and Finance Subcommittee meetings such as the one held March 17 through March 21, 2002 in Richmond, Virginia. Obviously, NARUC and regulatory personnel view NARUC membership valuable, if not invaluable, which is the way I view EEI membership.

Q. Do you have any further comments on Ms. Teel's proposed adjustment to dues and donations expense?

A. I just want to reiterate that I do understand the Commission's standard for inclusion of EEI dues, as articulated in the Kansas City Power & Light case. However, I also want to stress that, as explained above, ratepayers receive significant benefits from the Company's EEI membership. While those benefits may not be specifically quantifiable by the Company they most certainly do contribute to the Company's provision of safe and adequate service at a reasonable price, and therefore, benefit ratepayers. I strongly recommend that the Commission reassess its historical disallowance of EEI membership dues and allow the full amount in cost of service, or at a minimum the non-lobbying portion of EEI, as calculated by the Commission's own organization, NARUC.

VII. MoPSC ASSESSMENT

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. Staff witness Leasha Teel proposes to reduce test year expense by $456,397 in order to reflect in cost of service the MoPSC assessment for the fiscal year ended June 30, 2002.

Q. Do you agree with Staff witness Teel's proposed adjustment?

A. No, I do not. Ms. Teel is proposing to adjust the test year for items occurring outside the test year and the update period, which is inconsistent with the test year concept described by Staff witness Greg Meyer. *See Meyer Direct Testimony*, pp. 3-6. According to Mr. Meyer, "[t]he test year forms the basis for any adjustments . . . to appropriately reflect any on-going increase or decrease *shown in the financial records of the utility*." *Id.* at 4. In contrast, Ms. Teel's proposed adjustment includes items occurring after the test year ended June 30, 2001, and after the update period ended September 30, 2001. Therefore, the basis for Ms. Teel's proposed adjustment is not *shown in the financial records* of the Company as of the end of the test year and updated period. Like every other account, Ms. Teel's analysis of the MoPSC assessment should be confined to the amount reflected in the test year ended June 30, 2001, updated for known and measurable changes through September 30, 2001. By adjusting the test year amount to reflect events occurring outside the test year and the update period, Ms. Teel is departing from the test year concept that is so fundamental to this ratemaking proceeding. This proposed adjustment clearly depicts Ms. Teel's use of opportunism to the detriment of the Company and should not be supported by the Commission.

Q. Assuming the data on which staff witness Teel based her adjustment was considered to be appropriate for use in this proceeding, would you still conclude her adjustment to be opportunistic?

A. Yes I would. In her deposition Staff witness Teel suggests that she ignored the opportunity to average fluctuating historical information which would have been a benefit to the Company:

> Q. Now the particular adjustment that we were just talking about the PSC, the current year number was $3.4 something million and the previous year was $3.87 million and the previous fiscal year was $3.6 million. So it went from $3.6, $3.87 to $3.4. Now, if [this] were not the Missouri Public Service Commission Assessment which we know can be set by the Commission at whatever it wants and instead were another expense item if the expense over three years went from $3.6 million to close to $3.9 million and then down to $3.4 million, would that be a cause for scrutiny for adjustment? Would the fluctuation from going from a higher to the lowest point in the most recent year be some reason to do an average?
>
> A. Yes.
>
> Q. And if it were another category of expense you might consider an average of over a several year period if there were fluctuation?
>
> A. Given the assumption that it would be another expense, yes. It would depend on that various expense.

Teel April Depo., p. 40, ln. 23 through p. 41, ln. 20.

In light of this opportunism, I again recommend that the Commission not accept this adjustment proposed by Staff witness Teal.

VIII. VENICE POWER PLANT ADJUSTMENTS

Q. What is your understanding of the Staff's proposed adjustments in this area?

A. Staff witness Paul R. Harrison proposes six adjustments to plant in service, one adjustment to depreciation reserve and two adjustments to cost of service related to insurance proceeds received in settlement of claims resulting from a fire at the Company's Venice, Illinois, power plant. That fire occurred in August 2000. All of the proceeds from the insurance settlement were received after September 30, 2001.

Mr. Harrison proposes a total of six adjustments reducing plant in service by a total of $5,119,110. Mr. Harrison calculated these adjustments, by individual plant in service account, based on the ratio of post-fire Venice capital expenditures incurred through September 30, 2001 to total post-fire Venice capital expenditures incurred through December 31, 2001. In other words, the total insurance settlement was pro-rated in accordance with the timing of related capital expenditures.

Mr. Harrison proposes to increase the September 30, 2001 depreciation reserve by $2,078,000. Mr. Harrison proposes this adjustment because the Company "chose not to restore [Venice Power Plant] units 1 and 2 that were damaged as a result of the fire" but instead, chose to spend related insurance proceeds to improve other Venice generating units.

Mr. Harrison proposes two adjustments that reduce test year cost of service by a total of $8,428,425. Mr. Harrison determined the amount of his adjustments through a two-step process. First, if the amount of the insurance settlement equaled the amount expended during the test year ended June 30, 2001, then Mr. Harrison reduced test year expense by the full amount of the insurance settlement related to that account. Second, if the insurance settlement was greater than test year expense, then Mr. Harrison reduced test year expense by an amount of the insurance settlement based on the ratio of test year expense to total expense updated through December 31, 2001.

Q. Do you agree with Mr. Harrison's proposed adjustments resulting from the Venice fire insurance proceeds received after September 30, 2001?

A. No, I do not. Mr. Harrison is attempting to reduce test year plant in service, increase test year depreciation reserve and decrease test year cost of service as a result of insurance proceeds received after September 30, 2001. Adjustments related to items occurring after the test year and update period are inconsistent with the test year concept that is so fundamental to this ratemaking proceeding. The Commission should not permit the Staff to engage in opportunistic activities of this sort.

By proposing these adjustments, I believe Mr. Harrison is alleging that the amount of the insurance proceeds should be reflected in the test year because the amount of the settlement was known and measurable at September 30, 2001. However, as Mr. Harrison admitted in his April 11 deposition, the insurance settlement was not known and measurable until early 2002. See *Harrison Depo*, p. 61, lns. 21-4. Amounts received during October 2001 and November 2001 totaled only $7,500,000, or approximately one-third of the total settlement. After these initial payments were received, the remaining two-thirds of the total settlement remained subject to acceptance by the insurance carrier. It was not until December 28, 2001 that the Company knew the ultimate amount of the final settlement with any degree of certainty. Therefore, the amount of the insurance settlement was neither known nor measurable at September 30, 2001 or for a period of time thereafter. It is significant to note that it was not until May 1, 2002 that the Company received a final settlement amount.

Q. Why did the Company not reflect the insurance settlement in its accounting records as of September 30, 2001?

A. The Company recorded the anticipated insurance proceeds when the claims were accepted by the insurance carrier because accrual accounting, consistent with GAAP, requires that the Company record a gain contingency when the gain is realized. See Statement of Financial Accounting Standards No. 5, par. 17. Realization of this insurance settlement, which was considered a gain contingency, could only occur when the Company received the cash or otherwise reduced the claim to an amount so certain of recovery as to remove any contingency. As explained above, the Company received no cash before September 30, 2001 and was unable to remove substantial contingencies until the claim was ultimately settled in December 2001. If the Company had recorded the insurance proceeds in advance of their receipt or the claim being settled and accepted, as Mr. Harrison's proposed adjustments suggest, it would have violated GAAP.

Q. Do you have any further comments on the proposed adjustments resulting from the Venice Power Plant fire?

A. I would like to stress that this is yet another example of the Staff proposing opportunistic adjustments to the detriment of the Company. In this situation, Mr. Harrison is jeopardizing the fairness of the ratemaking process by altering the fundamental test year concept and by proposing adjustments that alter the Company's consistently applied accrual accounting method. Clearly, this type of standardless ratemaking should not be tolerated.

IX. AUTOMATED METER READING SERVICE EXPENSE

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. Staff witness Paul Harrison proposes a $910,197 decrease in test year cost of service by removing from automated meter reading service expense certain prior period adjustments and non-recurring charges. Mr. Harrison appropriately identified and removed from the test year two credits totaling $52,591 related to prior periods. Additionally, Mr. Harrison proposes to remove $871,655 of non-recurring retrofit charges required to convert the manual meters to automated meters, $88,306 of non-recurring polycarbonate meter cover charges required to replace the old meter covers and $2,827 of non-recurring "door hanger" notification tag charges incurred during the conversion to automated meters.

Q. Do you agree with Mr. Harrison's proposed adjustments related to the one-time retrofit charges, polycarbonate meter cover charges and "door hanger" notification tag charges?

A. No, I do not. As I discussed above, by wholesale excluding one-time, non-recurring costs from the cost of service, the Staff is denying the Company any opportunity to ever recover the costs of these items, despite the fact that they were both prudently incurred and beneficial to the ratepayers. Staff's adjustment also ignores the fact, discussed above, that similar one-time, non-recurring costs are incurred every year. In fact, Company witness Thomas R. Voss states in his rebuttal testimony in this case that $491,801 of the retrofit charges Mr. Harrison proposes be disallowed will actually be a recurring annual expense through the year 2015. As I have argued, accurate cost of service ratemaking should either include such one-time, non-recurring costs, or should make an allowance for a normalized level of one-time, non-recurring costs.

It merits noting that, judging from Staff's testimony, Staff performed no analysis whatsoever as regards whether these costs were beneficial to the ratepayers and whether they were prudently incurred. It strikes me that at the very least, any proposed adjustment ought to begin with Staff asking these elemental questions. For these reasons and the reasons cited above I recommend to the Commission that Mr. Harrison's proposed adjustments be rejected.

X. <u>INJURIES AND DAMAGES</u>

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. Staff witness Doyle L. Gibbs proposes to reduce test year injuries and damages expense by $5,204,754 reflecting an average of actual cash payments during the five-year period ended September 30, 2001. Mr. Gibbs believes a five-year average is an appropriate period over which to normalize this account because of significant annual fluctuations during that five-year period. Mr. Gibbs uses a cash basis to calculate his five-year average rather than the Company's consistently applied accrual basis because "[i]t is the Staff's opinion that on-oing [sic] rates should be based on an average reflecting actual payments, rather than based on estimates of future costs with unknown payment dates."[8]

Q. Can you describe how the Company records its liability and expense related to injuries and damages?

A. The Company records its liability and expense related to injuries and damages on the accrual basis, consistent with GAAP. According to Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies", the Company is required to accrue a liability for injuries and damages when (1) the event giving rise to the cash expenditure has occurred and payment is probable, and (2) the amount of the expenditure is reasonably estimable.

The Company reasonably estimates its probable liability on a periodic basis through discussions with the Company's lawyers who are closely involved with

[8] *Gibbs Direct Testimony*, p. 28, lns. 1-2.

specific injuries and damages matters. The amount of periodic expense accrued by the Company approximates the amount required to adjust the financial statement liability to that estimated amount which is probable of being paid.

Q. Was it appropriate for Mr. Gibbs to normalize injuries and damages expense?

A. Let me repeat that I believe that the Company's accrual basis financial statements for the test year ended June 30, 2001 reflect an appropriate level of operating expense on a going-forward basis. That being said, I understand normalization has been an accepted practice when addressing certain accounts that fluctuate significantly from year to year. As Mr. Gibbs notes in his testimony, injuries and damages expense has fluctuated significantly from year to year during the five years ended September 30, 2001. For that reason, I am not too surprised by Mr. Gibbs' proposal to normalize this account. However, I strongly disagree with Mr. Gibbs' arbitrary choice of five-years, and the fact that he chose five-years of cash charges instead of five-years of accrual basis expense.

Q. Why do you disagree with Mr. Gibbs' use of a five-year normalization period?

A. Because it is arbitrary and opportunistic. Mr. Gibbs fails to justify his choice of five years, other than stating "reliance on any *one* year would not be acceptable . . . ." Without offering a justification for choosing five-years instead of a different averaging period, Mr. Gibbs' choice is clearly arbitrary. Had Mr. Gibbs chosen a three-year or four-year, cash-basis averaging period, his proposed reduction would have been approximately $500,000 less. The fact that a five-year average creates a larger proposed adjustment leads me to believe that Mr. Gibbs' was opportunistic in choosing a five-year averaging period to the detriment of the Company.

Q. Is the cash basis an appropriate method of recording injuries and damages expense?

A. Absolutely not. The accrual basis of accounting is the appropriate method because it best matches revenues with the costs to generate those revenues. The cash basis fails to recognize amounts that are probable of being paid and reasonably estimable. My understanding is that the life of a significant personal injury case is generally about three to five years. Due to the length of time involved, if the cash basis is allowed for injuries and damages, future ratepayers receiving service a long time after the events giving rise to the injuries and damages payments will be forced to pay for such costs.

Other than stating, "it is the Staff's opinion", Mr. Gibbs fails to justify his conclusion that the cash method is more appropriate than the Company's consistently applied accrual method. Basing adjustments on arbitrary Staff opinions jeopardizes fundamental fairness and contributes to a standardless ratemaking proceeding. Moreover, Mr. Gibbs' use of the cash basis, when combined with his arbitrarily selected five-year averaging period, results in an adjustment that is approximately $1.7 million higher than it would have been had he averaged accrual-basis expense for the same five-year period. Once again, the choice of the cash basis instead of accrual basis expense appears opportunistic to the detriment of the Company.

Q. Do you have any recommendations for how injuries and damages expense should be determined for purposes of this rate case?

A. Yes, I do. As I previously testified, I believe that the accrual method, as reflected in the Company's financial statements for the most recent test year, provides a reasonable level of operating expense on a going-forward basis. In fact, the large payments made in August and September 2001 clearly support the fact that the Company's injuries and damages reserve balance – which has grown under the accrual method -- has not only been appropriate but accurately predictive of increasing future cash charges.

XI. LEGAL FEES

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. Staff witness John P. Cassidy proposes to reduce test year legal expense by $2,686,177 based on the difference between accrual basis expense recorded during the test year and cash basis legal fees paid during the twelve-month update period ended September 30, 2001. Mr. Cassidy also proposes to remove $486,905 from test year expense claiming that amount represents non-recurring charges related to the third sharing period of the second EARP.

Q. Can you describe how the Company records its liabilities and expense with regard to legal fees?

A. In order to state its books and records on an accrual basis, the Company periodically estimates the amount it expects to pay to outside legal counsel and accrues that amount ratably over the period in which the services are expected to be rendered. That estimate includes fees for services rendered but not yet billed. The amount expensed on the accrual basis is accumulated in a liability account, which is relieved when the Company actually pays the legal fees.

Q. Why has the Company accrued more during the test year than it has paid during any of the last few years?

A. The Company is incurring increased legal fees related to such costs that have occurred, and accrual accounting requires that the Company accrue for matters when the amounts to be paid are probable and reasonably estimable. In periods of increasing costs, because of increasing numbers of legal disputes or matters coupled with increasing professional services rates, accruals will naturally increase at a rate faster than cash payments.

The amount of the Company's test year legal fees accrual is consistent with the increase in the occurrence of injuries and damages. The Company expects increased injuries and damages payments. Correspondingly, it also expects an increase in legal fees related thereto. Another factor contributing to the Company's reasonable estimate of its probable legal fee liability is increased environmental issues. Once again, the higher legal fee accrual is consistent with increased environmental liabilities. Significantly, the Company often, and on a recurring basis, incurs legal fees investigating and assessing matters even before it is required to record liabilities related to injuries and damages and environmental issues.

Q. Is the cash basis an appropriate method for recording legal fees?

A. Absolutely not. As I have previously testified, I believe the accrual basis of accounting, as reflected in the Company's books and records during the June 30, 2001 test year, represents an appropriate level of operating expenses on a going-forward basis.

Mr. Cassidy has not provided any valid reason to depart from the accrual basis. In fact, at his deposition, he acknowledged that he did not review the Company's basis for accruing legal fees. *Cassidy Depo.* p. 55, lns. 10-13. Without assessing the Company's accrual accounting, Mr. Cassidy's reason for departing from accrual accounting is invalid.

Ratepayers today enjoy the benefits of the Company's actions and inactions. Those acts have legal consequences that may not trigger payment of legal fees until some time in the future. Nevertheless, the electric service customers are receiving today generates the level of legal costs reflected in the Company's cost of service and, therefore, such costs are the best reflection of costs anticipated to be incurred on a going forward basis. The accrual basis results in a better matching of revenues with the events giving rise to the payment of legal fees.

Q. Do you agree with Mr. Cassidy's proposed adjustment removing $486,905 from the test year because it relates to non-recurring costs associated with the third sharing period of the second EARP?

A. No, I do not. While I recognize that the Staff plans to include this amount in cost of service when calculating customer credits for the third sharing period of the second EARP, Mr. Cassidy's adjustment again fails to recognize a recurring level of non-recurring costs. If the Company is not allowed to recover prudently incurred non-recurring costs, then those costs will never be recovered. If costs such as this are not included in going-forward rates, then non-recurring costs that inevitably will occur in the future will not be recovered. I also note that the Staff has filed a complaint regarding this sharing period, and thus legal expenses relating to the period are recurring.

XII. ENVIRONMENTAL EXPENSE

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. Staff witness John Cassidy proposes to reduce environmental expense by $5,423,449 based on the difference between amounts paid during the twelve-month update period ended September 30, 2001 and the accrual basis expense as reflected in the Company's books and records for the test year. Mr. Cassidy asserts that, at September 30, 2001, the Company has, "amassed an over accrued environmental reserve balance totaling $14,233,749 . . . represent[ing] the amount that the Company thinks it might incur at some undetermined time in the future."[9]

Q. Please describe how the Company records its environmental liability and related expense.

A. The Company records its environmental liability and related expense on the accrual basis of accounting, consistent with GAAP. According to Statement of Financial Accounting Standards No. 5 and FASB Interpretation No. 14, the Company is required to accrue its best estimate of its liability for environmental costs when (1) the event giving rise to an expected cash expenditure has occurred and payment is probable, and (2) the amount of the expenditure is reasonably estimable.

The Company periodically estimates its minimum and maximum exposure on a site-by-site basis. Such periodic estimates involve internal analyses and discussions with outside counsel who are intimately familiar with the Company's environmental matters. The Company adjusts its total environmental reserve based on the aggregate of

[9] *Cassidy Direct Testimony*, p. 15, lns. 8-15.

these site-by-site, minimum/maximum analyses.

I believe Mr. Cassidy has misinterpreted the Company's response to Staff Data Request No. 32. By quoting "[t]he environmental reserve is not booked by individual site", Mr. Cassidy appears to be asserting that the Company does not analyze its liability on a site-by-site basis. *See Cassidy Direct Testimony*, p. 17, lns. 9-14. As I previously noted, while the Company adjusts its total environmental liability based on the aggregate of the minimum/maximum estimated exposures, it does determine that aggregate estimated exposure based on individual, site-by-site analyses.

The periodic expense accrued by the Company is the amount required to adjust the aggregate financial statement liability to the reasonably estimated amount probable of being paid.

Q. Is the cash basis an appropriate method of recording environmental expense?

A. Absolutely not. As I previously testified, the cash basis fails to recognize amounts that are probable of being paid and reasonably estimable. Mr. Cassidy asserts that the cash basis is more appropriate because he believes the Company has over accrued environmental expense during the test year and update period based on the difference between cash paid and accrual basis expense during the test year. Nowhere in Mr. Cassidy's testimony does he consider the probability and reasonableness of the Company's recorded environmental liabilities, and he has not asserted that such recorded liabilities are inappropriate.

Moreover, the accrual basis of recording environmental liabilities and related expense better assigns collection through rates to the ratepayers that benefited from the Company's actions that led to recorded environmental liabilities. Because of the length of time generally associated with environmental remediation projects, if recovery in rates is postponed until environmental liabilities are actually paid, ratepayers who did not benefit from the Company's acts will be required to pay for those acts. Prudent ratemaking principles should not allow such inequity.

Q. Do you have any recommendations for how environmental expense should be determined for purposes of this rate case?

A. As a general principle, I believe that the accrual basis expense, as reflected in the Company's financial statements for the June 30, 2001 test year, provides a reasonable level of operating expense on a going-forward basis. The Company expects to continue to incur this level of periodic expense, which is supported by the fact that the Company accrued an additional $5.3 million in December 2001 based on the site-by-site analysis discussed above.

I would also like to note that environmental expense is distinguishable from injuries and damages expense for the following two reasons. First, unlike injuries and damages, the Company has not yet been required to make significant payments related to its environmental liabilities. Second, the amounts and length of time required to resolve environmental liabilities tends to be much larger than injuries and damages. For these reasons, even if the Commission decides that the cash basis is more appropriate for injuries and damages, the inherent differences between environmental expense and injuries and damages dictate that the accrual basis is clearly superior to the cash basis for determining environmental expense.

XIII. UNCOLLECTIBLE EXPENSE

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. Staff witness Doyle Gibbs proposes to increase test year uncollectible expense by $1,467,371 to equal "net write-offs" during the update period ended September 30, 2001. As I discuss below, he should have proposed to increase test year uncollectible expense by $3,752,371.

Mr. Gibbs defines "net write-offs" as amounts charged against the Company's liability for uncollectible accounts, less recovery of amounts previously written off. In distinguishing net-write-offs from accrual basis uncollectible expense, Mr. Gibbs states "[i]t is the Staff's opinion that write-offs, since they reflect actual activity, are a better indicator of this cost than the accruals, which are based on estimates", citing "a long-standing Commission policy."[10] Mr. Gibbs proposes to use net write-offs for the update period ended September 30, 2001 (instead of the test year ended June 30, 2001) because of a "substantial increase in net write-offs during 2001."

Mr. Gibbs has made a fundamental error. In calculating his proposed adjustment, he has compared net write-offs for the twelve-months ended September 30, 2001 to accrual basis expense *for the twelve-months ended September 30, 2001.* Clearly, Mr. Gibbs should have calculated his proposed adjustment to be an increase to uncollectible expense of $3,752,371 based on the difference between net write-offs for the twelve-months ended September 30, 2001 ($9,009,371) and accrual basis expense for

[10] *Gibbs Direct Testimony*, p. 34, lns. 12-15

the test year ended June 30, 2001 ($5,257,000). The remainder of my testimony in this area will assume this correct proposed adjustment.

Q. Can you describe how the Company calculates and records its balance sheet reserve and related uncollectible expense?

A. In accordance with accrual accounting, on a periodic basis the Company assesses the sufficiency of its recorded reserve for uncollectible accounts receivable, including customer and miscellaneous receivables. In assessing the sufficiency of its balance sheet reserve, the Company considers historical trend information and specific events affecting individual customers, such as bankruptcy filings. The amount of uncollectible expense accrued by the Company approximates the amount required to adjust the balance sheet reserve to equal the Company's best estimate of its exposure to uncollectibles.

When specific receivables are deemed uncollectible, they are written-off against the balance sheet reserve without affecting accrual basis expense. Any recoveries of amounts previously written-off reinstate the balance sheet reserve with no direct effect on recorded expense.

Q. Do you agree with Mr. Gibbs' proposal to use net write-offs rather than accrual basis uncollectible expense?

A. No, I do not. As a general principle, I believe that amounts reflected in the Company's accrual basis financial statements for the test year and update period reflect a reasonable level of operating expense on a going-forward basis. If Mr. Gibbs had compared accrual basis uncollectible expense for the twelve-months ended September 30, 2001 to the test year ended June 30, 2001, his proposed adjustment would have been

$2,285,000. I believe that would have been the appropriate adjustment under the circumstances.

I do, however, understand the long-standing Commission policy of using net write-offs rather than accrual basis uncollectible expense. Obviously, should the Commission decide to continue with that policy, the amount of proposed adjustment S-13.4 must be changed to reflect a $3,752,371 increase to uncollectible expense.

XIV. TERRITORIAL AGREEMENTS

Q. What is your understanding of the Staff's proposed adjustment in this area?

A. Staff witness Doyle Gibbs proposes four adjustments related to the Company's territorial agreements with Black River Cooperative, Macon Electric Cooperative, Farmer's Electric Cooperative, the City of Kennett and Ozark Border Electric Cooperative. Mr. Gibbs proposes to increase plant in service by $1,390,000 related to distribution plant transferred, increase depreciation reserve by $180,183 related to the transferred distribution plant, increase test year revenue by $2,537,448 to restore the level of electric revenues existing before the agreements and increase test year maintenance expense by $443,737 for the difference in maintenance expense before and after the agreements. Proposed adjustments to depreciation expense and fuel expense related to the territorial agreements are addressed in those respective areas of Mr. Gibbs' and Staff witness Cassidy's testimonies.

According to Mr. Gibbs, these proposed adjustments "reverse the net reduction in earnings realized during the test year by restoring the net investment, revenue and expense levels as if the territorial agreements had not taken place."[11]

Mr. Gibbs believes these adjustments are necessary to avoid detriment to the public, as defined in RSMo 394.312. In his opinion, reflecting in electric rates the net loss of customers and related revenue resulting from the territorial agreements would constitute such a public detriment.

Q. Have the Company's territorial agreements been addressed in any previous rate-related hearing before the Missouri Public Service Commission?

A. Yes, two of them have been. In Case No. EO-96-14, the Commission ordered that the Company restore the effects of those territorial agreements for purposes of its Final Earnings Report and Credit Sharing Proposal for the EARP year ended June 30, 1998. In that proceeding, both the Staff and the Company agreed that the long-term effects of the territorial agreements would not be detrimental to the public. Nevertheless, the Commission found that because the Staff had reserved the right, either explicitly or impliedly, to examine the short-term effects of the territorial agreements on the EARP's customer credit mechanism, the adjustments were allowed for purposes of that proceeding.

The Commission's order regarding territorial agreements in Case No. EO-96-14 is currently pending an appeal before the Circuit Court of Cole County, Missouri. While the Company continues to assert the incorrectness of the Commission's order and in no

[11] *Gibbs Direct Testimony*, p. 33, lns. 8-10.

way agrees with or acquiesces in that decision, the remainder of my rebuttal testimony will address this issue assuming the Commission's order is upheld on appeal.

Q. Do you agree with Mr. Gibbs' proposed adjustments in this area?

A. Absolutely not. Mr. Gibbs' proposed adjustments are completely inappropriate because they (1) are based on a prior Commission order that is inapplicable to this ratemaking proceeding, (2) are based on inaccurate and out-of-date information and (3) violate well-settled "prudent management" ratemaking theory. For those reasons, I strongly disagree with Mr. Gibbs' proposed adjustments and assert that no adjustments related to territorial agreements should be made.

Q. Do Mr. Gibbs' proposed Territorial Agreement adjustments contain any other errors or omissions that have an impact in other areas of Staff's testimony?

A. Yes they do. Even if the Company accepted Mr. Gibbs' approach and his use of outdated data, his methodology would still be wrong, and unfair to the Company. By reversing the effects of these agreements, Mr. Gibbs attributed customers, and therefore kilowatt-hour usage, to the Company, which it in actuality did not have during the test year. While the Staff thereby increases the base of customers over which rates may be set, its calculations fail to credit the Company for offsetting expenses it would necessarily incur. For instance, Mr. Gibbs makes no adjustment to expense levels related to billing and mailing, meter reading, or uncollectible expense in light of these additional customers. Nor does the Staff adjust its coincident peak calculation to reflect the higher peak demand additional customers would necessarily entail. In short, Mr. Gibbs' proposed adjustments are also incomplete in that they do not fully include all the effects of restoring the agreements.

Q. Do you believe the Commission's decision in Case No. EO-96-14 is applicable to this proceeding?

A. No, I do not. First, Case No. EO-96-14 was a proceeding exclusively related to the Company's EARP and the related sharing mechanism used to determine customer credits. Second, the difference between short-term, hindsight-focused customer credits under the EARP and longer-term, forward-looking ratemaking is so significant that any decision from Case No. EO-96-14 regarding territorial agreements should be confined exclusively to that proceeding.

In Case No. EO-96-14, the Commission found that it "made no rate determination regarding net revenues associated with [the territorial agreements]" when it previously approved the Black River Cooperative and Macon Electric Cooperative agreements. Specifically, the Commission found that it could "re-examine the financial impacts of the territorial agreement[s] *as part of the annual sharing credits for UE's current EARP* and that adjustments to book earnings, based on more current data, could be proposed at that time." Clearly, based on the Commission's findings in Case No. EO-96-14, even if the Staff can propose adjustments for purposes of sharing credits under the Company's now-expired EARP, that power (if one exists) does not extend to any proceeding not directly related to annual sharing credits under the EARP. Therefore, Mr. Gibbs' reliance on the Commission's decision in Case No. EO-96-14 is inappropriate.

When it approved the Black River and Macon Electric Cooperative territorial agreements, the Company and the Staff agreed upon the *long-term* and strategic benefits to the public of entering into those agreements. Specifically, those benefits included reserving significant growth areas, consolidating its service territory, reducing the duplication of facilities and other efficiency increases. When it rendered its decision in Case No. EO-96-14, the Commission did not consider those longer-term benefits despite the fact that such longer-term benefits supported its approval of such territorial agreements. Instead, the Commission focused on the *short-term* effects of the sharing mechanism under the Company's EARP. The Commission's decision in Case No. EO-96-14 should be confined to that context and not applied to this longer-term, forward-looking ratemaking proceeding.

Q. Did Mr. Gibbs use current, accurate information in determining that, in his opinion, there has been a detriment to the public as a result of the territorial agreements?

A. No, he did not. Mr. Gibbs has relied on outdated and inaccurate information in calculating his proposed adjustments. For example, Mr. Gibbs used information dating back to the date the territorial agreements were entered into, and compared that information to data supplied by the Company for purposes of previous credit sharing periods under the EARP. Mr. Gibbs has not even updated the information he used from that used to propose adjustments to the previous June 30, 2000 test year. Moreover, Mr. Gibbs has disregarded the Company's responses to data requests showing information contrary to his calculations and failed to take into account benefits realized from the reduction in load requirements. Those shortcomings render Mr. Gibbs' proposed adjustments meaningless to this proceeding. Mr. Gibbs' failure to account for such changes is particularly relevant in light of the Commission's adoption of Staff's approach in Case No. EO-96-14 only "since there had been no substantial change or customer growth in the specific customer areas included in the territorial exchanges". The data that Mr. Gibbs ignored demonstrated such "substantial change or customer growth."

The Company does not track individual customer activity within its exchanged territories for two reasons. First, customers received in the territorial exchanges have been integrated into larger districts and the Company tracks service changes according to such district boundaries. It is not cost/beneficial to do otherwise. Second, the Company does not have access to service information related to its former customers in the areas given up to other utilities through the territorial agreements.

However, in Data Request No. 109, the Company provided analyses of electric revenues and customer numbers for the three districts that include the areas received through the Black River, Macon Electric, Farmer's Electric, City of Kennett and Ozark Border territorial agreements. Those analyses show precisely the "substantial change or customer growth" upon which the Commission premised its order in Case No. EO 96-14. For example, during the period 1998 through 2001, electric revenues in the Southeast District, which includes the areas received in the City of Kennett and Ozark Border agreements, increased from $100.5 million to $105.8 million. During that same period, electric revenues in the Little Dixie/Green Hills District, which includes the areas received in the Macon Electric and Farmer's Electric agreements, increased from $94.2 million to $100.9 million. Also during the same period, electric revenues in the Potosi/

St. Francois District, which includes the areas received in the Black River agreement, increased from $57.9 million to $58.8 million. Clearly, this is type of "substantial change or customer growth" to which the Commission was referring in Case No. EO-96-14.

The items noted above are intended merely as examples of improprieties in Mr. Gibbs' calculation of his proposed adjustments related to territorial agreements. Such improprieties exist, to some extent, in relation to each of the territorial agreements for which Mr. Gibbs proposes adjustments thereby rendering his proposed adjustments meaningless for this proceeding.

Q. What is the "prudent management" theory of ratemaking?

A. As I understand it, the prudent management theory "focuses on the decision making process by management and not on the results of the decision." *State v. Public Service Commission of State of Mo.*, 669 S.W.2d 941, 947 (Mo. Ct. App. W.D., 1984). Based on the prudent management theory, the court in that case found a distribution line extension was includable in rate base despite the fact that the line extension was not cost beneficial. *Id.* at 948. Inherent in that decision were the reasonableness of management's expectations and its lack of extravagance in completing the project. *Id.*

Q. How is the prudent management theory applicable to the Company's territorial agreements?

A. Under the prudent management theory, unless the Staff can show that management was imprudent in entering into its territorial agreements, the Commission cannot reverse the effects of those decisions for ratemaking purposes. Nowhere in his testimony does Mr. Gibbs assert that management's decisions to enter into the agreements were imprudent. Moreover, by approving the agreements and thereby determining that they were not detrimental to the public interest, the Commission has implicitly affirmed management's prudence. Clearly, based on the Commission's prudent management ratemaking theory, the effects of these territorial agreements cannot be reversed.

Q. Does Mr. Gibbs analyze the territorial agreements under the proper legal standard?

A. No, he does not. When deposed last year on the first testimony he submitted in this case, Mr. Gibbs admitted that when he refers to the "public interest" standard described above, under which the Commission is bound to review such territorial agreements, he takes into consideration only the interests of current ratepayers. *See Gibbs Nov. Depo.* p. 84. But the "public Interest" means more than just the interests of one segment – it means whether the agreement will benefit all parties in the aggregate, whether the agreement will capture efficiencies in the aggregate, eliminate duplicative service areas and so on. Mr. Gibbs should not be allowed to return to the bargaining table later and apply a different standard to what the Commission has already blessed.

Q. Do you have any additional remarks related to the treatment of territorial agreements in relation to this proceeding?

A. Yes, I do. I would like to reaffirm my position that there should be no adjustments related to territorial agreements. I assert that position because the agreements were entered into for the long-term benefit of ratepayers and because the short-term effects of those agreements, when viewed in light of complete, accurate and up to date information, do not present any detriment to the public.

Q. Does this conclude your testimony?

A. Yes it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

The Staff of the Missouri Public Service Commission, Complainant,	)	
vs.	)	Case No. EC-2002-1
Union Electric Company, d/b/a AmerenUE, Respondent.	)	

AFFIDAVIT OF MARTIN J. LYONS

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

Martin J. Lyons, being first duly sworn on his oath, states:

1. My name is Martin J. Lyons. I work in St. Louis, Missouri and am employed by Ameren Corporation as Controller.

2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Union Electric Company d/b/a AmerenUE consisting of 62 pages, Appendix A and Schedule 1, all of which have been prepared in written form for introduction into evidence in the above-referenced docket.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

Martin J. Lyons
Martin J. Lyons

Subscribed and sworn to before me this 7th day of May, 2002.

Debby Anzalone
Notary Public

My commission expires:

DEBBY ANZALONE
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: April 18, 2006

EXECUTIVE SUMMARY

Martin J. Lyons

Controller, Ameren Corporation

* * * * * * * * * *

My testimony expresses my fundamental belief that the accrual basis of accounting, which is embodied by generally accepted accounting principles (GAAP), is the appropriate basis of accounting for determining the Company's cost of service in this case. Accrual accounting is required by the Securities Exchange Commission (SEC), the Federal Energy Regulatory Commission (FERC), and the Missouri Public Service Commission (MoPSC) for regulatory reporting because it is the most systematic and rational of all possible accounting methods. GAAP represent a hierarchy of accrual accounting principles endorsed by every authoritative accounting organization in the United States. The Company has adhered to the accrual basis of accounting and GAAP in the development of its cost of service in this case. I believe that adherence to these principles should provide the Commission assurance that the Company's cost of service represents the most accurate depiction of the current cost of providing electric service to the Company's Missouri customers and the best proxy for what costs are expected to be in the near future.

In their direct testimony in this case, the MoPSC Staff have departed from GAAP in three major ways: (1) Application of non-GAAP accounting methods, including the cash basis; (2) Application of cost averaging and normalization practices; and (3) Exclusion of one-time, non-recurring items. In proposing these adjustments to depart from accrual basis accounting, the Staff provides no justification nor do they cite any unifying systematic or rational accounting framework as a basis. As a result, the Staff has recommended these departures in an arbitrary and inconsistent manner. Further, because the Staff's adjustments do not adhere to accrual basis accounting, they do not reflect current costs of providing service and would deny the Company the opportunity to recover prudently incurred costs. Of particular concern is that by throwing out costs labeled as "one-time non-recurring", the Staff fails to recognize that such costs occur year in and year out in a variety of different areas of Company operations. In addition, the Staff apparently has a flexible view of the concept of a test year. In fact, the Staff seems somewhat confused about exactly what constitutes a test year, and is opportunistic in the degree to which it finds itself unconstrained thereby. Frankly, the only unifying theme to the Staff's recommended departures from accrual basis GAAP is that in almost every instance they are detrimental to the Company.

In summation, my testimony expresses that, as a matter of policy, it is my firm recommendation to the Commission that accrual basis accounting standards be adhered to in determining the Company's cost of service in this case. Only through application of GAAP can the Commission and all of the Company's stakeholders be assured that costs are being aggregated and presented in a sound, systematic and rational manner. And, only when costs are aggregated and presented in this manner can everyone be assured that the Company's rates are just and reasonable. Accrual basis accounting accurately matches revenues with the costs incurred to produce those revenues, and represents the accumulated wisdom of years of accounting practice. It should not be arbitrarily displaced.

My testimony also rebuts specific adjustments proposed by Staff witnesses Paul R. Harrison, John P. Cassidy, Leasha S. Teel and Doyle L. Gibbs related to advertising, rate case expense, dues and donations, MoPSC assessment, Venice power plant adjustments, automated meter reading expense, injuries and damages, legal fees, environmental expense, uncollectible expense and territorial agreements. In my rebuttal to each of these specific adjustments I attempt to point out the various departures from accrual basis GAAP described above as well as various misunderstandings, inaccuracies, miscalculations, flaws in logic and other factors that render such adjustments inappropriate.

AUDIT REPORT ON THE EXPENDITURES

OF THE

EDISON ELECTRIC INSTITUTE

(For the 12 month period ended December 31, 1999)

JUNE 2001

COMMITTEE ON
UTILITY ASSOCIATION OVERSIGHT

National Association of
Regulatory Utility Commissioners
1101 Vermont Avenue; Suite 200
Washington, D.C. 20005

Telephone No. (202) 898-2200

SCHEDULE 1-1

EDISON ELECTRIC INSTITUTE
SUMMARY OF EXPENSES
FOR THE YEAR ENDED DECEMBER 31, 1999

EXPENSE CATEGORY	PERCENTAGE
1) Legislative Advocacy	15.57%
2) Legislative Policy Research	7.55%
3) Regulatory Advocacy	12.58%
4) Regulatory Policy Research	7.35%
5) Advertising	3.52%
6) Marketing	7.52%
7) Utility Operations & Engineering	8.89%
8) Finance, Legal, Planning and Customer Service	31.94%
9) Public Relations	5.08%
TOTAL	100.00%

Note: The table above was prepared by the Staff Subcommittee on Utility Association Oversight and should be read in conjunction with the audited financial statements and schedules contained within this report. The expense categories listed above relate to audit definitions found on page VII-1 herein.

Edison Electric Institute
Audit Definitions of Accounts Used
For NARUC Reporting Requirement

LEGISLATIVE ADVOCACY (LA) - EEI defines the term "legislative advocacy" consistent with the definition of the term "lobbying" in IRC Section 162 (e). Title 26 USC 162 (e) (see Page I-4)

LEGISLATIVE POLICY RESEARCH (LP) - The cost of all efforts spent on research or the preparation of general or specific background information, studies, or analysis of proposed or potential legislation to determine its scope and potential impact, for use by EEI or its member companies. This account shall also include the cost of researching and responding to ALL inquiries regarding the potential impact, proper implementation, or effect of proposed or potential legislation but shall not include costs for legislative advocacy.

Legislative Policy Research begins when resources are expended for the purposed described in the above areas.

REGULATORY ADVOCACY (RA) - The cost of all written and oral communications with Federal or State regulatory agencies intended to influence the actions of such agencies and the cost of other expenditures which contribute in a general manner to furthering an EEI or member company position on a regulatory or administrative matter.

REGULATORY POLICY RESEARCH (RP) - Includes all costs divided into the following categories:

(1) Federal - The cost of studying and responding to notices of inquiry or proposed Federal rulemaking or administrative or regulatory proceedings, including the filing of comments on proposed regulatory or administrative actions; discussions with federal regulatory agencies to determine the status or timing of activities, or procedures of the agencies; the preparation of general or specific background information, studies or analysis, for use by EEI or its member companies to determine the scope and potential impact of proposed, or potential federal regulatory or administrative action; the cost of researching and responding to **ALL** inquiries regarding the potential impact, proper implementation, or effect of, proposed or potential federal regulatory or administrative actions; and the cost of monitoring existing federal government programs.

(2) State - All direct and indirect costs which are incurred for the purpose of an EEI or member company response to a State notice of inquiry or proposed State rulemaking or administrative, or regulatory proceeding, including the filing of comments on proposed regulatory, or administrative actions.

ADVERTISING (A1) - All costs, including costs of development (both direct and indirect), of paid and public service advertising in newspapers, magazines, radio, television and billboards and similar displays.

Advertising costs include the following categories:

(1) **Conservation** -Identifies conservation techniques, benefits, demonstrates conservation methods including peak clipping, valley filling or load shifting;

(2) **Safety** - Promotes safety, e.g., informing customers of hazards;

(3) **Customer education** - Informs about ways to reduce costs; promotes use of efficient appliances; promotes efficient use of utility service; optional payment plans; financial assistance, etc.

(4) **Legally required** - Is required by law or other governmental requirement;

(5) **Promotes consumption** - Promotes continued or increased sales; i.e., maintaining or increasing sales to present or prospective customers;

(6) **Institutional** - Enhances the image of EEI or of the utility industry as a business entity;

MARKETING AND DEMAND SIDE MANAGEMENT (M1) - The cost of all efforts (with the exception of advertising) to influence the demand for or sales of electricity. This account shall include the cost of research, publications, conferences, training sessions, meetings with trade allies, committee meetings or other efforts undertaken for the purpose of influencing the demand for or sales of electricity. Demand Side Management and marketing costs include the following:

(1) **Strategic Conservation** - expenses related to exploration, development, analysis and implementation of means by which load shape might be modified by a reduction in sales as well as a change in the pattern of use;

(2) **Peak Clipping** - expenses related to explorations, development, analysis and implementation of means by which load shape might be modified by the reduction of peak load;

(3) **Valley Filling** - expenses related to exploration, development, analysis and implementation of means by which load shape might be modified by increasing off-peak loads.

(4) **Load Shifting** - expenses related to exploration, development, analysis and implementation of means by which load shape might be modified by shifting loads from on-peak to off-peak periods;

(5) **Strategic Load Growth** - expenses related to exploration, development, analysis and implementation of means by which load shape might be modified by a general increase in sales;

(6) **Flexible Load Shape** - expenses related to exploration, development, analysis and implementation of means by which load shape might be modified temporarily.

UTILITY OPERATIONS AND ENGINEERING (UE) - The cost of collecting and providing information on utility operations and engineering issues to member companies, other utilities, and other utility organizations. For purposed of this definition, operations and engineering shall include engineering and standards, fossil and synfuels, nuclear power, and environment. This category shall not include costs for activities related to legislative advocacy or research, regulatory advocacy or research, surveys and analysis of State laws and regulation, public relations, or litigation.

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FINANCE, LEGAL, PLANNING, AND CUSTOMER SERVICE (FL) - The cost of collecting and providing information on finance, legal and planning issues to member companies, other utilities and other utility organizations.

For purposes of this definition, finance, legal and planning shall include accounting, finance and regulation, legal, strategic planning, human resource management, information and administration, and information systems and library services. Customer Service and Support Information include expenses relating to the acquisition, compilation, categorization and dissemination of information useful in the improvement of the quality and value of service rendered to customers.

This category shall not include costs for activities related to legislative advocacy, legislative policy research, regulatory advocacy, regulatory policy research, surveys and analysis of State laws and regulation, sales promotion, public relations or litigation.

PUBLIC RELATIONS (PR) - The cost of developing and promoting reciprocal understanding and goodwill between EEI or its member companies and the various publics with which they interact including but not limited to the cost of developing and advancing an EEI or member company relationship or position with the media and the costs associated with responding to media inquiries. Public Relations shall include the costs associated with public opinion research which seeks to enhance the image of EEI, its member companies, or of the utility industry as a business entity or otherwise seeks to influence public opinion on matters not relating to legislative or regulatory issues.

The cost of public relations shall also include the costs associated with EEI employee time charges for time donated to outside organizations other than EEI member companies and any other expenses whose ultimate purpose if to develop goodwill or enhance the image of EEI, its member companies, or of the utility industry as a business entity, which do not more properly relate to other categories.

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GENERAL AND ADMINISTRATIVE (GA) - Administrative expenses (subscriptions, membership fees to professional organizations, travel, etc.) for all divisions, except the Administrative and Treasury Division (A&T), and the Human Resource Department (HR) were allocated to the various NARUC categories in proportion to direct salary dollars within the respective divisions. Administrative expenses in the A&T Division were allocated in proportion to direct salary dollars.

OVERHEAD (OO) - Corporate-wide expenses allocated to the various NARUC categories in proportion to total company direct salary dollars. Overhead consists primarily of General Office (rent, depreciation, communications, maintenance, office supplies, postage, insurance, etc.) expenses.