STATE OF MISSOURI

PUBLIC SERVICE COMMISSION

TRANSCRIPT OF PROCEEDINGS

Hearing

December 14, 2004
Jefferson City, Missouri
Volume 12

In the Matter of the Tariff Filing)
of The Empire District Electric)
Company to Implement a General) Case No. ER-2004-0570
Rate Increase for Retail Electric)
Service Provided to Customers in)
Its Missouri Service Area)

KEVIN A. THOMPSON, Presiding,
DEPUTY CHIEF REGULATORY LAW JUDGE.

STEVE GAW,
ROBERT M. CLAYTON,
JEFF DAVIS,
LINWARD "LIN" APPLING,
COMMISSIONERS.

REPORTED BY:

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P R O C E E D I N G S

JUDGE THOMPSON: Okay. Mr. Coffman, let's go back on the record.

MR. COFFMAN: I'm ready to roll.

JUDGE THOMPSON: Go for it.

JAMES H. VANDER WEIDE, being previously sworn, testified as follows:

CROSS-EXAMINATION BY MR. COFFMAN:

Q. Good morning, Mr. Vander Weide.

A. Good morning, Mr. Coffman. How are you this morning?

Q. I'm much more alert than when we left last night. I'm going to do my best to be brief here, and if you can stick to answering the question, that should help us along as well.

A. I'll do my best.

Q. Would you agree with me that a company's overall risk is a factor of both business risk and financial risk?

A. Yes.

Q. And would you agree with me that business risk can be defined as the variability of operating income arising from the characteristics of that firm's industry?

A. Yes.

Q. Would you agree with me that business risk or one source of business risk is sales variability?

A. Yes.

Q. Would you agree with me that financial risk can be defined as the variability of future income arising from a firm's fixed financing costs?

A. Yes, I would.

Q. Would you agree with me that one source of financial risk is interest payments on debt?

A. Yes.

Q. And all things being equal, wouldn't it be true that the greater the percentage of fixed charges to a total income of a company, the greater the financial risk, all things being equal?

A. Yes.

Q. And would you agree with me that the yearly interest expense on Empire's long-term debt as of the end of June 2004 was $22,539,311?

A. I don't have that figure in front of me, but I believe I did that calculation and --

MR. COFFMAN: I have a response to a Data Request, if I may approach.

JUDGE THOMPSON: You may.

BY MR. COFFMAN:

Q. Can you identify what I've handed you?

A. Yes. This is Request No. 2002, and it shows the interest expenses as of June 3, 2004.

Q. And would that number be $22,539,311?

A. There are a lot of numbers on this page, and I'm not seeing where it's summarized anywhere.

Q. I would direct you to the first part of the spreadsheet there and the eighth column under yearly interest expense.

A. Okay. Yes, I see that.

Q. Is that number correct?

A. Yes, it is.

Q. Is it correct that you calculated the weighted average cost of capital for your electric group to be 7.71 percent?

A. Let me just check that out to be sure.

Q. I found that on your direct testimony, page 51.

A. Yes, that's correct.

Q. And you did the same calculation for an LDC natural gas proxy group and got a number of 8.08 percent?

A. Yes.

Q. And the difference between those two, between your electric and your LDC group, was what, 37 basis points?

A. That's correct.

Q. Okay. And I thought I heard you testify yesterday that even though there was a 37 basis point difference between the gas and electric groups, that that didn't suggest to you that the LDC companies were more risky than electric companies?

A. No, because I presented direct risk data for the LDCs that showed that, in fact, the LDCs were less risky than Empire and also less risky than the electric companies.

Q. And -- but you still think that these proxy groups are of some validity even though they -- the numbers don't bear that out?

A. I don't think there's any doubt that they have validity, because there's -- the bond ratings for the LDCs were averaged an A, whereas the bond ratings for the electric companies averaged BBB+, and for Empire was BBB. And the business risk profiles were also safer for the natural gas companies, and the ValueLine safety ranks were -- indicated greater safety for the LDCs.

Q. Okay. Now, were you here yesterday where -- when we had a discussion about Dr. Murry's criticism of Mr. Murray's inclusion of one utility that was, I guess, not investment grade and facing some financial troubles?

A. Yes, I was.

Q. And was DPL at least one of the companies that was being used as --

A. I don't recall the exact company. I was here, but I don't recall the company that it was.

Q. Is DPL one of the companies included in your electric proxy group?

A. Yes, it is.

Q. And do you see any problem with including DPL in your electric proxy group?

A. If that were the only company, there would be a big problem. But as I mentioned yesterday, what I do is compare the average for the entire group because I'm going to be looking at the cost of equity for the entire group. And the average bond rating and the average risk, business risk profile and the average ValueLine safety rank for the electric proxy group were all safer than for Empire.

Q. When you calculated the weighted average cost of capital for both your proxy groups, you used a hybrid capital structure which consisted of a market value of common equity and a book value of preferred stock and long-term debt, correct?

A. I wouldn't call it a hybrid capital structure. It's very common when one is measuring a market value capital structure to use the book value of debt as an approximation to the market value of debt, because the two are often very close. And it's more difficult to measure the market value of debt when there are a lot of issues outstanding. So I would call that a market value capital structure, not a hybrid capital structure.

Q. So if I didn't use the label that you disagree with, you would still agree that what you did was use a market value of common equity and a book value of preferred stock and long-term debt?

A. That's technically what I did, but the book value of debt is a close approximation to the market value of debt, and so as is very common in finance, that's how the market value capital structure is measured. So I would view that as a market value capital structure.

Q. And would you agree with me weighted average cost of capital that you used was calculated using after-tax market cost rates for preferred stock and long-term debt?

A. Yes. Again, that's -- that's generally how it's done.

Q. Is it correct that the average weighted cost of capital for your -- for both of your proxy groups when you blended the electric and LDC groups together was 7.9 percent?

A. Yes.

Q. And just so we're clear, this percentage is after-tax market cost rates and what you call a market capital structure consisting of market value of common equity and book value of preferred stock and long-term debt?

A. I'm going to say yes, with the same caveat of my prior answer, that the book value of debt is a very close approximation to the market value of debt, and hence, it also represents the market value of debt.

Q. Isn't it correct that during your deposition that you were not -- you were not able to point to any journal articles that recommended the use of this method for determining the cost of capital in a regulated arena?

A. I don't think I would characterize that at all, what I -- that way at all.

Q. At your deposition, sir?

A. At my deposition I wouldn't characterize it that way. What I --

Q. Could I direct you to your deposition, please?

A. Could I say what I believe I said?

Q. I just would like an answer to my question, whether at your deposition, sir, you were able to identify any journal articles or support for the use of your method in the regulated arena. I understand you have support in other areas, but in a regulated --

A. There wouldn't be any in the regulated arena because there aren't journal articles that specify -- I don't know of any journal articles that talk specifically about the regulated arena, because the same principles apply in the regulated and the unregulated arena. That's how the cost of capital is defined for all publicly traded companies. So there wouldn't be journal articles.

Q. And I understand in your professional judgment -- correct me if I'm wrong -- that you believe that this new method is really what is necessary in order to come up with a number that would allow a company to attract capital in the capital market?

A. Again, I wouldn't characterize it as a new method. This is the method that is always used to calculate the cost of capital for publicly traded companies.

Q. But isn't it correct that in all the cases that you've done over 30-plus years of making return on equity recommendations, it wasn't until April of 2004 that you ever used this methodology in a public utility rate case?

A. It's new in public -- for me in public utility rate cases. I have used it in telecommunications cases, which some people call public utilities, although it's debatable, but they are regulated since 1996.

Q. But as far as a rate -- cost of service, rate of return rate case, you --

A. I've used it --

Q. -- did not use it until April 2004?

A. I've used it for telephone companies since 1996 --

Q. And in answer to --

A. -- in regulated cases.

Q. But in answer to my question, had you ever used it in a non-telephone rate case prior to April 2004?

A. No.

Q. Thank you. Would it be correct to say that you developed your return on equity recommendation for Empire by adjusting your proxy groups upward by 60 basis points in order to, in your words, reflect the higher leverage in Empire's capital structure?

A. Yes.

Q. And just so I'm clear, in all the cases that you testified in electric or natural gas rate cases prior to April of 2004, you had never taken this final leverage adjustment step in your cost of capital analysis; is that correct?

A. That's correct. And it has nothing to do with whether this is the right method to use right now.

MR. COFFMAN: Permission to approach?

JUDGE THOMPSON: You may.

BY MR. COFFMAN:

Q. Can you identify what I handed you, sir?

A. Yes. You handed me my direct testimony in Docket No. 99-0534 before the Illinois Commerce Commission in a case involving Mid-American Energy Company.

Q. Would you please read your testimony from page 3 of that document, lines 50 to 55. Would you read it into the record, please.

A. Yes. The question is, What is the purpose of your testimony? And the answer is, I've been asked to make an independent appraisal of the cost of equity capital for the natural gas distribution operations of Mid-American Energy Company, paren, Mid-American, and to recommend a rate of return on equity that is fair, that allows Mid-American to attract capital on reasonable terms and that maintains the firm's financial integrity.

Q. Okay. And would you agree with me that that is almost identical to the purpose of your testimony as stated in your direct testimony filed in this case in April of 2004?

A. I will agree that the words are pretty much the same, and the way that I would explain that is that --

Q. Well, sir, you will have an opportunity to explain your answer on redirect.

A. All right. That will be fine.

Q. Your --

A. Then the answer is yes.

MR. COFFMAN: Thank you. Permission to approach again?

JUDGE THOMPSON: You may.

BY MR. COFFMAN:

Q. Would you identify the document I've just handed you now?

A. Yes. You've handed me my direct testimony before the Florida Public Service Commission in Docket No. 000824-EI, filed September 14, 2001, in a case involving Florida Power Corporation's earnings.

Q. And would you please read into the record your question and answer on page 4 of that document, lines 2 through 7.

A. What is the purpose of your testimony?

I have been asked by Florida Power Corporation, Florida Power, to prepare an independent appraisal of Florida Power's cost of equity and to recommend a rate of return on equity that is fair, that allows Florida Power to attract capital on reasonable terms, and that allows Florida Power to maintain its financial integrity.

Q. Thank you. Would you agree with me that with respect to ratemaking for regulated utilities, that it is universal practice to calculate the utility's weighted average cost of capital using book value weights for debt, equity an-- preferred equity and common equity, along with embedded cost rates for debt, preferred equity and market cost rates for common equity?

A. Yes.

Q. Just a second. With regard to this aspect of you using a new method of calculating return on equity since April of this year, I believe that in your deposition, you stated that in a sense your assignment has changed since this time. Would that be a fair summary of your --

A. Yes, it would.

Q. -- deposition testimony?

And would it be a fair summary of your deposition testimony that only recently were you actually tasked with recommending a rate of return that would truly allow your clients to attract capital in the marketplace?

A. Yes.

Q. And I'm going back to -- I want to go back to, I guess, my line of questions and make sure I'm clear.

We identified the long-term debt for Empire as of June 30, 2004. Would you agree with me that regardless of how you measure Empire's capital structure either using book values or market values, that its yearly interest expense on long-term debt as of that fixed date would be the same regardless?

A. Yes.

MR. COFFMAN: I think I've asked enough questions. Thank you.

JUDGE THOMPSON: Thank you, Mr. Coffman. We're ready for questions from the Bench. Commissioner Clayton?

COMMISSIONER CLAYTON: No questions.

JUDGE THOMPSON: Commissioner Appling?

COMMISSIONER APPLING: No questions.

JUDGE THOMPSON: The other three Commissioners are upstairs preparing for the Commissioners' agenda meeting. What I'm going to do is allow you to sit down now and we'll move on to the next witness. And then when the other Commissioners come back, we'll allow them to ask their questions, if any, and then we'll do recross and redirect at that time. Why don't you go ahead and step down, sir.

And who's our next witness, Mr. Swearengen?

MR. SWEARENGEN: Bill Gipson.

JUDGE THOMPSON: Very good.

(Witness sworn.)

JUDGE THOMPSON: Do you understand if you were to give false testimony in this proceeding, you could be prosecuted for the crime of perjury?

THE WITNESS: Yes, I do.

JUDGE THOMPSON: Please take your seat. Spell your last name for the reporter. I know Mr. Swearengen's going to ask you to state your name, so I won't do that.

THE WITNESS: It's Gipson, G-i-p-s-o-n.

JUDGE THOMPSON: You may inquire.

MR. SWEARENGEN: Thank you, Judge.

BILL GIPSON testified as follows:

DIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Would you state your name for the record, please.

A. It's Bill Gipson, G-I-P-S-O-N.

Q. And by whom are you employed and in what capacity?

A. The Empire District Electric Company, Joplin, Missouri. I'm the president and CEO.

Q. And am I correct in understanding that you have caused to be prepared for purposes of this case certain direct and surrebuttal testimony in question and answer form?

A. I have.

Q. And do you have a copy of that testimony with you this morning?

A. I do.

Q. Are there any changes that you need to make with respect to your direct testimony?

A. There are not.

Q. How about your surrebuttal testimony, are there any changes or corrections you need to make with respect to that testimony?

A. There are not.

Q. If I asked you the questions contained in those two pieces of testimony, would your answers this morning be the same?

A. Yes, they would.

Q. And would they be true and correct to the best of your knowledge, information and belief?

A. Yes, they would.

MR. SWEARENGEN: With that, your Honor, I would offer into evidence Mr. Gipson's direct testimony, which I believe is Exhibit 1, his surrebuttal, which I believe is Exhibit 2, and tender the witness. Thank you.

JUDGE THOMPSON: Any objections to the receipt of Exhibits 1 or 2?

MR. KRUEGER: No objection.

JUDGE THOMPSON: Hearing none, the same are received and made a part of the record of this proceeding.

(EXHIBIT NOS. 1 AND 2 WERE RECEIVED INTO EVIDENCE.)

JUDGE THOMPSON: Mr. Conrad, do you have any cross?

MR. CONRAD: I do not. Thank you, sir.

JUDGE THOMPSON: Mr. Krueger?

MR. KRUEGER: Thank you, your Honor.

CROSS-EXAMINATION BY MR. KRUEGER:

Q. Good morning, Mr. Gipson.

A. Good morning, Mr. Krueger.

Q. Does Empire have a written dividend policy?

A. No, sir, we do not.

Q. Has Empire ever done any internal analysis to determine a reasonable dividend payout ratio in light of Empire's need for future capital improvements?

A. Ever, was that your question?

Q. Yes.

A. To my knowledge, since I've been the president and CEO -- well, since I've been the president and CEO, the answer is no. I can't speak to ever.

Q. And when did you become president and CEO?

A. On May 1st, 2002.

Q. But you have no knowledge of any such analysis prior to that either?

A. I do not.

Q. Okay. Do you believe that Empire's recent high dividend payout ratio back to 2001 was a consequence of wildly fluctuating natural gas prices?

A. I believe that was a contributing factor.

Q. And do you think that the failed merger with Aquila was also a factor?

A. It was a factor in 2001.

Q. Do you see this problem associated with fluctuating natural gas prices as a short-term problem?

A. I do.

Q. But the high dividend payout ratio goes back for many years, back to about 1992, does it?

A. I know the dividend has been constant since 1992. I'd have to look at the data to see what the payout ratio was in those earlier years. But certainly since the deregulation of the wholesale market for electricity and the impact of natural gas on purchased power prices that came along with that, there has been some difficulty in obtaining earnings sufficient to support the dividend.

Q. Did Empire face the natural gas volatility during the years '92 to 2000 that it did in recent years?

A. Not to the extent we did in recent -- we have in recent years because of the fact that I just stated, and the commercial operation of the combined cycle facility in June of 2001 dramatically increased our usage of natural gas.

Q. Do you believe that Empire's stock is a surrogate for an income-related stock?

A. I believe I stated that in the deposition.

Q. And that's your position today?

A. It is.

Q. And do you believe that because it is a surrogate for an income-related stock, a cut in the dividend would cause Empire's cost of common equity to go up?

A. I believe I testified to that in deposition, and that's my position, yes.

Q. When you indicated that it was a surrogate for an income-related stock, did you mean that investors almost see Empire's stock as a debt-like security and wouldn't expected dividend to be cut, much as a coupon is not cut with a debt?

A. No, I didn't intend that, Mr. Krueger.

Q. Okay. And in what sense then would it be a surrogate?

A. I think that utility stocks are generally viewed in the marketplace as income-related stocks versus growth-related stocks. I think one of our expert witnesses drew the distinction to a company like Empire or Kansas City Power & Light to Microsoft. Microsoft for a number of years in its beginning was a growth-related stock and only recently began to pay a dividend to its shareholders.

Q. Do you think that is more true for Empire than for other utility stocks?

A. I don't know that I could characterize it as more true for Empire than other utility stocks.

Q. Has Empire ever done any studies to evaluate the impact that a reduction in Empire's dividend would have on its cost of common equity?

A. No.

Q. Has Empire ever considered hiring a corporate consultant to evaluate Empire's current dividend payment practice?

A. No.

Q. Has Empire ever done any studies to evaluate the impact on Empire's current dividend that Empire's -- excuse me -- that Empire's current dividend policy has on its cost of capital?

A. Before I answer that question, I think the previous two questions you said -- you used the word ever again.

Q. Okay.
A. Is that --
Q. I did. And would you like to clarify that?
A. I would.
Q. To your recollection?
A. To my recollection, or at least since I've been the president and the CEO, the answer to those questions is no.
Q. Okay.
A. Now, would you repeat the last question, please?
Q. All right. Sure. Has Empire ever done any studies to evaluate the impact on Empire's current dividend -- that Empire's current dividend policy has on its cost of capital?
A. I'm sorry. I didn't follow your question. Please try again.
Q. Has Empire ever done any studies to evaluate the impact that its dividend payout ratio has on its cost of capital?
A. No, not since I've been president and CEO.
Q. No studies?
A. No studies.
Q. Has Empire ever made any attempt to forecast the rate at which electricity will grow, which

your electricity sales will grow in the future?
A. Absolutely.
Q. And what are the results of the most recent study?
A. We are projecting customer growth at about 1.6 percent annualized, and I believe that's about where we are 12 months ended. We also take a look at the organic growth in the existing customer base. And when you mold those or blend those two factors together, you end up with about a 2.4, 2.5 percent growth in kilowatt hour sales and demand.
Q. And that's your current estimate?
A. That is our current estimate, yes, sir.
Q. For how far into the future does that --
A. We usually forecast for about a five-year period going forward.
MR. KRUEGER: Okay. Thank you. That's all the questions I have.
JUDGE THOMPSON: Thank you, Mr. Krueger. Mr. Coffman?
MR. COFFMAN: Mr. Krueger asked all the questions I would have asked. Thank you.
JUDGE THOMPSON: Questions from the Bench, Commissioner Clayton?
COMMISSIONER CLAYTON: I don't think I have

any questions.

JUDGE THOMPSON: Commissioner Appling?

QUESTIONS BY COMMISSIONER APPLING:

Q. Good morning, Mr. Gipson.

A. Good morning, Commissioner.

Q. Help me out a little bit, if you will. Do you-all have any plans in the future to look outside of gas-fired utility or gas/electric production?

A. Yes. The answer to that question is yes. We believe that our resource mix needs to be balanced between coal, natural gas-fired and renewable resources. We have been working earnestly to identify different coal projects in which we might participate, and also looking at self-build options. A self-build option for a company our size may be a difficult process, so we've been concentrating more on the joint opportunities.

With respect to the renewables portion of our portfolio, I'd draw your attention to a press release we issued yesterday announcing a wind energy contract between Empire and PPM Energy that will begin the first part of 2006 or the latter part of 2005. That will account for about 10 percent of our energy needs that will be produced by wind energy. We think there's some tremendous benefits in doing that, not only from an environmental standpoint, but certainly from an economical standpoint.

Q. I'm just curious because no one seemed to know where gas is going to go to, and I'm pretty sure it's not going to go down very quickly. So it would seem to me that you're all kind of heavily dependent on gas at the present time.

A. We are dependent on gas for a larger portion of our energy mix than most of the other utilities in the state. I don't know that it's a lot different than some other utilities across the country that are in a similar situation that Empire has been in.

If you take a look at -- at the dependence on natural gas, that really came about -- or energy prices that are influenced by natural gas, that really came about, as I mentioned in -- in Mr. Krueger's cross, that with the advent of deregulation in the wholesale price of energy where the energy became not a cost-based -- cost-based cost but a market-based cost for the company.

And the construction of the combined cycle facility in 2001, that is really what has driven up our dependency on natural gas. The combined cycle facility that we built for commercial operation in 2001 was built at a time when natural gas prices were in the $2 range. And when you combine cost of the fuel and the capital cost, the O&M cost as associated with that kind of resource versus a coal-fired resource at that time, the -- and with the projections that virtually everyone was making with respect to the price of natural gas, that was the lowest cost resource.

The natural gas market has changed significantly since the time that that particular resource came online, much in advance of what all of the experts were predicting. That's where we find ourselves today.

COMMISSIONER APPLING: Thank you very much, sir.

JUDGE THOMPSON: Commissioner Clayton?

QUESTIONS BY COMMISSIONER CLAYTON:

Q. Mr. Gipson, I just want to ask a couple of questions to follow up with Commissioner Appling as well as a refresher from our meeting when you came to visit the Commission about a year ago when I first was appointed. Do you remember coming up?

A. I do. You asked me if I was a lobbyist or an attorney.

Q. I remember. I remember that day, and I wasn't aware of who you were, and you did come in and I was, like, well, are you the regulatory affairs guy, and you casually said, well, no, I'm the CEO. So I will apologize on the record for that misstep on my part and insult.

But I wanted to ask you again -- I'm glad that you remember that, by the way.
A. It's something I'll not forget.
Q. Okay. I wanted to ask, you've been with the company for many years?
A. I have.
Q. How long have you been CEO?
A. Since May 2002.
Q. 2002. And you were in senior management, I assume, before that. How long had you been in senior management?
A. I was in senior management beginning in the spring of 1997.
Q. What is the percentage of fuel, of natural gas that is part of the fuel mix that Empire uses?
A. If you separate fuel from purchased power?
Q. Why don't we start with fuel and then go to purchased power.
A. I can't identify the -- without some background in front of me the exact number.
Q. Well, you can es-- you don't have to give me an exact number, just an estimate.
A. I think if I take a look at the energy that is delivered through our system, the combination of natural gas-fired energy and the energy that we buy

through non-contract purchased power, is about 30 percent.
Q. So 30 percent is from natural gas?
A. Natural gas and purchased power that is not contracted, previously contracted.
Q. And the remaining 70 percent, from what source would it come?
A. Coal.
Q. Entirely coal?
A. Now, there's a little bit of hydro. We own a small hydro facility, but it's less than 1 percent.
Q. How does this fuel mix compare in the industry?
A. You know, I think if you take a look at the industry, it would kind of depend on what part of the country.
Q. Well, why don't we start with Missouri, and then you can talk about the region, because I'm sure those would be different the further south that you get.
A. With Missouri I believe it's pretty similar with the kind of resource mix that you have at Aquila for its Missouri-based operations. I believe it is substantially more gas-fired energy or purchased power than, say, a Kansas City Power & Light or an AmerenUE.
As you move into parts of the country where there might be more ready access to natural gas-fired

resources, say in Oklahoma or Texas, I think that percentage of natural gas-fired resources is pretty similar to some other utilities that you might find in that part of the region.

Q. Okay. It is Empire's desire to move away from this heavy percentage of natural gas?

A. We are intent upon exercising that.

Q. How do you intend on making that change, and are there impediments that stand in the way of making the change?

A. As I referred to Commissioner Appling, yesterday we executed an agreement for about 10 percent of our -- or we announced the execution of an agreement for about 10 percent of our energy to be derived from wind energy. That's a first step. The next step is to identify either a coal-fired resource, either from a purchased power perspective or an ownership perspective in a -- in either an existing or new facility. We have a number of companies that we've been dealing with over the past couple of years on that issue.

The issue for us is the expiration of a purchased power arrangement that we have today with Western Resources for about 160 megawatts of coal-fired capacity and energy out of their Jeffrey facility. That expires in May of 2010. I'll tell you we've had some conversations with Western about renewing that contract. Those discussions have not come to fruition at this juncture. That is one angle.

We've spent considerable time with companies like City Utilities in Springfield, Tenaska, Western Resources, Kansas City Power & Light, Aquilla.

Q. Does Empire have any -- what impediments would stand in the way of Empire?

A. Well, certainly one of the impediments that stands in the way is the financial health of the company and really bringing about stability in the financial health of the company with respect to earnings. And I think that's one of the important issues that the Commission will decide in this case.

I don't think that it's prudent -- I don't think that capital markets would look favorably upon a utility that got healthy just in advance of the commercial operation of that next coal-fired resource. I think we need to demonstrate a longer-term stability in the financial health of the company.

That's one of the important aspects of this case. I think the other thing that the financial markets are going to look to is the Commission's reaction to that kind of resource. A lot of effort has been expended thus far in terms of educating the General Assembly about the need to take a look at these projects in advance of their commercial operation or construction and give the Commission an opportunity to look at all aspects of that decision to determine a number of factors.

But I think the most important factor for the Commission to determine is whether that's a prudent decision on behalf of the company for its -- not only for its consumers and shareholders, but the state as well.

Q. That would be for just construction or for all power arrangements?

A. I think the most important issue is construction.

Q. What size of -- how many megawatt size of plant would you be considering with such -- if such legislation were passed?

A. I think the way that we have tried to look at it, Commissioner, is not so much in terms of the size as defined by megawatts but the size in terms of the dollar impact. And for us, something that would approach -- you know, our market cap today is about 500 million. If we take a look at building a -- let's say 150 megawatts of coal-fired resource that -- I'll make the math easy for myself, at $2,000 a KW, we're talking about issuing -- you know, if we stay at the 50/50 level, issuing on the order of 150 million in common stock and

150 million in debt.

I'm not sure that that would be of the size that would require that kind of determination up front, but once you get past that, you know, that $200 million mark, 2 or $300 million mark, I think it's something that -- for our company would be something that the capital market would look for.

Q. What is your eventual goal of your optimal mix of power?

A. I think that we -- that would depend on the price of natural gas, frankly, but we would seek to try to lower our exposure to natural gas as an overall percentage to something less than 20 percent or so.

Q. 20 percent. How much of your generation is now -- how much generation do you generate? How much is actually your own generation?

A. Well, we have sufficient capacity to generate all of our -- all of our needs. Many of those facilities are built as peaking, peaking plants, and generally are natural gas or oil-fired. But those are facilities that don't run but a few hours a year. We have sufficient capacity, as I said, to meet all of our needs plus the required capacity excess that's required by the southwest power pool. Did that answer your question?

Q. I think it did. Thank you. Sorry about the crack about the lobbyist bit.

A. I didn't --

Q. I hope you can get through that since you're not going to forget.

A. I didn't know whether to be insulted because you called me a lobbyist or an attorney.

COMMISSIONER CLAYTON: I'll forgive you for that one.

COMMISSIONER APPLING: I think he's coming back pretty good.

FURTHER QUESTIONS BY COMMISSIONER APPLING:

Q. Let me just while you're here -- and we're going to go upstairs for our agenda meeting, but let me just confirm a couple of points with you, if you wouldn't mind.

In your direct testimony in April -- and I'm sure this is still correct, but correct me if I'm wrong -- you said you needed $38.3 million more, which is close to 15 percent. And you said that the company needed the money to pay for two 50-megawatt peaking generation units. Is that still correct?

A. That's correct.

Q. Infrastructure repair and related -- related to tornado damage, still correct?

A. That's correct.

Q. And higher natural gas price, which I -- that's still correct. I think the company asked for 11.65, Empire witness Murry chose 12, and Mr. Vander Weide chose 11.3, and I think we settled -- you agreed that you would ask for 11.3 percent. Is that still correct?

A. Ask that part of your question again.

Q. Your ROE, it was -- you recommended 11.65, I believe?

A. Yes.

Q. Murry chose 12?

A. Yes.

Q. And Mr. Vander Weide chose 11.3, I believe it was?

A. Yes.

Q. And you also mentioned that the Commission should provide an interim energy charge?

A. Yes.

Q. You still stick to that?

A. Yes.

Q. Okay. I just wanted to make sure that before you left here that you and I looked at each other, and that's exactly what you're still holding to. Thank you very much.

A. Thank you.

COMMISSIONER APPLING: Appreciate your

time.

JUDGE THOMPSON: Thank you, Commissioner. As we did with Mr. Vander Weide, we will allow Mr. Gipson to step down, and when the agenda meeting is over, we will take up additional questions from the Bench, recross and redirect at that time. Thank you for your testimony, sir.

I assume Mr. Knapp is next?

MR. SWEARENGEN: Yes. I would call Mr. Knapp.

(Witness sworn.)

JUDGE THOMPSON: Do you understand that if you were to give false testimony in this proceeding, you could be prosecuted for the crime of perjury?

THE WITNESS: Yes, sir.

JUDGE THOMPSON: Please take your seat. Spell your last name for the reporter, if you would.

THE WITNESS: K-n-a-p-p.

JUDGE THOMPSON: Thank you. You may inquire.

GREGORY A. KNAPP testified as follows:

DIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Would you state your name for the record, please.

A. Gregory A. Knapp.

Q. By whom are you employed and in what

capacity?
A. The Empire District Electric Company. I'm vice president of finance and CFO.
Q. Did you prepare some rebuttal testimony and surrebuttal testimony in connection with this proceeding?
A. Yes, I did.
Q. And cause it to be filed with the Commission?
A. Yes.
Q. Do you have a copy of that testimony with you this morning?
A. Yes, I do.
Q. And do you understand your rebuttal testimony has been marked as Exhibit 28 and your surrebuttal testimony Exhibit 29?
A. Yes.
Q. Are there any changes or corrections that you need to make at this time with respect to your rebuttal testimony?
A. No.
Q. Are there any changes that you need to make with respect to your surrebuttal testimony?
A. No.
Q. So if I ask the questions contained in those two documents, your answers this morning under oath

would be as stated in those documents?

A. Yes.

Q. And those answers would be true and correct to the best of your knowledge, information and belief?

A. Yes.

MR. SWEARENGEN: With that, your Honor, I would offer into evidence Exhibits 28 and 29 and tender the witness.

JUDGE THOMPSON: Any objections to the receipt of Exhibits 28 or 29?

MR. KRUEGER: No, your Honor.

JUDGE THOMPSON: Hearing none, the same are received and made a part of the record of this proceeding.

(EXHIBIT NOS. 28 AND 29 WERE RECEIVED INTO EVIDENCE.)

JUDGE THOMPSON: Let's see. The order of cross is a little bit different here.

No, it's not. Stu?

MR. CONRAD: No questions, your Honor, for Mr. Knapp.

JUDGE THOMPSON: Very good. Mr. Krueger?

MR. KRUEGER: Thank you, your Honor.

CROSS-EXAMINATION BY MR. KRUEGER:

Q. Good morning, Mr. Knapp.

A. Good morning.

Q. Your duties with Empire include financial planning?

A. Yes, sir.

Q. Planning for the financing of future capital expenditures?

A. Yes, sir.

Q. On page 4, lines 11 through 12 of your rebuttal testimony, you state that borrowing money is more expensive than using funds generated internally. Is it also true that issuing new common equity is more expensive than using funds generated internally?

A. Yes, sir.

Q. And by funds generated internally, you're referring primarily to funds generated through earnings?

A. Yes, sir.

Q. And when dividends are paid out, that reduces the amount of funds generated internally that are available for other purposes?

A. That reduces the cash in the bank, yes.

Q. Has Empire ever incurred short-term debt?

A. Yes.

Q. To pay a dividend?

A. To pay out dividend?

Q. Yes.

A. The way the corporate financing basically works -- and I had this question in the deposition, so I kind of go through the same thing. But short-term debt is issued as the bank balance needs to be replenished for the payment of the bills that we pay, the fuel expenses, the payroll, dividends, construction expenditures, just the whole litany of items that a corporation could pay. And the way it works in -- customarily in a utility company is that level of short-term debt reaches a point where it's not going to be paid down through the normal course of operations of the company, then it's converted into long-term debt or common equity. So indirectly, yes.

Q. Has Empire issued any new common -- excuse me. Strike that.

Has Empire issued new common equity on several occasions in recent years?

A. Yes.

Q. How often, say, in the last 10 years, do you recall?

A. In the last ten years, I'd have to look. I know in the last three years there's been three separate occasions.

Q. Okay. And there are transaction costs associated with each of these issuances of common equity?

A. Yes.

Q. Now, if Empire's constantly distributing dividends that equal or exceed its earnings, then isn't Empire incurring higher costs due to its decision not to reduce its dividends?

A. I think that the issue with dividends -- tell me the question again. I'm sorry.

Q. Okay. If Empire is constantly distributing dividends that equal or exceed its earnings, then isn't Empire incurring higher costs due to its decision not to reduce its dividend?

A. If the question is had we reduced or eliminated dividends at some point in the past, would our costs be lower now, I think one of the assumptions I might make, or observation, might be that I'm not sure that we could have sold that common equity. So I don't know what the cost would have been, because we might not have been able to even have access to the capital market.

Q. When you file a rate case, do you seek to recover the transaction costs associated with the issuance of equity?

A. Yes.

Q. Have you -- have any written recommendations been made concerning a desired dividend payout ratio to optimize retained earnings for future investment needs?

A. Not that I'm aware of.

Q. To your knowledge, is there any possibility that Empire may reduce its dividends in the future?

A. I think that it's been referred to yesterday, and also it's been in print. There have been a couple of the analysts that cover us that have indicated if the company's earnings don't move to a place where the dividend can be covered, then that's a difficult situation for continuing the dividend.

I think that the problem is not the dividend level, as we've had people talk about in the last two days. The problem is the level of the ability of the company to recover costs to cover those dividends. That's not a situation that can go on forever.

Q. To your knowledge has there been any discussion of reducing the dividends?

A. No, not serious discussion.

Q. Does Empire believe it's going to be able to grow its dividend soon?

A. I would like to be able to set in the meeting room at the office and have that discussion. I think the first level of discussion that we have to have is when we're able to look at our earnings and understand that they are at a level that is providing coverage of the dividends and then some. And that has to go for a period of time, and then like any company, that would be a great conversation to have.

MR. KRUEGER: That's all the questions I have, your Honor.

JUDGE THOMPSON: Very well. Mr. Coffman?

MR. COFFMAN: No questions.

JUDGE THOMPSON: Well, Mr. Knapp, just as we've done with the last several witnesses, we're going to ask you to step down, because the Commissioners may have questions for you when they are done with agenda session.

And I believe we're now ready for Mr. Murray.

MR. SWEARENGEN: Can we go off the record just a minute, your Honor, so I might consult with my files.

JUDGE THOMPSON: Absolutely.

MR. SWEARENGEN: Thank you. Would it be possible to take a few minute break?

JUDGE THOMPSON: Why don't we go ahead and take five minutes.

(A BREAK WAS TAKEN.)

MR. SWEARENGEN: Judge, before we proceed with the witness, may I just note for the record these are pleadings that I have filed.

JUDGE THOMPSON: I thought what I would do is I will swear the witness, and then we will take up the issue of your objection. In fact, your objection, I suppose, is most properly directed towards the prefiled testimony, correct?

MR. SWEARENGEN: That is true.

JUDGE THOMPSON: So at the point of offering that I think would be the point to take that up.

MR. SWEARENGEN: That would be fine. Thank you.

(Witness sworn.)

JUDGE THOMPSON: Do you understand that if you were to give false testimony in this proceeding, you can be prosecuted for the crime of perjury?

THE WITNESS: Yes.

JUDGE THOMPSON: Please take a seat and spell your last name for the reporter, if you would.

THE WITNESS: Last name is M-U-R-R-A-Y.

JUDGE THOMPSON: You may inquire.

MR. KRUEGER: Thank you, your Honor.

DAVID MURRAY testified as follows:

DIRECT EXAMINATION BY MR. KRUEGER:

Q. State your name and address for the record, please.

A. My name is David Murray. The address is 200 Madison Street, Missouri Public Service Commission, 65102.

Q. By whom are you employed and in what capacity?
A. I'm employed by the Missouri Public Service Commission as a Utility Auditor 3.
Q. Did you prepare and cause to be filed in this case the direct testimony of David Murray, Exhibit 62, the rebuttal testimony of David Murray, Exhibit 63, and the surrebuttal testimony of David Murray, Exhibit 64, which includes both NP and HC versions?
A. Yes, I did.
Q. Do you have any corrections or changes to make to any of those documents at this time?
A. Just a few.
Q. Okay. Let's start with the direct testimony. Are there changes to the direct testimony?
A. No changes to the direct. I have changes to the rebuttal testimony.
Q. Where is the first change?
A. Page 12, line 13, I believe there were some corrections yesterday from Dr. Vander Weide's testimony on 9.7 versus 9.4. The 9.7 should be 9.4, just as it is in Vander Weide's testimony.
Q. Okay. Thank you. Where's the next one in the rebuttal testimony?
A. I believe that's all I have in the rebuttal

testimony.

Q. Are there changes in the surrebuttal testimony?

A. Yes, there is. On page 10, line 9, I indicate an example attached to my direct testimony. That should be rebuttal testimony.

Q. Other changes in the surrebuttal testimony?

A. I believe that's it.

Q. Okay. Thank you. With those changes, is everything in your direct, rebuttal and surrebuttal testimony true and correct?

A. Yes, it is.

Q. And if I asked you those questions today, would your answers be the same?

A. Yes, they would.

MR. KRUEGER: Your Honor, I would offer Exhibit 62, 63 and 64 and tender the witness for cross-examination.

JUDGE THOMPSON: Objections?

MR. SWEARENGEN: Yes, your Honor. The company objects for the reasons that we have set forth in a motion which we filed earlier today. I recognize under the rules that the other parties will have an opportunity to respond to that motion, perhaps within 10 days. Given that, the company would have no objection to proceeding with the cross-examination of this witness, so long as it is done subject to our objection, which we would understand the Commission would perhaps rule on at some later time, perhaps at the time they decided the case.

JUDGE THOMPSON: Comments? Reactions?

MR. KRUEGER: Your Honor, without waiving my right to file a written responsive pleading to this, I'd like to make a few points, and perhaps the Commission could rule in our favor on this today and save some trouble. It appears that the issues that have been raised by this motion are virtually identical to the issues that were raised in a similar motion that was presented in the MGE case just this summer.

There were numerous pleadings --

JUDGE THOMPSON: Could I ask a question? In the MGE case, were those objections directed at this particular witness?

MR. KRUEGER: They were directed at this particular witness. The facts are virtually identical, except that Mr. Murray has more experience now, and the Commission directed -- responded to this motion in an Order regarding MGE's motion to exclude certain testimony and opinions of David Murray. That order was issued on June 8, 2004. The relevant portions are on page 2 where they address the merits of the motion and they conclude that Mr. Murray is qualified as an expert.

The Order goes on to say that if anything, the points raised go only to the credibility of Mr. Murray, but do not affect his qualifications as an expert.

JUDGE THOMPSON: Could I see the Commission Order you're referring to?

MR. KRUEGER: You may.

JUDGE THOMPSON: Thank you.

MR. COFFMAN: Your Honor, when appropriate, I'd like to supplement what Mr. Krueger said.

JUDGE THOMPSON: Please.

MR. COFFMAN: I just wanted to point out that there was also a similar motion filed in this case regarding Mr. Allen's testimony, nearly identical, and as far as I can tell from these two motions, they are essentially identical to the motions filed in the MGE case against Mr. Murray and Mr. Allen.

I would point out that there was also a subsequent Order regarding the motion in the MGE case on Travis Allen's testimony which even further elaborated on the law beyond what -- the Order I believe you're reviewing now.

And Mr. Swearengen probably feels that since this matter is now on appeal, that he has an obligation to lodge the same arguments here in this case, but I believe the Commission's analysis in the MGE case is correct and would support Mr. Krueger's opposition to the motion.

JUDGE THOMPSON: You're aware of both of these orders, this one and the one Mr. Coffman referred to?

MR. SWEARENGEN: Yes, your Honor.

JUDGE THOMPSON: Okay. And is it true that the MGE case is on appeal with respect to those issues?

MR. SWEARENGEN: Those issues are included in the issues that are on appeal, that's correct.

JUDGE THOMPSON: Mr. Conrad?

MR. CONRAD: Not to belabor this point, but I, too, was involved in the MGE case, and, in fact, applied for but was denied CLE credit for coming and listening to I think the $700-an-hour New York attorney.

MR. SWEARENGEN: That would not be me, your Honor.

JUDGE THOMPSON: I remember that. I think I watched a Gunsmoke rerun or something instead of coming to that.

MR. CONRAD: But to me the answer to that is very simple, and that is I would confirm generally what I think Mr. Krueger's point has been, although I would use probably not the terminology of credibility but would use the point that it simply goes to the weight that would be assigned to the witness's testimony. The Commission has, in some 30 years of my experience with it, has distinguished itself in being able to assign appropriate weight to various witnesses and accord them such weight as it finds due, and it doesn't really need admissibility. It simply goes to the weight, and that's where we are. Thank you.

JUDGE THOMPSON: Thank you. Let me ask you some questions. Are you under oath? What is the general purpose of your testimony in this case?

THE WITNESS: The general purpose of my testimony is to recommend a fair and reasonable rate of return to be authorized on Empire's rate base of their investment and their utility infrastructure.

JUDGE THOMPSON: And how did you arrive at whatever number or numbers you offer in your opinion?

THE WITNESS: I employed three cost of capital models, one first being the DCF, which is what I gave primary reliance to. I also applied the capital asset pricing model, which is another cost of equity model that's used in the finance world.

I used a risk premium model which measures earned returns over risk-free returns to determine what is an appropriate risk premium for an investor to earn over that risk-free rate to invest in an equity security. I looked at that for Empire specifically, and then I also looked at a group of four comparable companies to measure the reasonableness of my results from using those cost of capital models.

JUDGE THOMPSON: Are you familiar with the testimony filed in this case by Dr. Vander Weide and by Dr. Murry?

THE WITNESS: Yes, I am.

JUDGE THOMPSON: And did either of those persons use any of the methods you described?

THE WITNESS: Yes, they did.

JUDGE THOMPSON: So you've got known experts using those methods. Now, you have a bachelor's degree in business and also a master's degree; is that correct?

THE WITNESS: Yes, I have a bachelor's degree in -- it's actually a bachelor of science in business administration with an emphasis in finance in banking and real estate. Then I have a master's in business administration that I just earned in December 2003.

JUDGE THOMPSON: And where or when did you learn to conduct the sort of analysis that you conducted in this case and that your testimony concerns?

THE WITNESS: In the financial curriculum in my bachelor's undergraduate degree. In the early '90s, obviously the cost of capital models as Dr. Vander Weide indicated I think in some of his cross-examination, they were just general theories of finance that can apply across the board.

JUDGE THOMPSON: So they were part of the academic curriculum that you followed --

THE WITNESS: That's correct.

JUDGE THOMPSON: -- and for which you have received two degrees?

THE WITNESS: Yes. There was more focused in my undergraduate degree, but there were financial courses in my master's degree.

JUDGE THOMPSON: Okay. Based on his testimony, I find that he has at least some qualifications, and therefore I'm going to recognize him as an expert for the purpose of this proceeding. And I will overrule that part of your motion.

With respect to the data that you used, that you analyzed and on which your opinion is based, if you know, is that the sort of data that is relied upon generally by experts in this field when rendering the same or similar opinions?

THE WITNESS: Yes. Myself and the company witnesses and OPC witness Allen used ValueLine, IBES, Standard & Poor's, used yields from risk-free securities that are published by the United States government. We used -- I'm trying to think of some of the other sources that we used. But obviously there's a disagreement on the weight that should be given to some of those sources.

JUDGE THOMPSON: I understand that. Based on your familiarity with the testimony provided by Drs. Murry and Vander Weide, did they use the same sort of data?

THE WITNESS: Yes, they did.

JUDGE THOMPSON: Again, those are acknowledged experts in this field, and consequently, it is my determination that the data relied upon by Mr. Murray is of the sort that is reasonably relied on. Therefore, I will overrule the second portion of your motion.

Any other objections to Exhibit 62, 63 or 64?

(No response.)

JUDGE THOMPSON: Hearing none, the same are received over objection.

(EXHIBIT NOS. 62, 63 AND 64 WERE RECEIVED INTO EVIDENCE.)

JUDGE THOMPSON: Thank you very much, Mr. Krueger.

MR. KRUEGER: Thank you, your Honor.

JUDGE THOMPSON: Mr. Conrad?

THE WITNESS: Before we proceed, can I make a request? This chair is faulty. It keeps on falling down. Can I exchange this chair?

JUDGE THOMPSON: I will not burden your testimony with a faulty chair.

THE WITNESS: Thank you.

MR. CONRAD: It was good enough for the other experts.

JUDGE THOMPSON: Well, I don't know. Do we need to give them another chance to testify?

MR. CONRAD: Did they rely on the same seat?

JUDGE THOMPSON: You know, a chair is part of those fundamentals. Okay. A little bit of levity never hurts.

MR. CONRAD: Well, your Honor, I do not have any questions for Mr. Murray.

JUDGE THOMPSON: Thank you very much, Mr. Conrad. Mr. Coffman?

MR. COFFMAN: No questions.

JUDGE THOMPSON: Mr. Swearengen?

MR. SWEARENGEN: Yes, your Honor. Could I simply start by having an exhibit marked, please?

JUDGE THOMPSON: You may. You may start however you would like.

MR. SWEARENGEN: Thank you.

JUDGE THOMPSON: This will be Exhibit 122. And how shall we describe this?

MR. SWEARENGEN: These are Data Requests which the company submitted to the witness, and his responses.

(EXHIBIT NO. 122 WAS MARKED FOR IDENTIFICATION BY THE REPORTER.)

JUDGE THOMPSON: Very well.

MR. SWEARENGEN: What number was that?

JUDGE THOMPSON: 122.

Please proceed.

CROSS-EXAMINATION BY MR. SWEARENGEN:

Q. Good morning, Mr. Murray. How are you?

A. Pretty good. How are you doing?

Q. Fine, thank you. You have in front of you what has been marked for purposes of identification as Exhibit 122, which is a 31-page document. Do you have that?

A. Yes, I do.

Q. Could you describe what that is, please?

A. It appears to be the Data Requests that were sent to me by Empire regarding all sorts of issues regarding degrees and work experience, things of that nature.

Q. And not only are the Data Requests included there, but also your responses --

A. Yes, they are.

Q. -- to those Data Requests?

A. Yes.

Q. And those responses, I take it, are true and correct to the best of your knowledge, information and belief?

A. Yes.

Q. For the record, would I be correct if I said they include Data Requests 483 through 508?

A. Yes.

MR. SWEARENGEN: Thank you. I would offer into evidence Exhibit 122.

MR. KRUEGER: No objection.

MR. CONRAD: Judge, I just have one question. I don't know whether it rises to an objection. These are -- and this may be an EFIS thing, and maybe that's what I'm not clear about. The boilerplate on this says the attached information provided to Missouri Public Service Commission Staff, and -- but it would appear that the response is being provided by a member of the Staff. So I guess I'm -- is that just part of the form that you use when you do this on EFIS?

JUDGE THOMPSON: Frankly, I don't know. The Adjudication Division is excluded from the Data Request module of EFIS, so I have no idea what goes on.

MR. SWEARENGEN: And I can't explain it either, your Honor, although my understanding is based on the witness' statement. These are the questions that were propounded to him and the answers.

MR. CONRAD: And with that, I don't have an objection. I'm just kind of curious about the form.

JUDGE THOMPSON: I appreciate your identifying yet another of the beneficial features of EFIS. Perhaps by the time I retire, they'll all be fixed. Any other objections to the receipt of this exhibit?

(No response.)

JUDGE THOMPSON: Hearing none, the same is received and made a part of the record of this proceeding.

(EXHIBIT NO. 122 WAS RECEIVED INTO EVIDENCE.)

MR. SWEARENGEN: Thank you.

BY MR. SWEARENGEN:

Q. Mr. Murray, let me just start out by asking, as a philosophical matter, do you think that the

Empire District Electric Company or for that matter any utility subject to this Commission's jurisdiction should be forced to live what I will call a hand-to-mouth existence? In other words, given just enough rate relief to get by?

A. Just enough rate relief to get by? Can you please elaborate for me a little bit on that?

Q. Well, in other words, given enough rate relief to get by for a year or so, and then be forced to come back to the Commission with another request for rate relief?

A. I believe a utility should be allowed to recover its cost of service, and there are many factors that go into whether or not they're going to be able to earn that cost of service.

Q. So is the answer to my question yes or no?

A. I believe that we should recommend a rate of return that's equitable and that's based on the cost of capital to the utility.

Q. And if you do that and the company is forced to come back shortly thereafter for another request for rate relief, would you agree that someone might characterize that as a hand-to-mouth existence?

A. I'm not sure how somebody would characterize that.

Q. You think it's possible that someone could say that the Commission is just giving them enough to get by?

A. I don't know how somebody would characterize that.

Q. How would you characterize it?

A. I would characterize it as recommending a cost of service to the utility.

Q. Do you think that's an efficient and effective way to regulate?

A. I believe that the principles of regulation is to allow them to recover their cost of service.

Q. Let me ask you this question: With respect to the purpose of your testimony in this case, would I be correct if I said the purpose of your testimony is to determine and make a recommendation to this Commission as to what an investor must have in the way of a return to make an investment in the common stock of Empire?

A. That's exactly the objective of the cost of capital models, to determine the required rate of return of the investor.

Q. Well, is that the purpose of your testimony?

A. Yes, it is. I'm recommending the cost of capital.

Q. I think at page 31 of your direct testimony, if you could turn to that, please.
A. Yes.
Q. -- there at lines 5 and 6, you testify the rate of return witnesses' objective is to estimate investors' required rate of return.
A. That's correct.
Q. And let me ask you this: Is the required rate of return in your mind the same as the cost of capital?
A. Yes, it is.
Q. Now, I recall that you filed testimony as a Staff cost of capital witness in Aquila's last electric rate case which was Case ER-2004-0034. Do you recall that?
A. I do recall that.
Q. And you testified in that proceeding, I believe, back in March of this year?
A. That sounds about right.
Q. Do you recall in that proceeding when you were on the witness stand, I asked you whether in putting together your recommendation, you looked at any decisions of other public utility commissions. And I think my question to you was, Have you ever looked at any decisions of other public utility commissions or public service

commissions and read those decisions where they discussed the authorized returns that they were allowing for the companies under their jurisdictions? And your answer was no. Do you recall that?

A. I recall a question similar to that.

Q. And your answer?

A. Yes.

Q. And that was your answer, no?

A. If that's on the transcript, that was my answer.

Q. And I asked you, You never have? And you said, No. There are many things that go on. I have enough stuff to do here as far as doing my economic analysis using the DCF model and the capital asset pricing model. As far as what goes on in the specifics of cases throughout this country, I would be working 24/7 to be able to keep up with that. Do you recall that testimony?

A. Yes, there's a lot of data in all those cases.

Q. And do you recall testifying in that same Aquila case in your prepared testimony that the Staff of the -- this Commission does not use or consider allowed return on equities in other jurisdictions in order to recommend a fair and reasonable return on equity for utility companies in Missouri? Do you recall that?

A. That sounds correct.
Q. And do you recall in that case when I asked you on the witness stand about that Staff policy, and you said, We don't look at allowed ROEs or earned ROEs before we do our analysis to come up with our recommendation. Do you recall that?
A. I recall that.
Q. And that was your testimony in that case?
A. If that's on the transcript, that's my testimony.
Q. Do you have any reason to dispute it?
A. No, I have no reason to doubt that.
Q. Do you recall also in that Aquila case when I asked you whether or not you thought what another state regulatory commission determined to be a fair return for a utility company is relevant or not, and your answer was, and I quote, It is not relevant to my cost of capital analysis? Do you recall that?
A. Yes, I do.
Q. And you also testified in that case with respect to return on equities authorized by other commissions, and your quote was -- your statement was, That's not how we test the reasonableness of our ROEs. Do you recall that?
A. That's correct.

Q. And using the word "our" in that case and on the witness stand this morning, I assume you would be referring to the Commission Staff?
A. Yes.
Q. Now, were you the cost of capital witness for the Staff in the recent Missouri Gas Energy case?
A. Yes, I was.
Q. And if I recall correctly, your recommended return on equity in that case was 8.52 percent to 9.52 percent; is that correct?
A. That's correct.
Q. Would it be fair to say that your recommendation in that MGE case was based on what you consider to be the cost of capital for MGE?
A. Yes, it was.
Q. And would I be correct if I said in that case, in the MGE case, the Commission awarded MGE a 10.5 percent ROE which was approximately 100 basis points above your high?
A. That's correct.
Q. I take it you read the Commission's Order in the MGE case?
A. Not the entire Order, but parts of the Order, yes.
Q. Have you read the parts pertaining to the

cost of capital issue?

A. Of course.

Q. Then you would agree with me that the Commission said in that Order, and it's talking about what goes on in other jurisdictions with respect to cost of capital, and I'm quoting, the na-- and this is the Commission speaking: The national average is a good indicator of the capital market in which Southern Union will have to compete for the equity needed to finance MGE's operations, end quote.

Do you recall reading that statement which appears on page 19 of the Commission's Report and Order?

A. Yes, I do.

Q. Do you agree with that statement?

A. I believe that's the Commission's view on what they think.

Q. That wasn't my question. My question was, do you agree with that statement?

A. No.

Q. Do you recall in the Commission's decision in the MGE case, also at page 19, where the Commission said, and I quote, The Commission has an obligation under the law and well as a matter of practical necessity to allow Southern Union an opportunity to earn a return that will allow it to compete in the capital market. No one, including ratepayers, benefits if MGE is starved for capital, unquote.

Do you recall reading that statement in the Commission's Report and Order?

A. Yes, I do.

Q. And do you agree with those statements?

A. Would you repeat the statement one more time, please?

Q. Yes. The Commission has an obligation under the law and well as a matter of practical necessity to allow Southern Union an opportunity to earn a return that will allow it to compete in the capital market. No one, including ratepayers, benefits if MGE is starved for capital.

A. I agree.

Q. You agree with that statement?

A. Yes, I do.

Q. And would you agree that that statement or those statements apply to Empire in this case?

A. Yes, I do.

Q. Would you agree that what goes on with respect to returns authorized for other companies in other jurisdictions is a good indicator of the capital market in which Empire will have to compete for the equity it will need to finance its operations?

A. That's a very narrow part of the entire capital market. So no, it doesn't represent what's going on with the broader capital markets.
Q. So you don't think what goes on with respect to returns being authorized by other commissions for other utility companies, electric utility companies, gas utility companies in other jurisdictions is a good indication of the capital market in which Empire will have to compete for capital?
A. Wall Street's much larger than just other utility companies.
Q. Is that a yes answer or a no answer?
A. That's a no.
Q. You don't agree with that statement?
A. No.
Q. Let me ask you this question: In light of the Commission's decision, recent decision in the MGE case, have you changed your cost of capital approach in any respect?
A. No, I haven't.
Q. Is it your understanding that Empire has a need for new generation capacity?
A. That's my understanding from reading certain company witnesses' testimony, yes.
Q. Would you agree that to acquire that new

generation, that Empire will have to go to the capital markets?

A. To some extent I believe that will be the case, since they're not retaining earnings, yes.

Q. Would you agree that this Commission should allow Empire an opportunity to earn a return that will allow it to compete in the capital markets?

A. Yes.

Q. Would you agree that ultimately the company's customers, its ratepayers will be harmed if Empire has a difficult time attracting capital or has to pay more for capital because of increased risk?

A. Repeat the question, please.

Q. Would you agree that ultimately the company's customers will be harmed if Empire has a difficult time in attracting capital or has to pay more for capital because of increased risk?

A. If that's allowed to be put into the rates, yes, that's correct.

Q. What do you mean, if that is allowed to be put into rates?

A. If the -- if the increased cost is put into the rate of return recommendation, obviously that would result in higher rates.

Q. And that would be harmful to the customers?

A. Yes. If a company's cost of capital is going up for reasons other than -- you know, other than the general economic conditions, then yes.

Q. Would you agree that it is important for a company such as Empire to be creditworthy?

A. Can you please define creditworthy?

Q. Well, I'll let you define it. How would you define it?

A. The least investment period is usually the benchmark that one would look to, so if a company falls below investment grade, then obviously that's a concern. But we have to look at the specifics as to why a company may have fallen below investment grade.

Q. Back to my question. Do you think it is important for a company such as Empire to be creditworthy, using your definition of the term?

A. It's desirable to have Empire to be at least investment grade, which is at least BBB- or above.

Q. And that's creditworthy in your mind?

A. That's investment grade. Obviously being investment grade's important. Once you fall below investment grade, the spread for the required return is much greater than it is between any other -- any other rating category.

Q. And is investment grade creditworthy in your mind?

A. There are very differing degrees of creditworthy. Investment grade is considered to be stable.

Q. Is it considered to be creditworthy?

A. You can be creditworthy at a B credit rating. It doesn't necessarily mean that you have good creditworthiness. There's different degrees of being creditworthy.

Investment grade credit rating means you're fairly stable. There's fair assurance that you're going to receive your return back on your debt investment.

Q. Well, if I ask you to define the term creditworthy, which I thought you did a while ago, and I thought you said it was investment grade, would you now have some other definition of that term?

A. No. Investment grade is generally recognized as being of a stable creditworthiness.

Q. And is that the term -- is that the definition that you apply to that term creditworthy?

A. Of stable creditworthiness, yes.

Q. Stable creditworthiness?

A. Yes.

Q. Now, is there such a thing as unstable creditworthiness?

A. Well, yes. If you're on the border of being in default, I mean, yes, obviously your creditworthiness is questionable.
Q. And it's unstable?
A. Yes.
Q. And you may not be creditworthy?
A. Exactly.
Q. Would you agree that the level of creditworthiness, as you're now using that term, of a company will dictate not only the cost that it pays to borrow the money but the level of access it will have to the credit markets?
A. I think it has more to do with the cost. If you're borderline default, then you may have a problem accessing the capital markets whatsoever, but anything below investment grade is going to be more of a cost issue. Obviously there's investors that like to be speculative and invest in the debt of a company that's below investment grade. Aquila is a good example of that. If you're willing to pay a high enough price, you'll find investors that are willing to take the risk.
Q. So you're saying it doesn't really matter then in terms of creditworthiness as far as access to the capital market is concerned, in your view?
A. There's all sorts of investors out there,

obviously. We talked about that. There's investors that prefer stability of a utility, and there's investors that like to do -- you know, do a value play like with Aquila.

MR. SWEARENGEN: Your Honor, I would move that that answer be stricken as nonresponsive. It called for a yes or no.

JUDGE THOMPSON: Would you agree that the level of creditworthiness, as you're now using the term, of a company that at this time take not only the something that it pays to borrow the money but the level of access it will have to the credit markets? Is that the question?

THE REPORTER: There's a question after that.

JUDGE THOMPSON: Would you read the question back, please?

(THE REQUESTED TESTIMONY WAS READ BY THE REPORTER.)

MR. SWEARENGEN: That calls for a yes or no answer.

JUDGE THOMPSON: I believe it does. We'll strike the answer, and please give us a yes or no response, Mr. Murray.

THE WITNESS: The level, yes.

BY MR. SWEARENGEN:

Q. Let me ask you this: Do you still have your direct testimony there?

A. Yes, I do.

Q. Turn to page 20 if you would, please.

A. Yes.

Q. There on line 17 through 19, I believe you quote a Standard & Poor's statement concerning Empire; is that right?

A. Yes.

Q. And there you quote that statement and set out these words: In addition, the need for additional generation capacity could strain the company's long-term financial profile. Of paramount importance, however, will be the MPSC's treatment in the company's upcoming rate case, correct?

A. Yes.

Q. Is that the rate case that we're involved in right now?

A. Yes, it is.

Q. Thank you. Let me ask you this: By that statement from Standard & Poor's that you set out in your testimony, is it -- do you understand S&P to suggest that Empire needs a sufficient return in this case in order to finance the building of a -- the building of additional generation capacity?

A. I don't think there's any specific mention of a return. It's just talking about treatment in the overall rate case.

Q. And what would the treatment in the overall rate case consist of?

A. Well, obviously the bottom line revenue requirement that is authorized.

Q. And would that be made up of giving the company an opportunity to recover its prudent and necessary operating costs?

A. Yes.

Q. And would that include giving the company an opportunity to earn a rate of return, an authorized rate of return?

A. A fair and reasonable rate of return, that's correct.

Q. Would you agree that the fair and reasonable rate of return which the Commission would authorize for Empire in this case should be sufficient, should be adequate to allow for sufficient cash flows to maintain the financial health of the company?

A. It should be set at a level to maintain sufficient cash flows. If there's a normal circumstance for the company where, you know, they follow what's been recommended from Staff as far as what is prudent, prudently incurred expenses, and there's normal weather, there's -- there are not any plant outages, what have you, as long as there are normal circumstances which I -- that's what the objective of a rate case is, to look at, try to normalize the circumstances based on all those factors that go into determining revenue requirement, yes, the cash flow -- if all those considerations are taken into account, then the cash flows should be able to cover an interest expense.

Q. And maintain the financial health of the company?

A. Yes.

Q. I think you said earlier that you agree that the company should recover its prudently incurred and necessary operating costs?

A. Yes.

Q. Let me ask you this: Hypothetically, if that doesn't happen, if the company does not get a fair return in this case and can't recover its prudently incurred operating costs, would you agree that its financial flexibility might be threatened?

A. It may be.

Q. And its access to capital at a reasonable cost would be limited?

A. Yes.

Q. Now, you take the position that nonetheless the company would still have some access to some capital?

A. Yes.

Q. Under any scenario?

A. Unless they're in default and people withdraw from the market to provide them capital, yes.

Q. Would you agree that an order issued by this Commission that is perceived by the financial community as negative can have a far-reaching impact on the company's creditworthiness?

A. If it's from the credit rating or the fixed debt investment community, yes.

Q. What about any other aspects of the financial communities? What other parts of the financial communities are there other than the fixed debt part?

A. We have debt and equity investors obviously. Obviously there -- you know, debt investors are looking at different things than equity investors are. For instance, if there were items that look like it, you know, improved the -- I'm trying to think of a good example here.

Obviously if the cash flows and the risk taken by the company are more stable, then the debt investors will see it as more favorable equity investors, depending on the type of equity investor. If a company takes a risk going into a project that may achieve a higher rate of return, that may ultimately improve the shareholders' stock price. Then they may be attracted to that type of opportunity.

So -- so everybody's looking at different things when they're investing, depending on what type of investor you are.

Q. Well, let me ask you about the -- I think you talked about the debt investors. Let's talk a little bit about the equity investor. Is it possible that the equity investor community could perceive an Order of this Commission as negative?

A. I'm sure they would want the entire rate increase request to be authorized. They would view that as very positive.

MR. SWEARENGEN: Well, your Honor, I'm going to once again ask that the answer be stricken as nonresponsive. It called for a yes or no.

JUDGE THOMPSON: Read me the question, please, Kellene.

(THE REQUESTED TESTIMONY WAS READ BY THE REPORTER.)

JUDGE THOMPSON: I'm going to go ahead and grant the motion and direct the witness to give a yes or no response.

THE WITNESS: You didn't specify what type of Order. I mean, there's all sorts of types of Orders that they can issue. One could be of a rate increase of 15 million, one could be a rate increase of 5 million.

MR. SWEARENGEN: Judge, I think you asked him to answer yes or no.

MR. KRUEGER: I think he's asking for clarification of the question so he can understand whether the answer is yes or no, your Honor.

JUDGE THOMPSON: Yes, if you're able to answer yes or no, then please do so. If not, you'll have to indicate that you don't understand the question or that you need clarification.

THE WITNESS: I don't understand, because an Order is very vague. That doesn't specify what kind of order you're talking about.

BY MR. SWEARENGEN:

Q. Let me ask you this question: Let's assume that this Commission issues an order in this case. Okay. Can you make that assumption?

A. Sure.

Q. Is it possible that equity investors could view that order as negative?

A. It's possible. They can view any order as negative or positive.

Q. And if they would do that, could that have a far-reaching impact on the ability of this company to attract capital?

A. No.

Q. You said, I think, earlier that your objective in this case was to estimate the rate of return which investors require?

A. Yes.

Q. And specifically with respect to the common stock of Empire?

A. That's part of the rate of return, that's correct, yes.

Q. And to do that in this case, to come up with your estimate of the required rate of return that investors would expect, you used the discounted cash flow, or DCF method; is that true?

A. Let me clarify. When you say required return that investors would expect, I think there's a difference between a required return and expected return. I just want to make sure that's clear.

MR. SWEARENGEN: Your Honor, once again, I ask that that be stricken. That wasn't my question. He's answering some other question that maybe he wanted me to ask at some point down the road, and maybe I will, but --

MR. KRUEGER: I believe the question did include the term "required return that investors would expect." I'm not positive about that.

JUDGE THOMPSON: Well, let's be positive. Kellene, why don't you read me the question again.

(THE REQUESTED TESTIMONY WAS READ BY THE REPORTER.)

MR. SWEARENGEN: And once again, your Honor, that calls for a yes or no.

JUDGE THOMPSON: Would you read me the answer to that?

(THE REQUESTED TESTIMONY WAS READ BY THE REPORTER.)

JUDGE THOMPSON: That sounds like he was asking for clarification. I'm not going to strike that.

Are you able to give a yes or no answer to the question?

THE WITNESS: If he's asking specifically about a required return, I can. If he's --

JUDGE THOMPSON: But you're not sure if he's asking --

THE WITNESS: No, I'm not sure if he's asking about required or expected.

MR. SWEARENGEN: Let me ask --

JUDGE THOMPSON: Why don't you ask him to clarify.

MR. SWEARENGEN: Well, let me ask the

question again.

BY MR. SWEARENGEN:

Q. To do this, my question was, in this case, to come up with your estimate of investors' required rate of return, you used the DCF method; isn't that true?

A. That is correct.

Q. Would you agree with me that a fundamental assumption of the DCF model is that the company whose cost of equity is being estimated operates in a steady-state equilibrium?

A. Yes, that's an assumption.

Q. So you would agree, then, I guess, that the company's dividend payout ratio and rate of return on equity are expected to remain relatively constant?

A. That's an assumption of the DCF, that's correct.

Q. And its earnings, dividends, book value and stock price are all expected to grow at the same rate in perpetuity?

A. That's another assumption of the DCF, yes.

Q. Would you agree that Empire is currently earning a return on equity that is less than its allowed return?

A. I don't know for sure on that.

Q. Do you have any idea what return Empire is currently earning?

A. I know what's reported in the financial press, and that's a company-wide number. I do know that that has been reported at 7.8 percent.

Q. And when you say company-wide, what do you mean by that?

A. Empire Consolidated.

Q. And what does Empire Consolidated consist of?

A. Empire Consolidated consists of all the regulated operations, which includes Oklahoma, Arkansas, Kansas and their non-regulated operations as well.

Q. Would you agree that 80 to 85 percent of those operations are regulated operations in the state of Missouri?

A. At least, yes.

Q. At least?

A. Yes. I mean, it's a high percentage of the revenues.

Q. And would you agree that 7.8 percent is less than Empire's allowed return?

A. That number itself, yes, it is.

Q. And would you agree that that is a situation that is unsustainable in the long run?

A. It's not good for a company to earn less than its cost of equity. That's not going to create value for the shareholders.

Q. Is it unsustainable in the long run?

A. In perpetuity it would be unsustainable. Obviously there's situations where companies underearn with the expectation that they eventually earn their cost of equity.

Q. How would you define long run?

A. In perpetuity, as I said.

Q. Would you agree that Empire's dividends currently exceed its earnings?

A. On a consistent basis, yes.

Q. Would you agree that this is a situation that is unsustainable in the long run?

A. Yes.

Q. Would you agree that rating agencies place Empire on a negative watch for a bond downgrade?

A. Yes. Excuse me. That's Standard & Poor's. I have not seen a report from Moody's and Fitch. I've just seen a report from Standard & Poor's.

Q. Is that a situation that is unsustainable in the long run?

A. I'm sorry. I don't understand that question.

Q. The fact that the rating agencies have

placed Empire on a negative watch for a bond downgrade.
A. I don't understand how that would be unsustainable. I --
Q. You think that is sustainable in the long run or unsustainable in the long run?
A. If they're downgraded, it's -- that's going to be one even. I don't understand how -- I'm not understanding your logic with how that would be sustainable to continue to be downgraded or unsustainable to --
Q. So you can't answer the question?
A. I can't answer that question.
Q. Would you agree that given your earlier response, that Empire violates the fundamental assumptions of the DCF model?
A. They're not in a steady state. They don't -- their required rate of return obviously changes over time. Their payout ratio is over 100 years. Yes, it's just like any other company. Very rarely do all the other assumptions hold true.
Q. So your answer is yes, that Empire violates the fundamental assumptions of the DCF model?
A. Yes.
Q. Doesn't that suggest extreme care in applying the DCF model to Empire in this case?

A. Very extreme care, you're correct.

Q. Now, I think earlier you wanted to get at something that I want to ask you about, and I think on page 40 of your direct testimony beginning on line 14 --

A. Yes.

Q. -- you say, the DCF model estimates the cost of common equity. To the company the cost of common equity is the investors' required rate of return, which may or may not be equivalent to the expected return on common equity of the investor.

A. Yes.

Q. That's your testimony, right?

A. Yes, it is.

Q. So the process, the goal of the process that you're going through in your testimony is to anticipate the investors' required return. You admit the DCF model may produce a number that is not equivalent to the expected return of the investor; is that correct?

A. Exactly.

Q. And I take it, then, that in your mind, there's a difference between expected and required return?

A. Yes, there is.

Q. When you use the DCF model in this case, or in any case for that matter, would I be correct in saying that you perform what I will call a company-specific DCF analysis?

A. In this case I did. I believe Empire is the only case I've been able to do that with.

Q. And when you perform a company-specific DCF analysis as you have done for Empire in this case, is it true that you focus on and use exclusively information pertaining to that company?

A. Yes. That's the beautiful thing about the DCF, is I get to use the dividend of Empire, the stock price of Empire and the expected growth of Empire, so yes, it's very company-specific information.

Q. And the company-specific DCF approach gives no consideration to other companies; is that a fair statement?

A. Oh, it's an opportunity cost, so it does give consideration to other companies. They -- like you've indicated before, they operate in a -- in the capital markets. So the cost of capital that is determined from an Empire Company's specific DCF result is going to be driven by the cost of capital of other utilities --

Q. Well, let me ask you --

A. -- and other companies as well.

Q. Let me ask you about that. I think you said that when you use a company-specific DCF analysis as you did for Empire in this case, you focus on and use exclusively information pertaining to that company; is that true?

A. Yes he.

Q. And what is that information?

A. The dividend and stock price, which is going to be influenced by opportunity costs, opportunities for other investments, and the growth of the company.

Q. It's the Empire dividend and the Empire stock price; is that correct?

A. Empire stock price as traded in the capital markets, yes.

Q. And any other information that pertains directly to Empire that is used in that formula, what would that be?

A. Expected growth, expected long-term sustainable growth of the company.

Q. Would it be fair to say that the company-specific DCF approach is the primary tool that you used in this case for determining the cost of capital or the rate of return for Empire?

A. Yes, it's the primary tool.

Q. Let me ask you this question: Hypothetically if you were going to look at a group of comparable electric utilities for purposes of making a cost of equity recommendation to this Commission for an electric company such as Empire, would you include any other Missouri jurisdictional electric company such as AmerenUE or Aquila or Kansas City Power & Light Company?

A. No, I would not include Aquila, I would not include KCPL because they're part of Great Plains Energy, which is more or less diversified now, but half of its -- half of its revenues from strategic energy. The -- with AmerenUE they become more and more diversified. I'd have to look at them at the time of a rate case or a complaint case. It just depends, because obviously it's a very dynamic world right now in the utility industry.

Q. You recall the old St. Joseph Light & Power Company, do you not?

A. That was before my time. I think they were acquired right before I started here, but I do recall that.

Q. Do you have any knowledge or information about them? Would you have considered them to be a pure play electric utility similar to Empire?

A. To my understanding, yes, they were.

Q. And if you were going to do an analysis, if you were going to look at a group of comparable electric companies for purposes of making a rate of return recommendation to this Commission, would you include a company like the St. Joe Light & Power Company which had all of its electric operations here in Missouri?

A. No. Traditionally my criteria have excluded companies with Missouri operations.

Q. And why is that?

A. Just to get an idea from what the cost of capital is in other jurisdictions. It kind of gives a test of, you know, reasonableness as to, you know, what's going on elsewhere.

Q. From a theoretical standpoint, would there be any concern in your mind about using Missouri jurisdictional utilities in such a study from the standpoint of circularity?

A. I believe that that is a concern that actually Dr. Vander Weide brought up in his cross-examination, and that's why he did not do an Empire company-specific DCF analysis. A lot of that depends on, I guess, what's going on with -- you know, with any given environment. But I do think that -- and I'll be quite honest with you, I do think that there are, you know, there are shortcomings of excluding companies that -- that are regulated by the State of Missouri because of the fact we are -- as we're all well aware here, there's a lot of discussion of the Missouri regulatory climate.

And if we wanted to look at a company such as St. Joe Light & Power that's exposed to the regulatory climate in Missouri, we would see how that may be affecting their costs of equity, say, for instance -- say, for instance, they didn't have a fuel mix issue like Empire did. We might be able to get a better idea as to what is really affecting their cost of equity. Is it their -- is it some of their -- the fuel mix issues that they have, or is it more Missouri regulation?

So it would obviously be something that could be interesting and very informative to look at. For that reason I wouldn't be opposed to taking a look at it to get an idea what the differences are in the companies that are operating in Missouri under the same regulation.

Q. Do you know whether or not any of your predecessors working for the Staff in your department have taken the position that in doing a cost of equity analysis and recommendation, that Missouri jurisdictional should be excluded because of reasons of circularity?

A. Like I said, I believe that may be something that's been mentioned before. But it can be very informational, and obviously we're doing a company-specific analysis on Empire here, and that -- like I said, that's the beauty of doing a company-specific analysis on Empire; it's very company-specific.

Instead of starting with a comparable group and trying to make risk adjustments to get to Empire's cost of capital, we're going right to Empire. Let's take a look at their costs of capital, which is their opportunity costs. So I think that that's a very good method to go about determining Empire's cost of capital.

Q. Would you agree that that approach you just described for determining the cost of capital for Empire takes circularity to its ultimate extreme by focusing exclusively on the facts and circumstances of only one company that is essentially regulated by only one Commission?

A. I think it depends on how you do your analysis, if it takes it to the extreme. If you allow for influences to be made in your growth rate based on a rate increase that's going to happen in Missouri without looking at the fundamentals of the company, then yes, it is taken to an extreme. But if you do a careful DCF analysis, as you indicated before, of Empire based on its -- the fundamentals of the company, I think it's a very reliable estimate.

Q. You have no concern, then, with respect to the issues that others have raised about the circularity aspects of a company-specific DCF analysis for a company regulated almost exclusively by one Commission?

A. Oh, there's concerns. I'm cognizant of those issues when I recommend the growth rate. I think that's why you have to look a little deeper into what the fundamentals are of the company.

Q. When you perform your company-specific DCF analysis and come up with a number which you believe to be the cost of capital, would you agree that in making that calculation and making your recommendation, you're not looking at returns being awarded to other companies with similar risks?

A. Not specifically. The cost of capital is when you're looking at their stock price, that's traded in the capital market, so obviously investors are pricing Empire's stock based on their view of what's going on in other states, and like I said, more importantly in the entire world of the capital markets.

Q. How many other companies did you look at with similar risks in developing your estimated cost of capital rate of return for Empire under your company-specific DCF analysis?

A. In my direct testimony I looked at four. Since all these witnesses filed testimony, I've been able to look at many more.

Q. You looked at four in performing your --

A. My direct testimony, yes.

Q. -- your company-specific DCF analysis?
A. Oh, I'm sorry. In my company-specific. I thought you were talking about my analysis in general. No. In the company-specific analysis, I just looked at Empire obviously, hence company-specific.
Q. Do you have Schedule 28 to your direct testimony?
A. Yes, I do.
Q. And am I correct that that shows that you're recommending a long -- a cost of long-term debt for Empire of 7.22 percent?
A. That's correct.
Q. And in that same schedule, do you recommend a cost for Empire's trust-preferred securities of 8.93 percent?
A. 8.92, yes, not 8.93.
Q. Thank you. Would you agree that because of its prior claim to returns, that debt is less risky for investors than common stock equity?
A. That's correct.
Q. And would you agree that because of prior -- a prior claim to return, that the trust-preferred securities are less risky than common stock equity?
A. Yes.
Q. And you're recommending a range in the cost

of equity for Empire between 8.29 percent and 9.29 percent; is that true?

A. Yes.

Q. And the midpoint would be 8.79 percent --

A. That's correct.

Q. -- is that correct?

And that midpoint is lower than Empire's cost of trust preferred securities?

A. Please define cost of preferred stock.

Q. Well, how would you define it?

A. I would define it as the current yield on trust preferred stock. This is an embedded cost number. What's more important is the current yield on trust preferred stock.

Q. And what is that?

A. It has been trading about 7.9 to 8.1 percent in the last, you know, couple months since I've been following it.

Q. Let me ask you, you've got testimony, do you not, on the situation with respect to Empire's dividends?

A. Yes, I do.

Q. Would you agree that the management of the company, the board of directors of Empire has the discretion to determine the company's dividend policy?

A. That's in our discretion, yes.

Q. And that's not something that the Commission Staff or the Office of Public Counsel or even the Commission itself should dictate?

A. I don't know that we've ever challenged that. No, we haven't. So, yes, we don't have -- it's a management decision.

Q. Would you agree with me that as a general proposition, most companies that reduce dividends do so because of financial distress?

A. No.

Q. Your answer is no?

A. Yes.

Q. Is it your testimony or your position, is it the Staff's position that Empire is currently in financial distress?

A. No.

Q. Would you agree that Empire has maintained its current dividend level since about 1992?

A. It is exactly 1992, yes.

Q. Would you agree that Empire earns a return below that of the industry?

A. I haven't studied that.

Q. You don't know?

A. I don't know.

Q. Would you agree that if over the last 10 years Empire's earnings would have been higher, its dividend payout ratio would have been lower?

A. Of course.

Q. And on a going-forward basis, would you agree that an increase in Empire's earnings will lower its dividend payout ratio if the dividend remains constant?

A. Of course.

MR. SWEARENGEN: That's all I have. Thank you.

JUDGE THOMPSON: Very well. I believe we're ready for questions from the Bench. And I'm actually going to ask some myself before we allow you to sit down, because here, after all, is my chance.

QUESTIONS BY JUDGE THOMPSON:

Q. Now, I know you're familiar with the United States Supreme Court decision in the Bluefield case because I see it quoted in your testimony.

A. Yes.

Q. And you would agree, I assume, that that decision states that Empire is entitled to a rate of return that is commensurate with the amount of risk as measured against other businesses in the same general area; is that correct?

A. Yes.

Q. I know I'm slaughtering the Court's language. But that's the general concept?
A. Yes.
Q. So what level of risk do you assign to Empire?
A. I assign the level of risk that investors assign.
Q. And how do you reach that figure?
A. Through the discounted cash flow analysis. Basically that's -- like I said, that's the beauty of that model is just by taking your dividend into the stock price, you determine what the required dividend yield is, which Empire's pretty high. It has a high dividend yield right now versus the rest of the utility industry.
And then you just -- you assign a growth that investors expect to that dividend yield, and that allows you to determine what investors are requiring for return for the risk that is inherent with Empire.
Q. Why don't you walk me through the stages of that analysis so that I understand how it works.
A. Okay. With -- with the DCF analysis, obviously the -- I'll use the annual form. There's been some discussion as to whether annual or quarterly should be used, but I think all -- three of four witnesses used the annual form of the DCF analysis.

And under the DCF -- annual form of the DCF, the classical DCF model, what you're trying to do is you're estimating when you invest in a stock, you're determining what is your expected dividend for the next year when you own the stock, and --

Q. Is Empire's stock publicly traded?

A. Yes, it is.

Q. Okay. And does the current market prices have -- play any role in that analysis?

A. Quite a bit.

Q. Okay. Please proceed.

A. Okay. So and then -- obviously because Empire, we're all aware that they're at least not going to be able to increase their dividend, so you know that they're going to be paying $1.28 on -- you know, per share next year, and this is -- this is why it's kind of equivalent to a coupon on debt in my mind is because this $1.28 is -- has all but been almost tried to be giving the impression to the utility investors that they're not going to cut this. It's actually a coupon on that -- on that utility stock. So you --

Q. So you're saying it's more like a bond, in your mind?

A. Yes, it is.

Q. And that's because it has essentially or traditionally or historically a guaranteed return of a certain level?

A. I wouldn't say guaranteed. It's a fixed dividend and it hasn't changed since 1992, and management is very committed to keep that $1.28.

Q. But at that point we're just talking about expectations of investors; is that right?

A. Yes.

Q. Is there an objective level of risk that has -- business risk that has nothing to do with what investors expect?

A. Oh, I think all the risk factors are targeted towards the investment community. I think if you want to look at, say, S&P, they have a credit rating of BBB currently on Empire. That gives investors an idea as to what the -- what the creditworthiness is of this company. For Empire, S&P currently assigns a business profile of 6. That gives you an idea of what business risk is of Empire.

And I think Empire's business profile of 6 is similar to KCPL's. They have a 6 business profile. I'm not sure what AmerenUE or those other companies are, but there are outside indicators. But -- such as I think one of the witnesses in this case has looked at some of the ValueLine indicators.

One of the concerns I have is you when look at that, when you look at those risk indicators that are provided by outside sources, the cost of capital is not confirming that that's -- you know, that those are, in fact, riskier industries, such as when the natural gas cost equity comes up higher than the electric utility cost of equity.

It would imply that maybe investors are pricing those electric utility stocks higher than the natural gas utility stocks; hence, thereby the cost of equity is cheaper, regardless of the fact that there are those outside risk indicators.

Q. Okay.

A. And I think that's why it's important to look at a company's specific DCF analysis.

Q. Now, you mentioned a comparison to Kansas City Power & Light.

A. Yes.

Q. You indicated, I think, a rate of 6?

A. A business profile of 6, that's correct.

Q. Is similar between the two companies?

A. Yes, it is.

Q. Now, if you know, does Kansas City Power & Light depend on natural gas to the same extent as Empire does?

A. To my knowledge, not to the same extent.

Q. Okay. Wouldn't Empire's high level of dependence on natural gas in the face of a very volatile natural gas market inject a considerable additional element of risk into the business operations of Empire?

A. That would be one factor you would think about. That's why some of these outside businesses or these indicators of risk have to be taken with a little bit of caution. KCPL does have nuclear exposure. I know it's been talked down a little bit in recent history. But if the nuclear generation went down, then they may be exposed to the purchased power markets. So there are multi -- KCPL's management is aggressive in managing their capital cost. They have an embedded cost of debt down in the

5 percent range, so --

Q. In what way did you modify or adjust your analysis to reflect the additional amount of risk caused by Empire's high degree of reliance on natural gas as a fuel and the volatility of the natural gas market?

A. I looked at the DCF analysis, and it gives you the risk level that investors are putting -- or are assigning to Empire stock.

Q. Let me ask you this: Are you familiar with the testimony given by the two Empire witnesses, the two experts? You indicated you were, I believe.

A. Yes, I am.

Q. And also with that provided by Mr. Allen for Public Counsel?

A. Yes.

Q. And the methods you have used are similar to those employed by those other three witnesses; is that correct?

A. I'd say more similar to OPC witness Allen and Company witness Murry, less similar to -- I mean the models are the same, but Vander Weide, he looked at a comparable group and didn't even look at Empire.

Q. Okay. Well, how is it that the cost of capital or the figures you ultimately arrived at are the lowest of those provided by any of these witnesses?

A. A lot of it has to do with the dividend yield that I chose. I know that I used six months of stock prices, versus OPC witness Allen used six weeks of stock prices. And when I used the six months at the beginning of the year, the first three months of the year stock price was trading around the $22 range.

The next three months, April, May, June, stock price went down to, you know, 20-some-odd dollars a share. It since has rebounded in the last month or so. So I mean, I captured an up and down cycle in my average -- in my average stock prices. So when you take the di-- obviously it's a simple mathematical calculation. When you take that dividend of $1.28 and divide that into my higher stock price, you're going to have a lower dividend yield than what OPC witness Travis Allen had.

And then the reason why -- but let me just point out, Travis Allen, OPC witness Allen had a growth rate of 3 percent, which is in the growth rate range that I had of 2.25 to 2.35.

Q. And by growth rate, just what is it that's going to be grown?

A. Well, it's not dividends; it's earnings. Well, that's the theory, is that you're trying to come up with a proxy as to what -- as to getting how that stock price is going to appreciate, and tradit-- you know, traditionally it was the cash flows, the dividends that determines how much that stock price is going to appreciate over time.

Q. But in this case, the evidence is that the stock price, the dividend has no rational relationship to the company's performance; isn't that true? In other words, there is a figure that for whatever reason management has fixed upon and has maintained historically over a long period of time and that does not change, given changes in the company's performance; isn't that right?

A. Well, the dividend doesn't change, yes, you're right, the dividend level itself.

Q. So I don't understand how -- I mean, your analysis is driven by the dividend level, it sounds like.

A. Well, the dividend yield. One of the things that a lot of -- a lot of rate of return witnesses have -- have transitioned to is to look at earnings growth rate as a proxy for the dividend growth rate. And the theory, the thought process behind that is you're not going to be able to grow your dividend any faster than your earnings, and that's -- that ultimately --

Q. But in this case that relationship does not exist, does it? Because, in fact, I thought the evidence was that at one time they even borrowed money in order to be able to pay that dividend; isn't that correct?

A. That's correct.

Q. So there is not a relationship between the growth of earnings and dividends. The dividend's fixed for reasons other than not having a relationship to the growth of earnings; isn't that correct?

A. That's correct.

Q. So doesn't that require some kind of serious adjustment and modification to your mold?

A. And that's exactly what I did when I used 2.25 to 3.25 earnings growth. I think Dr. Murry has other companies in his comparable group that have kept their dividends flat for reasons other than their earnings can't sustain it, but he didn't use that dividend growth rate in his ultimate recommendation. He looked at the earnings proxy. And that's what I said.

Dr. Vander Weide looks at earnings growth for his prox-- IBES does not give dividend growth forecast; it gives earnings growth forecast. I believe almost every witness in this case is looking primarily to earnings growth forecast rather than dividend growth forecast.

So yes, that was the original -- I'll be quite honest with you, the DCF model has many -- I know that's a bad thing to say, because I think it's 9 out of 10 times -- 9 out of 10 times if somebody says that, they're probably going to lie to you, but I heard that on the radio.

Q. Mr. Murray, I -- believe me, I have absolutely no belief or suspicion that you're lying to me. I do not think that at all. But I'd like to know -- I mean, it seems to me that what we've heard about the way this company conducts its business respect to dividends is perhaps somewhat unusual. And I'd like to know whether your model takes that unusual dividend regime properly into account or whether the model is, in fact, unable to take that into account, and thus is producing a skewed result.

A. No. I said I do not believe that, and that's why I indicated it has to be a very careful analysis when you use the DCF model on Empire, because, yeah, the fact that dividends aren't growing, you're not going to use that as a proxy for your growth rate, and three of the witnesses, three of the four witnesses that did Empire company-specific DCF analyses looked to earnings as a proxy.

And like I said, my point is that most of the time that's done even if dividends are growing at the same rate as earnings. Because of the fact that there are so many things that go on in the real world, most of the time none of these assumptions -- I mean, quite a few of them do -- I mean, constant payout ratio, that very rarely ever exists because you can't have a constant payout ratio. Things happen.

Q. But they do. But they do have a constant payout level. It may not be a ratio, but an amount.

A. Well, they have a constant dividend level but not payout ratio. The payout ratio is the assumption under the DCF, so the payout ratio fluctuates from year to year, the required rate of return fluctuates from year to year, the earned return fluctuates from year to year. And that applies to, you know, just about any company you can find out there.

Q. Is the DCF model the only model that's available in the world of financial analysis in order to conduct this kind of analysis?

A. No.

Q. Are there other ways of doing it?

A. Yes, and they've been introduced in this case.

Q. And is there any reason to prefer one analytical technique over another?

A. In my mind, yes.

Q. And what is that reason?

A. The DCF model, as I indicated with Empire specifically, it is very, very specific to the company information. With the capital asset pricing model, you're looking at historical returns from 19 -- usually 1926 up to the current period, and that captures all sorts of economic cycles, but it doesn't necessarily capture the current capital economic environment.

Q. Let me ask you this: Are you familiar with the results of Empire's last rate case?

A. The results of the rate of return analysis? I'm sorry.

Q. Right. There was a rate case prior to this one, I assume?

A. Yes.

Q. Okay.

A. Two years ago.

Q. And that resulted either through agreement or by order of the Commission in a return on equity number, correct?

A. We don't specify. We don't determine what the ROE is in the settlement.

Q. Was that case determined by settlement?

A. Yes, it was.

Q. And there was no specific ROE number?

A. No.

Q. Was there a revenue level agreed to?

A. I believe it was 11 million, a rate increase.

Q. And surely that would have equated to some ROE number; isn't that correct?

A. I don't recall any ROE number being taken out of that settlement.

Q. Well, I realize that perhaps in the settlement you didn't agree to a specific ROE number, but you just agreed to an amount of dollars. Nonetheless, if you work through the equation, you could derive an ROE number, could you not?

A. I don't know. I don't do the reconciliation.

Q. Okay. Do you know who could answer that question for me?

A. I don't recall. I think -- I believe Carey Featherstone was the -- did the revenue requirement reconciliation in the last case. If there was anything implied in there, then that's -- and he's not on this case, but I don't know for sure. I can try to find out and see if there is somebody that --

Q. Would you say today that Empire is a financially sound company?

A. Yes.

Q. Okay. It's not in a precarious financial condition?

A. Once the -- I mean, obviously you have the issue of the fuel volatility, and I think that's going to be attempted to be addressed in this case. That's not good. I mean, obviously we're all recognizing that their earnings are down below, you know, their traditional normal levels, but it's the expectation.

Q. That's exactly what the Commission's wrestling with here, isn't it?

A. Exactly.

JUDGE THOMPSON: Thank you. I don't think

I have any further questions. And we're going to allow you to step down so that when the Commissioners come back from agenda, they can take up what questions they have, and then we'll do recross and redirect at that time.

And I believe we're ready for Mr. Allen; is that correct?

MR. COFFMAN: If that's your pleasure.

JUDGE THOMPSON: That is my pleasure. And I understand, Mr. Swearengen, you're going to interpose the same objection as you did with respect to this witness; is that correct?

MR. SWEARENGEN: Yes.

JUDGE THOMPSON: Very well.

MR. SWEARENGEN: And if I forget, remind me.

JUDGE THOMPSON: I certainly will.

(Witness sworn.)

JUDGE THOMPSON: Do you understand that if you were to give false testimony in this proceeding, you could be prosecuted for the crime of perjury?

THE WITNESS: I do.

JUDGE THOMPSON: Please take a seat and spell your last name.

THE WITNESS: A-l-l-e-n.

JUDGE THOMPSON: Thank you, sir. You may

inquire.

TRAVIS ALLEN testified as follows:

DIRECT EXAMINATION BY MR. COFFMAN:

Q. Please state your name again for the record.

A. Travis Allen.

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

A. I'm employed by the Office of the Public Counsel, State of Missouri, as a financial analyst.

Q. Are you the same Travis Allen that has caused to be filed in this case prepared direct, rebuttal and surrebuttal testimony which has been marked as Exhibit 81, 82 and 83 accordingly?

A. Yes.

Q. Do you have any corrections to those prepared testimonies today?

A. Just a couple.

Q. Okay. Please refer to where you need to make a correction.

A. I had -- we had -- our office had filed a correction to rebuttal schedule -- corrected direct Schedule TA-13. We had EFIS'd that on, I believe, Friday.

MR. SWEARENGEN: Excuse me. What schedule?

THE WITNESS: Corrected direct

Schedule TA-13.

MR. SWEARENGEN: Thank you.

MR. COFFMAN: Your Honor, that has been filed -- EFIS'd since, I believe, Friday, and I have extra copies today for anyone that would like one today.

JUDGE THOMPSON: Okay. This is a correction to a schedule?

MR. COFFMAN: Yes.

JUDGE THOMPSON: A schedule that originally is attached to one of his pieces of prefiled testimony?

MR. COFFMAN: Yes.

JUDGE THOMPSON: Okay. So it's a substitute exhibit; is that right?

MR. COFFMAN: That is correct. The intent would be to supersede TA-13 from his prefiled testimony.

MR. SWEARENGEN: This says Allen rebuttal?

MR. COFFMAN: Yes.

MR. SWEARENGEN: I thought you said it was correcting a schedule to his direct testimony.

MR. COFFMAN: I believe it is in both.

THE WITNESS: Do you want me to clarify this up?

BY MR. COFFMAN:

Q. Please clarify, Mr. Allen.

A. This was a Schedule TA-13 from my direct testimony, and at that time that I filed it from my rebuttal, I had placed it in my rebuttal testimony because I had neglected to subtract out the costs of preferred stock so that the actual cost or the level of preferred stock was incorrect in my direct testimony.

So I attached that to my rebuttal testimony, and then subsequently I had -- I corrected the pretax interest coverage ratios. And that's what's on EFIS right now.

JUDGE THOMPSON: Is that what we have here?

THE WITNESS: Correct. Yes.

MR. COFFMAN: So, your Honor, there is -- so it is attached -- there is a TA-13 attached to both direct and rebuttal testimony. The intent is that this -- what we had called December 11, 2004 corrected TA-13 supercedes both the TA-13 in direct and rebuttal prefiled testimony.

JUDGE THOMPSON: Okay.

MR. COFFMAN: This is the last, best and hopefully the last version of this document.

JUDGE THOMPSON: Do you have copies for the Bench?

MR. COFFMAN: Yes.

JUDGE THOMPSON: Is this HC?

MR. COFFMAN: No, sir. Although it's not

labeled such on the top, on EFIS and in the letter sent to the other parties, we have called this the December 11, 2004 corrected TA-13.

JUDGE THOMPSON: I'll need one more copy. Thank you.

BY MR. COFFMAN:

Q. Are there any corrections that you're aware of, Mr. Allen, to your testimonies?

A. There's one other correction that I'm aware of to my surrebuttal testimony. Page 12, line 12.

Q. Yes.

A. It says, I am still waiting for this -- for the response to this Data Request, and I have received that now. So I just want to make that.

Q. So are you -- are you suggesting that that second sentence on line 12, page 12, needs to be struck?

A. Yes.

Q. Does that conclude any corrections that you're aware to your three prepared testimonies?

A. Yes.

Q. With those corrections, if I asked you the same questions contained in those here today, would your answers be the same or substantially similar?

A. Yes.

MR. COFFMAN: I would now tender Mr. Allen for cross-examination and offer into the record Exhibit 81, 82 and 83.

MR. SWEARENGEN: Your Honor, we would object to the receipt of those testimonies for the reasons stated in the motion which we filed with the Commission earlier today. Thank you.

MR. COFFMAN: And, your Honor, I would respond to that motion in the same manner that we responded to a similar motion in the Missouri Gas Energy case and note that I believe that the Commission's analysis in its order regarding MGE's motion to exclude certain testimony and opinions of Travis Allen, which was issued on July 20, 2004, in Case No. GR-2004-020, is a fair reflection of the law, and would ask that you deny this motion on similar grounds.

MR. KRUEGER: Staff concurs with the Public Counsel's position on this motion, your Honor.

JUDGE THOMPSON: Okay. Mr. Allen, what is your educational background?

THE WITNESS: I received a bachelor's degree in economics and finance from Southern Illinois University Edwardsville with a specialization in financial markets and institutions in December 2001. And then in May of 2003 I earned a master's degree in economics and finance with a specialization in finance from Southern

Illinois University Edwardsville.

JUDGE THOMPSON: And what methodology did you use to produce the opinion that you are here to testify about?

THE WITNESS: I used two cost of capital models; one being the discounted cash flow model and the other one being the capital asset pricing model.

JUDGE THOMPSON: And where and when did you learn how to conduct those analytical techniques?

THE WITNESS: I was trained with the use of those models in both my undergraduate and graduate studies.

JUDGE THOMPSON: And are you familiar with the testimony of Dr. Murry and Dr. Vander Weide that has been offered in this case?

THE WITNESS: Yes, I am.

JUDGE THOMPSON: Did either of those witnesses use either of the method that you've used?

THE WITNESS: Yes, they did.

JUDGE THOMPSON: Okay. Based on that, I find that the witness has at least some qualifications, which is what reported Missouri decisions require, and therefore, I'm going to allow him to testify as an expert in any -- to the extent he is less experienced or less knowledgable than other witnesses in this case, that will go to weight rather than to admissibility.

Now, Mr. Allen, with respect to the data that you relied on in reaching your opinion, is that data of the sort that is generally relied upon by experts in your field in producing such opinions?

THE WITNESS: Yes. I relied on -- I used ValueLine data in my analysis, Thompson Financial data, S&P data, and that is information that is reasonably relied upon by experts in the field.

JUDGE THOMPSON: And did either Dr. Murry or Dr. Vander Weide use the same or similar information?

THE WITNESS: Yes, they did.

JUDGE THOMPSON: Okay. And the reason I ask about that is because, of course, Dr. Murry and Dr. Vander Weide testified without objection as experts in this field, and therefore, what they did and what they relied upon provide us a useful benchmark in measuring what experts in that field do.

And based upon this testimony, I find that the information relied upon by this witness is reasonably reliable, and I will overrule that portion of the motion as well. Therefore, I'm overruling the motion on both prongs, and I will allow this witness to testify as an expert. And therefore, I will receive Exhibits 81, 82 and 83, unless there is some other objection that I have not yet heard.

(No response.)

JUDGE THOMPSON: Very well. This is received. Thank you, Mr. Coffman.

(EXHIBIT NOS. 81, 82 AND 83 WERE RECEIVED INTO EVIDENCE.)

JUDGE THOMPSON: And I believe first up for Mr. Allen will be Mr. Krueger.

MR. KRUEGER: No questions, your Honor.

JUDGE THOMPSON: Very well. Mr. Conrad?

MR. CONRAD: No questions. Thank you.

JUDGE THOMPSON: Thank you. Mr. Swearengen?

MR. SWEARENGEN: Yes, thank you.

THE WITNESS: Thought I was going to get a clean sweep.

JUDGE THOMPSON: You may get something for Christmas, sir, but that ain't it.

MR. SWEARENGEN: Could I have an exhibit marked, please?

JUDGE THOMPSON: Yes, you may.

This would be Exhibit 123 offered by Empire, and these are, I believe, data Requests to Mr. Allen and responses; is that correct?

MR. SWEARENGEN: That is correct, your

Honor.

(EXHIBIT NO. 123 WAS MARKED FOR IDENTIFICATION BY THE REPORTER.)

JUDGE THOMPSON: I don't know if we have the same problem with the boilerplate or not. It doesn't look like it.

THE WITNESS: I didn't -- I didn't reply via EFIS.

JUDGE THOMPSON: Well, that was sensible.

MR. CONRAD: Not to shortcut this, Judge, but I would stipulate admissability of 123.

JUDGE THOMPSON: Thank you. Anyone else want to join in that stipulation?

MR. KRUEGER: I will, your Honor.

JUDGE THOMPSON: I think I only need to hear from Mr. Coffman.

MR. COFFMAN: Let me just make sure this is complete here.

No objection.

JUDGE THOMPSON: Very well. Exhibit 123 is received and made a part of the record of this proceeding.

(EXHIBIT NO. 123 WAS RECEIVED INTO EVIDENCE.)

MR. SWEARENGEN: Thank you very much.

JUDGE THOMPSON: Thank you. Yes, please

proceed.

CROSS-EXAMINATION BY MR. SWEARENGEN:

Q. Good morning, Mr. Allen. How are you today?

A. Good morning, Mr. Swearengen. I'm doing good. And you?

Q. Fine. Thank you. At your rebuttal testimony, I believe at pages 42 and 43, you testify that if the Commission implements an interim energy charge for Empire in this case, that that will decrease Empire's overall level of risk, and therefore, decrease the company's overall cost of capital; is that your testimony?

A. I'm sorry. What was the page number?

Q. Well, I noted 42 or 43. Do you recall testifying in the manner I just described? Look at the top of page 43.

A. I'm just reading over what I testified to. Yeah, I stated all else equal, it would -- implementation of an interim energy charge would result in decrease in Empire's overall level of risk.

Q. Let me ask you this: Would you agree that Empire should be allowed to recover its reasonably and prudently incurred costs?

A. Yeah, I believe that's the purpose of regulation.

Q. And one of those costs would be its fuel costs? That would be an operating cost?
A. That's correct.
Q. And as an operating cost, if it were reasonably and prudently incurred in the provision of utility service to its customers, you would agree that that cost should be reflected in and recovered through rates?
A. Reasonable and prudent cost recovery, yes.
Q. Including fuel cost?
A. That's part of cost, yes.
Q. Can you think of any reason that the company should not be allowed to recover its reasonably and prudently incurred costs for fuel?
A. If it's reasonably and prudently incurred, then no. My understanding of regulation as the way it's done in Missouri is that a -- the Commission Staff sets a general price for the cost of fuel, and if the company is able to procure fuel at a cheaper price than what the established rate is, then they are able to benefit from that and keep that extra revenue, I suppose. And if the cost is above that, then they have to essentially absorb those extra costs. That's my understanding how it works.
Q. Would you agree that as a general principle, fuel is -- in the case of Empire, is necessary

for the provision of safe and adequate service for its customers, some level of fuel?

A. Yes, I would agree with that.

Q. And would you agree that that level of fuel, whatever it is, has a cost associated with it?

A. Yes, I would agree with that.

Q. And if that level of fuel and the associated cost is prudently incurred, would you agree there's no reason why the company should not recover that cost through rates?

A. Again, my understanding is that the Staff does an analysis of what the prudent fuel procurement cost is going to be.

MR. SWEARENGEN: Your Honor, I'm going to object. That's -- he's not being responsive to the question.

JUDGE THOMPSON: I think that is a yes or no question, sir. We'll go ahead and strike that answer and see if we can get a yes or a no.

THE WITNESS: Can I hear the question again?

JUDGE THOMPSON: Can you read it back to us, please?

(THE REQUESTED TESTIMONY WAS READ BY THE REPORTER.)

MR. COFFMAN: Objection. I think that may be ambiguous exactly what is being referred to by that level.

JUDGE THOMPSON: It's not ambiguous to me, so I'm going to overrule your objection. If the witness finds it ambiguous, then of course the witness will indicate that when he answers.

THE WITNESS: I'm sorry, but can I ask to hear it one more time?

(THE REQUESTED TESTIMONY WAS READ BY THE REPORTER.)

THE WITNESS: I would agree that if it's prudently incurred, then yes. And that would be factored into the Staff's analysis of what prudent fuel costs would be. That's my understanding of how it works.

BY MR. SWEARENGEN:

Q. And would that be something that the Commission should then in its decision give the company those costs in rates?

A. When you say give the company those costs in rates, you're talking about fuel costs still?

Q. The same costs that we've been talking about, the necessary and prudently incurred costs for fuel at a level this Commission determines is necessary for the provision of safe and adequate service.

A. Yes. I believe this Commission will hear testimony and determine what prudently -- the prudent cost of fuel is and should allow the company to recover those costs. But let me specify my answer, though, that it's not a guarantee.

Q. Let me ask you this question: Under those circumstances that you have just described, the Commission says, here's the level of fuel and here's the cost and we're going to let the company recover those. Is there any reason why the company should be penalized with a lower return on equity than would otherwise be awarded?

A. I guess I don't follow your question.

Q. Let me ask it this way: The Commission in this proceeding will determine a level of fuel and an associated cost, and you said when they do that, they should allow the company to recover those costs through rates; is that correct?

A. Yeah. I said that if it's a prudent cost, then they should allow the company the opportunity to recover those costs.

Q. Okay. And if they do that, is that a reason to award a lower return on equity than otherwise might be the case?

A. No. I think that they should be allowed to earn their cost of equity.

Q. Let me ask you this: Let's assume for purposes of my question that there is evidence in this case that Empire will experience annual fuel costs of $137.5 millon, and the Commission puts that amount in Empire's base rates. There's no interim energy charge.

A. Okay.

Q. Under those circumstances, you would not propose a reduction to the authorized return on equity; is that correct?

A. My recommendation would be that they should be allowed to earn their cost of capital -- their cost of equity and cost -- subsequent cost of capital that I recommended in my testimony.

Q. Let's assume that the Commission states in its order in this case that it is possible or likely that Empire will incur $137.5 million of fuel expense based on the evidence, same number, but the Commission only puts 127.5 million in base rates and puts the additional 10 million in an interim energy charge subject to refund.

Under that scenario with an interim energy charge in place, am I correct in understanding your testimony that you would argue for reducing the company's return on equity?

A. Let me see if I've got the scenario correct. You said $137.5 million is the fuel cost and they're putting 127.5 million into base rates with 10 million sub-- and then an extra 10 million IEC subject to refund; is that correct? Do I understand that correctly?

Q. That's right. So we get to the same place. We get to $137.5 million, but we get to it in two components. Part of it in permanent rates, part of it in an interim energy charge.

MR. CONRAD: Your Honor, is counsel making an assumption about the volatility of those fuel costs on a projected basis?

JUDGE THOMPSON: I don't know.

MR. SWEARENGEN: I'm just asking the witness to assume those facts for the purposes of my hypothetical.

BY MR. SWEARENGEN:

Q. Now, the question is, under that scenario, would you argue for reducing the company's return on equity because of the existence of an interim energy charge? You can answer that yes or no.

A. My analysis would not have factored in the effect of a risk-reducing IEC. So the fact that the company would be able to -- to essentially guarant-- well --

Q. Can you answer the question yes or no? And then if you want to explain it, perhaps your counsel will ask you to do that later.

A. Would I argue that the ROE should be decreased?

Q. Can you answer the question yes or no?

A. I'm asking for the question again.

MR. SWEARENGEN: Would you read the question back, please?

(THE REQUESTED TESTIMONY WAS READ BY THE REPORTER.)

THE WITNESS: I can't answer yes or no. I would have to look at the -- all the other factors. But like I said in my testimony, all else equal, the addition of this IEC would be a risk-reducing factor, and I think that's something the Commission should keep in mind. But I can't answer that yes or no.

BY MR. SWEARENGEN:

Q. Let's assume that in its order the Commission says it believes that the company will likely incur $137.5 million in annual fuel expense. However, the Commission decides to only put 125 million in base rates so that the company's potentially at risk for an additional 12.5 million. Do you understand that, those assumptions?

A. One more time.

Q. The Commission says it's likely the company will incur $137.5 million in fuel expense, but the Commission only puts 125 million in base rates so that the company is potentially at risk for the additional 12.5 million.

A. Okay.

JUDGE THOMPSON: The question is, would he reduce his recommendation then?

BY MR. SWEARENGEN:

Q. The question is, under your theory, should the company's return on equity and adjusted upward for the additional risk that the company is facing?

A. Like I said, I never made a recommendation like to the Commission. All I said was, all else equal in my testimony, if an IEC is implemented, then that would be a risk-reducing factor.

Q. Well, I know that's what you said in your testimony, but can you answer the question that I put to you this morning?

A. I can't answer it yes or no. I can answer it as, you know, all else equal, if the investment community thought that this company was at a higher risk of not recovering, then all else equal, that would be a risk-increasing factor.

Q. Well, what do you think? I mean, you're the one that's making the recommendation to the Commission in this case, not the investment community.

A. What I think is -- is not important when I'm trying to gauge investors' expectations.

JUDGE THOMPSON: Well, if you're testifying as an expert, sir, then I think what you think is important.

THE WITNESS: As an expert, what I am trying to do is funnel through information from investors to this Commission, is what I'm saying. And what I'm saying is, all else equal, then this would be a risk-increasing factor that the Commission would have to think about. That's my answer.

JUDGE THOMPSON: I think that was a yes.

MR. SWEARENGEN: I think it was, too. Thank you.

BY MR. SWEARENGEN:

Q. Let me ask you this question: Isn't your position in your filed testimony for a downward risk adjustment -- that's what I'm going to call it, a downward risk adjustment if the interim energy charge is implemented inconsistent with the position the Office of Public Counsel took back in Empire's 2001 rate case ER-2001-299?

A. I don't know.

Q. Are you familiar with that case?
A. No.
Q. You have no knowledge of that case at all?
A. No.
Q. If I represented to you that that was a case in which this Commission authorized an interim energy charge for the Empire District Electric Company, would you have any reason to dispute that?
A. You know what, you said 2001 case?
Q. Yes.
A. I want to correct my answer. I have heard about this case.
Q. Okay.
A. I thought -- is this the case where there was a settlement agreement? Is this the one you're talking about?
Q. It's not the case where there was a settlement agreement.
A. Okay. The one that I'm familiar with, I think, is 2002 where there was a settlement agreement. I'm not familiar with 2001.
Q. Let me ask the question this way, because I think you are thinking about the right case, but you're a little confused about it. Let me represent to you that in the 2001 rate case, there was a settlement agreement with

respect to the interim energy charge.
A. Okay.
Q. And you are familiar with that case, then, I take it, at least that aspect of it?
A. If that's the case in which there was a settlement agreement, then yeah.
Q. And that was a proceeding in which an interim energy charge was authorized perhaps for the first time for the Empire District Electric Company; is that correct?
A. I don't know that.
Q. You don't know that. Let me ask you this question: Are you aware of your predecessor's recommended return on equity in that case, a range of 10 to 10.25 percent?
A. No.
Q. Have you read the Commission's Report and Order in that proceeding where the Commission adopted the Public Counsel's low end of that range, 10 percent as an authorized return on equity for the Empire District Electric Company?
A. No.
Q. You're not aware of that?
A. No.
Q. So if I told you the Commission adopted a

10 percent ROE for Empire in that case, even though an interim energy charge was also being implemented, you wouldn't know whether that was right or not?

A. I wouldn't know.

Q. Let me ask you this question: To the extent that that case that we're talking about, the 2001 electric rate case, represented a situation where your office, the Office of the Public Counsel, agreed to an interim energy charge but left on the table for litigation other issues, including return on equity, would you agree that that was a proceeding in which an interim energy charge was developed and implemented even though it was not part of a global rate case settlement?

A. I don't -- can you rephrase your question or clarify that? I don't understand your question.

MR. SWEARENGEN: Could you please read it back?

(THE REQUESTED TESTIMONY WAS READ BY THE REPORTER.)

MR. COFFMAN: Your Honor, I'm going to object to the question. The witness said he didn't participate in that rate case, he hasn't read the Commission's Order in that rate case. Mr. Swearengen and I can discuss in briefs similarities and dissimilarities in that case and what exactly was settled and not settled, but I'm not sure this witness is qualified to answer questions about what was or was not settled in 2001 rate cases.

JUDGE THOMPSON: I'm going to overrule the objection. If you're able to answer the question, please do.

THE WITNESS: I don't know.

BY MR. SWEARENGEN:

Q. Let me ask this question: To the extent that the Office of Public Counsel in this proceeding, in this present rate case, has represented to the Commission that in the past his office has only been willing to agree to an interim energy charge as a part of a global settlement of all issues, and assuming the question that I posed to you earlier, the fact situation is correct, would you agree that the position of your office is inconsistent in this proceeding? If you know. If you don't know, that's fine.

A. I don't know.

Q. Would you agree that Empire must compete for capital in capital markets with other utility companies?

A. Other utility companies and other companies that bear the same risk return relationship, correct. Yes.

Q. And with respect to those other utility companies, and specifically other electric utility companies, would you agree that they are likely allowed to recover their necessary and prudently incurred fuel cost through their rates?
A. My understanding is that all but three states have an interim energy charge or not -- a fuel transfer or fuel flow-through charge in the rates. So I would agree that that is likely the case.
Q. That those companies are either recovering their fuel costs through base rates or through some sort of interim energy charge or fuel adjustment mechanism or some combination of the two; is that true?
A. That's likely the case, yes.
Q. And would you agree that in those instances, the return authorized by the commissions that have jurisdiction over those companies would have been set with those facts in mind?
A. I can't speak to the specifics of the case, but I would imagine that they were set based on risk return relationships.
Q. Based on what type of relationships?
A. Overall risk return relationships, yes.
Q. And specifically recognizing that the company's recovering its fuel costs either through base

rate or through a fuel adjustment clause?

A. Certainly that's something that's factored into the overall risk relationship, but it's not just -- they don't look just at one specific risk factor. They look at the overall risk of the company.

Q. For example, there's been some testimony in this proceeding, and, in fact, I think an Order has been entered by the Oklahoma Corporation Commission involving Empire where that Commission set a return on equity for Empire at 11.2 percent. Would you agree with me that in doing that, the Oklahoma Commissioner recognized the existence of a fuel adjustment clause --

MR. KRUEGER: Your Honor, I object to that question because I think it mischaracterizes what the Oklahoma Commission ordered in that case.

MR. COFFMAN: I was going to make the same objection.

MR. SWEARENGEN: Well, the Order will speak for itself, and it's in evidence.

MR. KRUEGER: The hypothetical is not based upon a factual. It's not factually accurate, though.

JUDGE THOMPSON: What do you say the Oklahoma Commission did?

MR. KRUEGER: The Oklahoma Order only states that there was testimony or a statement from Staff counsel regarding the ROE, but the Commission made no order regarding ROE.

MR. SWEARENGEN: Well, the Order will speak for itself, and we believe that it specifically authorizes ab 11.27 percent ROE.

BY MR. SWEARENGEN:

Q. But for purposes of my question, assuming that to be the case, would you also assume that the Commission took into account in doing that --

A. I'm sorry. Was there a ruling on the objection?

JUDGE THOMPSON: I think he's restating the question so that we don't have to rule on the objection.

THE WITNESS: Okay.

MR. SWEARENGEN: Assuming that to be the case --

MR. COFFMAN: Objection. I'm just -- I'm not sure that the question is clear about what is being assumed to be the case.

JUDGE THOMPSON: We are assuming that the Oklahoma Commission authorized a rate of return on equity of --

MR. SWEARENGEN: 11.27 percent.

JUDGE THOMPSON: Thank you, sir. 11.27 percent.

MR. COFFMAN: Regardless of whether that's the case or not?

JUDGE THOMPSON: Regardless of whether that's the case or not. Exactly. A hypothetical.

Are you able to respond, sir?

THE WITNESS: What's the question?

BY MR. SWEARENGEN:

Q. The question is, would you assume that they did that or would have done that with the full knowledge of the existence of a fuel adjustment clause in the state of Oklahoma?

A. Would I assume that in setting their ROE, that they factored in the fuel adjustment clause? I don't know the specifics of the case. If we're talking hypothetical cases, I would make that assumption. I can make that assumption.

Q. On I guess page 3 and 4, pages 3 and 4 of your rebuttal testimony, do you have that?

A. Yes.

Q. You discuss there why you think the Commission should not put much weight on the equity returns allowed for other utilities in other jurisdictions; is that correct?

A. That's correct.

Q. Aren't those the -- aren't those electric utilities in other jurisdictions the companies with which Empire must compete for capital in the capital markets?

A. In general, I'll agree with that. I don't know the specific risk return relationships of these companies, but I can make that assumption.

Q. And would you also agree with me that whatever these other Commissions are doing and for whatever reason they're doing it with respect to authorizing returns, that is the universe in which Empire must compete for capital?

A. Well, as I said in my testimony, I think there's a distinction there between what's actually authorized and what investors require. And what's authorized does not necessarily mean what investors are requiring. And what investors are requiring, that's where -- that's what Empire must compete with.

Q. So let me make sure I understand your testimony. You're saying that what all of these other commissions are doing across the country in terms of awarding returns are not based on what investors require?

A. I can't speak to the individual cases, but I can speak to Empire, and based on my analysis, I believe Empire cost of equity is 8.96 to 9.41.

Q. I understand that. But that's not my question. My question is, these other commissions across

the country are making rate of return decisions for whatever reason; is that true?
A. That they're making rate of return decisions for whatever reasons? I guess that's true.
Q. You wouldn't argue with that. Okay. And whatever those decisions are, and whatever those authorized returns are, that creates the real world, the factual circumstances in which Empire must compete for capital; is that true?
A. No, I wouldn't agree with that.
Q. And why not?
A. Like I said, it's not the authorized return. It's the required return that -- that is important to investors and what investors are going to have to compete with.
Q. And so once again, is it your testimony that what all the other commissions are doing all across the country is not determining the required return when they come up with an authorized return?
A. Like I said, I can't speak to the specifics of the case, but I can speak to the specifics of this case where I actually did an analysis on Empire --
Q. I understand that.
A. -- and determined the required return for Empire.

Q. Let's get at it this way, then. Let's assume that what all these other Commissions are doing is, in fact, determining the required return for these companies --

A. Okay.

Q. -- and that is the return that they authorize the companies to earn in their decisions.

A. Okay.

Q. Now, would you agree, given those circumstances, that that creates the world situation in which Empire must compete for capital?

A. If that's the required return, yes.

Q. Let me ask you about your CAPM analysis.

A. Okay.

Q. C-A-P-M. What is a CAPM analysis?

A. It's a capital asset pricing model developed by Sharp, Widner and I want to say Black, but I can't -- I'm not sure that last guy was involved. But it's a relationship between market risk premium, the risk to the current and the current risk-free rate of return.

Q. And you did a CAPM analysis in this case?

A. Yes, I did.

Q. Am I correct that for purpose of your CAPM analysis you relied on a 90-day Treasury bill rate as your risk-free rate?

A. I relied on an average three-month T bill rate.

Q. Can you refer to your testimony where that is?

A. Yes. I'm there right now.

Q. And can you tell the Commission --

A. Oh, I'm sorry. Schedule TA-12.

Q. Turn to page 21 of your direct testimony, if you would, please.

A. Okay.

Q. There on line -- beginning on line 5, could you read the first three lines of that answer into the record?

A. Due to my belief that the yield on three-month U.S. Treasury bills should be the primary surrogate for the risk-free rate, I have decided to use the average yield on the three-month T bill from 5/03/2004 to 8/27/2004. This produced a risk-free rate of 1.274 percent.

Q. Would you agree that investors in common stock would typically have an investment horizon of greater than 90 days?

A. Typically, yes.

Q. And is it your understanding that the Federal Reserve from time to time adjusts short-term interest rates when attempting to influence or control the economy?

A. That's correct.

Q. And would you agree that the Federal Reserve's recent policy has been to set short-term rates, interest rates at historic low levels?

A. Define recent.

Q. Well, you define it.

A. Well, over this period, I believe from -- I don't have the information right in front of me, but I believe within the last few years they've been relatively low, historically speaking.

Q. Would you agree that the yields from short-term Treasury bills reflect the impact of factors different from those influencing long-term securities such as common stock?

A. I'm sorry. One more time.

Q. Would you agree that the yields from short-term Treasury bills reflect the impact of factors different from those influencing long-term securities such as common stock?

A. I believe there is a -- a time horizon difference between investors in three-month T bills and long-term investors in stock. If that's what you're getting at, then I would agree with that.

Q. Would you agree that the yields from short-term Treasury bills reflect the impact of factors different from those influencing long-term securities such as common stock?

A. I believe I just answered that question to the best of my ability.

Q. And what was your answer, yes?

A. I said I believe that there's a difference between investment horizon individuals who are wanting to purchase short-term debt securities, as opposed to individuals who are wanting to purchase common stock. So based on that, then I would agree with that.

Q. That the yields reflect the impact of factors different?

A. Yes.

JUDGE THOMPSON: Let me break in for a moment. We've reached the noon hour.

MR. SWEARENGEN: I have about one more question, and I'll be able to finish, if that's okay.

JUDGE THOMPSON: By all means.

MR. SWEARENGEN: Thank you.

BY MR. SWEARENGEN:

Q. Let me ask you this, Mr. Allen: Last week, I think it was Mr. Coffman brought up the subject of a recent Kansas electric rate case involving Aquila in connection with his concerns about an interim energy charge. My question to you is, if I told you that in that same case, the witness for the Citizens Utility Ratepayer Board, which is your counterpart in Kansas, testified that in calculating the cost of capital using the CAPM approach, one should determine a risk-free rate from the yield on long-term U.S. government bonds, would you be surprised by that?

A. No, I wouldn't be surprised by that. There's a lot of disagreement with regard to the CAPM and a lot of subjectivity involved in the use of CAPM. So that's part of a lot of the weaknesses of the capital asset. That's why I generally use it as a check of my DCF analysis.

Q. Would you agree that the risk-free rate from the yield on long-term U.S. government bonds during the last year has ranged from 4.65 percent to 5.56 percent?

A. I can't agree with that without that in front of me. I can tell you what the yield is as of yesterday.

Q. What was the yield as of yesterday?

A. When you say long-term, what investment horizon are you referring to?

Q. You define it.

A. Okay. For the maturities as of yesterday's Wall Street Journal, for a bond with a maturity on February 15, 2031, the current yield is 4.822 percent.

Q. Are there any bonds that go out beyond that on that document?

A. No, there are not.

Q. What was that percent?

A. 4.822 percent. And that's on page C-12 of Monday, December 13, 2004's Wall Street Journal in the section Money and Finance.

Q. Would you agree that most analysts are forecasting that rates will increase in the near future?

A. I'm sorry. On the Wall Street Journal that was in the Money and Investing section.

Repeat your question, please.

Q. Would you agree that most analysts are forecasting that rates will increase in the near future?

A. Are you talking about interest rates?

Q. Yes.

A. I would agree with that.

MR. SWEARENGEN: That's all. Thank you.

JUDGE THOMPSON: Thank you, Mr. Swearengen.

Well, we're ready for questions from the Bench for Mr. Allen as well. We're also ready for the lunch break, so we will be back -- it's about 5 after 12.

Let's come back at 1:15.

And if the Commissioners are ready, then we'll see -- we'll probably take up Mr. Vander Weide first, because I'm sure he probably wants to leave Jefferson City and go back to Carolina.

We are in recess until 1:15.

(THE LUNCH BREAK WAS TAKEN.)

JUDGE THOMPSON: I'm assured that at least one Commissioner is headed down here as quickly as he can.

I want to take up the issue of the letters you raised at the end of the day yesterday.

MR. COFFMAN: Yes.

JUDGE THOMPSON: In the old days, letters of that kind went into something called a letter file that was maintained in the case file. They were not part of the record. We can't put them in the record because they're not sworn. I mean, we can't put them in over objection because they're not sworn. You understand?

And the company has raised an objection, so I don't even know if we can receive them into a letters file.

MR. COFFMAN: Is there such a thing as a letters file? It used to be called the case papers.

JUDGE THOMPSON: Well, there really isn't anymore.

MR. COFFMAN: I mean, my concern is that there are several folks who are in the -- understood the past procedure and had been told by various folks, some folks in my office and some folks maybe at the Commission, that if they sent letters to my office, that they would be -- that the Commissioners would be able to view them, or at least they would be in some way available to be taken into consideration, and that their comments wouldn't simply be filed away where no -- you know, that their comments were irrelevant to the process. And I feel some obligation --

JUDGE THOMPSON: I appreciate your point.

MR. COFFMAN: -- in bringing that forward.

JUDGE THOMPSON: We did conduct two local public hearings in the service area of the company.

MR. COFFMAN: Of course, they were not on the original dates that we thought would be most convenient to the public, and many individuals commented in their letters and phone calls that the time and location were not convenient to them, and that in lieu of that, they would hope that their letters or calls would be in some way received.

And if there is such a thing that could be continued as in the past that these letters and names of individuals who have called could be placed in something like case papers, correspondence files, I would be happy to submit them with a letter. I just would like to know who to send them to.

MR. SWEARENGEN: And, Judge, we certainly have no objection to that. The company has no objection to the Commission seeing these letters. We're not concerned about that. Our concern is an evidentiary one and the Commission relying on the substance of these.

JUDGE THOMPSON: Let me see if I can broker some kind of settlement of this issue here. What if we were to receive them into the record not as evidence of anything therein stated, but rather simply as letters received by the Public Counsel? In other words, they're evidence only that the Public Counsel received these letters.

MR. CONRAD: They've affected the Public Counsel's state of mind.

JUDGE THOMPSON: Yeah.

MR. COFFMAN: Well, I wouldn't go that far.

JUDGE THOMPSON: I understand where you're coming from. What would you think of that, Mr. Swearengen?

MR. SWEARENGEN: We would have no objection to that.

MR. COFFMAN: I think that would be a fair perhaps continuation of past practice, a recognition that they are not evidence, the Commission could not necessarily rely on them in their final order, but that they would be -- the public would know that they were at least being presented to the Commission in some fashion. I think that would be a fair deal.

JUDGE THOMPSON: Okay. Why don't you prepare -- you've got them?

MR. COFFMAN: Yes.

JUDGE THOMPSON: Can we file them in EFIS?

MR. COFFMAN: I suppose if they were scanned, yes.

JUDGE THOMPSON: You know the way to the data center. I understand they scan just real well down there.

MR. COFFMAN: Okay.

MR. SWEARENGEN: I would just make the observation, I did glance at these letters. I can't say that I read them all in detail, because I didn't. I'm not sure that they all really have a bearing on this case. one in particular reports something to do with meter reading and an obligation to report unusual events to the secretary of Home Security, Tom Ridge.

JUDGE THOMPSON: We won't rely on that one for anything. Why don't you just file them with EFIS.

That way they're in the case record. All right?

MR. COFFMAN: Do my best to accomplish that.

JUDGE THOMPSON: Thank you. Okay. Mr. Vander Weide -- excuse me -- Dr. Vander Weide, I'll remind you that are still under oath. We are ready for questions from the Bench.

Chairman Gaw?

CHAIRMAN GAW: Thank you, Judge.

JAMES H. VANDER WEIDE, being previously sworn, testified as follows:

QUESTIONS BY CHAIRMAN GAW:

Q. Good afternoon, sir.
A. Good afternoon, Chairman Gaw.
Q. I assume that Vander Weide is Dutch?
A. Yes, it is.
Q. Which part of the country is it from?
A. From the northern part of Holland.
Q. North Holland?
A. Friesland from the northern.
Q. From Friesland?
A. Right.
Q. I'm familiar with that territory.

There were some suggestions in the -- in your earlier testimony, if I recall correctly, that normally there is -- there is some tracking between earnings and dividends. Do you recall testifying something about that?

A. Yes, I do, that within the context of the DCF model, that earnings and dividends were assumed to grow at the same rate.

Q. And is that -- why is that assumption in the DCF model?

A. Because it's a simplification that allows someone to derive a simple formula for the cost of equity. If someone used the more realistic assumption that they could grow at different rates, then you could put in different dividends in every future period, you know, 50 years, 100 years out, however many. But you couldn't derive a simple way to solve for the cost of equity, so it's only by making this simplifying assumption, which is admittedly simplifying, that you can easily derive a formula for the cost of equity.

Q. And why would it be that you could make that assumption, simplified though it may be, at all?

A. One should always evaluate the assumption very carefully. Almost all cost of equity models are based on some assumptions, and assumptions are -- the world is a very complex place, and so by necessity they're simplifying in some sense. But one ought to judge then when the simplifying assumptions will in any way so distort reality that the conclusions won't make any sense.

Q. In general, is that a flaw in the DCF model, or is it just -- is it just at times an inappropriate assumption for particular companies?

A. The latter is correct, that at times it's an inappropriate assumption for particular companies. In particular, Empire is one of those companies at this point in time, because their dividend and their earnings are very unlikely to grow at the same rate, at least for the foreseeable future.

Q. The general assumption that's in the DCF model, though, is not -- you would not consider it a flaw on its own?

A. No.

Q. And why is that?

A. Because as an approximation for many companies, their dividends and earnings, although not in every year, on average over time could be expected to grow at the same rate.

Q. And would that be considered appropriate practice for most companies to have their dividends have some degree of tracking with their earnings?

A. Well, it depends a whole lot on what their rate of -- what rate of return they're earning on their investments. Companies' management have an obligation, a fiduciary duty to their stockholders. And if the company is earning its cost of capital, at least its cost of capital, then it would normally retain a reasonable percentage of its earnings in order to reinvest in the business. And the stockholders, that would be in the interest of the stockholders, so management would be fulfilling its fiduciary duties.

When the company is not earning its cost of capital, however, that is, it's earning less than its cost of capital, then the shareholders would prefer that the company not retain any divi-- any earnings and not make any further investments in the company, and they would prefer that all of the earnings be paid out as dividends. And so if the company is in a situation where they're earning less than their cost of capital, there won't be a constant dividend payout ratio. The company will have an incentive to pay out everything.

And it would also be, then, disastrous if they retained anything at all or if they cut their dividend, because cutting their dividend at a time when they're earning less than their cost of capital would be the absolute worst thing that could happen to the shareholder, because it would guarantee that they would continue to make investments that earn less than the cost of capital. The only way to fix that situation is to increase their return to equal the cost of capital, and then once again, the dividend payout would likely remain at a relatively constant level.

Q. And if we were not talking about a regulated business, but if we were talking about business that was not regulated, whose responsibility would it be to try to get the house in order if that were the circumstance?

A. Well, if it's not a regulated business, then it's in the company's -- it's in management's responsibility to invest properly in projects that earn the cost of capital. If they cannot find any projects that don't earn the cost of capital, then they should return all of their earnings as dividends to the shareholders, and the shareholders can then invest those dividends themselves somewhere else where they can earn the cost of capital.

Q. What happens if that continues over time?

A. Eventually the firm will become liquidated, and that will -- it would occur just because in that line of business, there are no longer any projects that can earn the cost of capital.

Q. Now, so far at least some of what I've been hearing has talked a whole lot, Doctor, about -- about the

Commission's role in regard to earnings. Let me ask you this: Is management, in a regulated business, absolved of responsibility because of being regulated in regard to doing what their counterparts in unregulated industries are supposed to do?

A. Management is -- certainly has a very important role to play in investing its capital and in choosing the right dividend policy. What is very different between a regulated and an unregulated business is that the community and the customers have an interest in obtaining electricity, and they do not have an interest in the company being liquidated. So in that situation where the community has an interest in having an adequate supply of electricity, the only way that the interest of the customers can be balanced with the interest of the investors is for the Commissioners to allow the company to earn a return that is commensurate with the cost of capital. That is, to give them an opportunity to earn their cost of capital.

Q. And my question still is whether or not management no longer has any responsibility in a regulated environment to try to maximize earnings for shareholders?

A. Yes, they -- given the opportunity that the Commissioners afford them by setting rates that are equ-- that are equal to -- that recognize the cost of capital and recognize the expenses that the company is likely to incur and give them an opportunity to earn them on a timely basis, it's now management's responsibility to take full advantage of that opportunity, to operate efficiently and to provide safe and reliable service to the customers.

CHAIRMAN GAW: All right. Thank you very much. That's all I have.

JUDGE THOMPSON: Thank you, Commissioner. Commissioner Clayton?

COMMISSIONER CLAYTON: No questions.

JUDGE THOMPSON: Commissioner Davis?

COMMISSIONER DAVIS: No questions.

JUDGE THOMPSON: Commissioner Appling?

COMMISSIONER APPLING: No questions.

JUDGE THOMPSON: Recross based on questions from the Bench, Mr. Conrad?

MR. CONRAD: No questions, your Honor.

JUDGE THOMPSON: Mr. Krueger?

MR. KRUEGER: No questions, your Honor.

JUDGE THOMPSON: Mr. Coffman?

MR. COFFMAN: No questions.

JUDGE THOMPSON: Redirect?

MR. SWEARENGEN: Just a couple.

REDIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Dr. Vander Weide, you were asked this morning, I believe by Mr. Coffman from the Office of Public Counsel, whether financial risk is defined as the variability in operating income that results from fixed interest payments on a company's debt. Do you recall that question?

A. Yes, I do.

Q. Does variability in operating income caused by fixed interest payments provide the complete description or characterization of financial risk?

A. No, it doesn't. Financial risk as it relates to stockholders has to do with the variability in the value of the company. Operating income is only one and an imperfect aspect of the well-being of the shareholders. Shareholders are concerned with the variability of the value of the company to them.

And so financial risk as it relates to the use of leverage has to do with how much does leverage or the use of debt financing increase the variabilities of the value of the company. And that's usually measured by the market value of the debt and equity in the company's capital structure.

Q. So if I asked you whether or not the financial risk of a company such as Empire could be measured solely by the company's interest coverage ratio, what would your answer be?

A. The answer would be no, that it would be measured by the -- by the market value of the debt and equity and the company's capital structure.

Q. I think it was Mr. Krueger who asked you this morning about some cost of capital testimony that you had filed in some other cases in Florida and perhaps Illinois in the early 2000s. Do you recall those questions?

A. Yes, I do.

Q. And I think he asked you how you viewed the purpose of your testimony in those proceedings?

A. Yes.

Q. And what was your answer to that?

A. Well, my -- my answer was that I viewed my purpose as being different in those proceedings than I view it in this proceeding. In those proceedings, I viewed my purpose as providing an estimate of the cost of equity for companies of comparable risk, because that is how I viewed the requirements of the Hope case.

And although I used boilerplate language from the Hope case in those testimonies for my purpose that looks very similar to what I have in this case, I am now interpreting that boilerplate language quite differently. That is, I'm interpreting that boilerplate language as truly giving the company who's regulated and their investors an opportunity to attract capital in the marketplace in competition with the companies with comparable risk.

Q. Now, I think you said that you did not apply the discounted cash flow model to the Empire District Electric Company in this case in connection with your primary recommendation. Is that an accurate statement of what you did?

A. That's correct.

Q. And why is that?

A. Because -- there are several reasons. One reason is that the Empire District Company is in what I would characterize as an unstable economic situation at this time. That is, its dividend and its earnings are not in a situation where they can grow at the same rate. The company is not earning its cost of capital, which is a situation that can't continue for very long at all, and the company's bonds are threatened to be downgraded to be below investment grade. So the company doesn't obey the assumptions of the DCF model.

One can undoubtedly obtain greater accuracy and estimates of the cost of equity by applying the DCF model to a group of companies with comparable risk, and there's a degree of circularity that's involved in applying the DCF model to the company whose rates are regulated.

Q. Would you say that applying -- that the result one would obtain by applying the DCF model to Empire in this case would or would not provide an accurate measure of Empire's cost of equity?

A. It would not provide an accurate measure. There's quite a distinction between the result of applying a DCF model and the cost of equity. Those are two totally different things. The DCF model, as I've discussed previously, is based on approximating assumptions, and it's also based on estimates of highly uncertain inputs, such as growth rates.

If the assumptions don't apply to the company and if the estimates of the inputs are highly uncertain, then the result of applying the DCF model has very little relevance to the cost of equity. The cost of equity is the -- is the return that's required by investors, and the DCF model may or may not provide a good estimate of the return that's required by investors. And in the case of Empire, I don't believe it does.

Q. One last question. Turning back to the subject of financial risk which Mr. Coffman raised this morning in a question to you, is it your understanding that the Empire District Electric Company will have a need in the near term to go to the capital markets to finance capacity additions?

A. Yes. It's my understanding that the Empire Electric Company is forecasting a need for capital additions in the near future and that this would require additional capital resources from the capital markets.

Q. Does that fact in and of itself impact financial risk for this company?

A. It undoubtedly does. When electric companies are in an investment mode, they're considered to be more risky than when they're not in an investment mode. And the reason is that investments in electric generating assets or transmission or distribution assets are lumpy. By that I mean that they're very large in relationship to the size of the company. And especially for a small company, they can be exceedingly large in relationship to the size of that company. And in addition, the results of investing in electric generation plants are highly uncertain.

At various times gas-fired plants can be viewed as the most economic, and they certainly were several years ago. At the time that the company was investing in gas-fired plants, it was pretty unanimous that those were the most efficient types of plant that one could invest in at that point in time. At other times, coal plants are viewed as the most efficient and most economic, but there's high uncertainty not only in coal prices but in the environmental regulations involving coal plant. And at still other times nuclear plants are viewed as the most economic or most reliable or alternative energy.

Situations change very dramatically. What's viewed as the right type of plant at one time is -- goes out of favor at a different point in time, and it's easy to second guess then after the fact and say, well, now that we know what we know now, rather than know what you knew at the time the investment was made, it looks like you could have done -- we should have done something different.

Well, investors view that as a very high risk to make those investments, and so they generally require a higher return on companies that are in an investment mode than those that are not.

Q. One last question on financial risk. Are you aware, based on your experience, of a way to deal with rate of return and financial risk for a utility company on I will say a plant-specific or a capacity-specific or a project-specific type of approach?

A. Yes. It's been a concern for a long time because of the financial risk that investor-owned electric utilities have not been investing in new plant to the extent that might be in the best interest of the public. And so some states such as Iowa -- and I've been involved in several cases in Iowa -- have passed legislation that reduce some of the regulatory uncertainties associated with investments in new plant capacities.

And what they have, in fact, done is -- is allowed a process where the company can reach an agreement with the Commission on the -- on how the plant investment would be treated from a regulatory perspective.

And in Iowa in particular, there was an agreement on the rate of return, among other things, that would be allowed on the plant investment and new generating plants in the two cases that I was involved in for Mid-American Energy. The agreement was, I believe, that it would be a 12.25 percent rate of return on this new coal-fired plant, and that agreement was reached before the company made the investment, and it was specific to that particular investment.

MR. SWEARENGEN: Thank you. That's all I have. Thank you.

JUDGE THOMPSON: Thank you. You may step down, Dr. Vander Weide. You're excused. Thank you very much for your testimony in this proceeding.

Mr. Gipson, I'll remind you, sir, that you're still under oath.

Questions from the Bench, Chairman Gaw?

CHAIRMAN GAW: Thank you, Judge.

BILL GIPSON testified as follows:

QUESTIONS BY CHAIRMAN GAW:

Q. Good afternoon, Mr. Gipson. How are you?

A. I'm not feeling very good, Mr. Chairman.

Q. What's wrong?

A. It's something I ate, I think. No, I have a cold.

Q. Well, I'm sorry.

A. Thank you.

Q. I hope you're feeling better soon.

COMMISSIONER CLAYTON: And I called him a lobbyist.

BY CHAIRMAN GAW:

Q. I wasn't going to bring up Commissioner Clayton's discussion with you earlier, because I thought maybe that had something to do with what you were -- how you were feeling. I thought I better inquire further.

A. I sincerely hope I've not offended Commissioner Clayton.

Q. I'm sure he will eventually get over it. I heard your exchange earlier, so I'm, of course, just kidding.

Let me ask you a few questions. Some of

this may be HC, and if it is, please tell me.

MR. SWEARENGEN: I may not know.

BY CHAIRMAN GAW:

Q. Somebody can suggest to me whenever we get to that point.

A. I'll know.

Q. You were discussing earlier the issue of fuel mix?

A. Yes.

Q. And I heard some numbers from you in regard to fuel mix, and I wanted to get some clarification because I'm not -- I want to make sure we're talking about apples to apples comparisons. What is your fuel mix on your capacity-owned generation?

A. From a capacity standpoint?

Q. Yes.

A. Those units that are fired by coal, gas and hydro?

Q. Yes.

A. Hydro is less than 1 percent. Coal would amount to probably something on the order of 40 percent, and gas-fired or oil-fired resources would make up the difference, roughly 60 percent.

Q. 60, a little more than 60. 63 maybe to 64 percent?

A. I'll take that number.
Q. How does that, if you know, compare to the fuel mix of other Missouri regulated utilities and their capacity owned --
A. I don't know.
Q. -- generation, if you know?
A. With respect to capacity, I don't know, Commissioner.
Q. Would it be safe to say in regard to the generation that you own, that you are -- that you have significant amounts of capacity then on the gas side, if it's 63 to 64 percent?
A. Yes.
Q. Makes it even more dependent upon the gas market, I would assume?
A. Yeah. I think the thing that sort of pushes you over the edge on that is the combined cycle facility that came on in 2001 --
Q. Yes.
A. -- is 300 megawatts of our entire fleet.
Our entire fleet is about 1,100 megawatts. So that's a pretty significant piece that pushes you over the edge on that.
Q. Okay. Now, of course when you're looking at capacity, that capacity is what you're able to produce

if they're all up and running full?
A. That's correct.
Q. And when you're actually doing business, you're not going to turn all those generators on indiscriminately; you're going to turn on, I assume, your low-cost generation first?
A. Absolutely.
Q. And that would be generally in -- in your case would be your coal generation?
A. Generally it's the Iatan, Asbury, Jeffrey purchased contract that are -- that are the base load resources, followed then by the resources fired by combined cycle, natural gas, and then follow that with the peaking units, depending on their heat rate.
Those peaking units that make up that other 300 megawatts or so of that gas-fired capacity are only used a few hours of the year on average.
Q. All right. So the numbers that you gave Commissioner Clayton earlier in regard to your percentage, tell me what those numbers were again and what --
A. Yeah. Commissioner Clayton was asking about the fuel as a portion of our fuel mix, what part of that was natural gas, and my answer was, I don't have that broken out in terms of fuel. I can discuss it in terms of the -- the energy that's delivered in terms of megawatt

hours that are delivered through our system on an annual basis.

And about 30 percent of our energy is derived from either natural gas resources that we own ourselves or power that is purchased on the open market without benefits of a long-term contract that we believe is influenced by the price of natural gas.

Q. Okay. How much of that 30 percent, if you know, would be attributable to gas generation units that you own?

A. I don't know.

Q. Okay. Do you have any idea how it relates in that 30 percent?

A. You know, I look at that month in and month out. I generally don't look at it on an --

Q. Annual basis?

A. -- annual basis, no.

You know, it's going to depend on availability of power units. It depends on availability of other units in the region. It depends on the price of gas on the spot market. It depends on the price of gas that we have hedged. So it has so many variables that it can change pretty dramatically one way or the other.

Q. The other 70 percent was -- or approximately 70 percent, what was that made up of?

A. Coal.
Q. And is that all generation that you own or generation that you own, plus long-term contracts?
A. It's generation that we own, plus a long-term contract with Western Resources.
Q. Okay. And what plant is that? Is there a particular plant that you use?
A. With Western Resources?
Q. Yes.
A. That's from the Jeffrey facility.
Q. Okay. Did you have another long-term contract for coal besides with Western Resources or the Jeffrey plant?
A. Years ago we had a long time contract with Associated Electric, but that has since expired.
Q. All right. Now, in regard to the plants that you currently -- you currently have, you have Riverton 7 and 8?
A. That's correct.
Q. Projected retirement year?
A. We're waiting to see the final rule on mercury regulation before we try to put a date on the wall with respect to -- to the Riverton facility.
Q. Do you have a date on the wall right now?
A. No, sir, we don't.

Q. Have you -- do you have in regard to your accounting on your depreciation schedule?
A. I can't answer that, sir.
Q. Okay. Would it be possible that you had a projected retirement date of 2008 on Units 7 and 8?
A. That's possible.
Q. Are you anticipating taking them out of service in 2008?
A. It would depend on the rule promulgated by the EPA with respect to mercury regulation.
Q. Is there a rule being promulgated?
A. There is.
Q. And what's the status of it?
A. Supposed to have a final rule I believe in March 2005.
Q. Okay. And currently is there a draft of that rule then?
A. I believe there is.
Q. Would that -- and what does that -- if that draft were the one that were adopted, what would that do in regard to the mercury issue?
A. Well, the EPA really gave us or gave -- didn't give us -- gave the industry and the public several ditch options with respect to how to deal with mercury.
Q. Uh-huh.

A. And it will depend entirely upon which one of those options or variety of options the EPA chooses in its final rule. If it chooses -- boy, I'm going to get over my head here in just a minute, because I'm going to start using EPA acronyms. But I believe if -- if the EPA comes down on the side of best achievable control technology, that there's a -- there's a distinct possibility that we might be able to run the Riverton units longer than if the rule were the maximum achievable control technology.

Q. Okay. So give me a range of possibilities, then.

A. I wish I could give you a range of possibilities.

Q. You don't have any idea?

A. I think it's something on that 2008, maybe for the next 10 years, 2008 to 18.

Q. So you don't think there's any way it will last beyond 2018, those 2 units?

A. Those units were put into service in 1954. It's going to be tough to run them up through 18 if we can.

Q. Were they retro'd at any point? Are there scrubbers on those units?

A. No, there's not.

Q. What coal are they burning?
A. Western coal, a blend of local coal about 85/15.
Q. All right. And you have how many megawatts of capacity, do you know?
A. There's about -- I think about 100 megawatts, Commissioner.
Q. Okay. Maybe around 38 and the other around 53? Does that sound close?
A. That's correct.
Q. All right. And then you -- okay. What's your plans on replacing that if it were -- if the regs were to say to you basically you've got to take them down in '08, what are you going to do?
A. Well, in any event, we have the expiration of that Jeffrey resource in 2010.
Q. Uh-huh. How many megawatts is that?
A. That's 162.
Q. 162 at Jeffrey. Okay.
A. In any event, regardless of the mercury regulation, we need to bring about some additional coal-fired resources into our capacity mix, and to that end, as we discussed last July, we've had discussions with a number of companies. I listed those companies or some of those companies earlier for Commissioner Clayton.

In addition to that, we've engaged an engineering firm to take a look at self-build options for our company. As a step in that, we announced yesterday that we had executed a contract with PPM Energy for the delivery of about 500,000 megawatt hours on an annual basis, which will be about 10 percent of our energy needs to be derived from wind resources. Not only is that a good alternative for us from an environmental perspective, but it's economical as well when you compare it to certainly the purchased power market for energy that's fired with natural gas.

Q. I want to get back to the wind issue in just a moment. So in regard to the replacement of those plants, you're talking about a construction of something, is that correct, or that's a base load coal-type facility?

A. Yeah. We talked to Commissioner Clayton, or I spoke with Commissioner Clayton this morning about an effort to potentially negotiate an extension to the term on the Jeffrey resource. In any event, we have some coal-fired resources that need to be constructed.

Q. All right. And if those -- if the plants went out in -- Riverton 7 and 8 in '08, 2008, of course, is there any way you could construct a new coal plant by 2008 if you started today?

A. No.

Q. In fact, how long does it take generally to construct a new coal plant?
A. I think most of the engineering firms that we've spoken to would tell you it's something on the order of 42 to 50 months, 40 to 50 months.
Q. And you also have Asbury Units 1 and 2; is that correct?
A. Yes.
Q. When are they projected to retire on your books, do you know?
A. Long after me.
Q. Long after you?
A. Yes.
Q. Well, would it be -- is it possible that their projected retirement dates on your accounting schedules are 2000-- would be 2014?
A. That's probably correct.
Q. That's not too long after you, is it?
A. It depends. Depends on the outcome of this case.
Q. I see. I won't go down that road very far. Let me ask you this.
A. Now, Commissioner --
Q. Seriously.
A. -- with all seriousness, we intend to --

Q. Is that a real date or, I mean, looking at what those plants likely --
A. I'm not the depreciation witness, but I will tell you that with respect to the Asbury facility, we intend to install the necessary environmental equipment to continue that plant in operation.
Q. All right. And if that were to be installed, I would assume the reality would be you wouldn't be retiring those plants in 14, in 2014?
A. That's correct.
Q. It would be some later time after that?
A. That's correct.
Q. All right. You also have the Iatan Unit 1 currently?
A. Yes.
Q. You have a part interest in that?
A. Yeah, we own about a 12 percent interest, 80 megawatts.
Q. And there is a projected date, if I'm not mistaken, tell me if this sounds right, of 2014 on your accounting schedule.
A. I couldn't dispute it.
Q. Is it likely in your opinion that that plant is actually going to be taken out of service by 2014?

A. Again, I'm not the depreciation expert or witness in this case, but I'll tell you, I don't intend for that plant to be retired in 2014.

Q. And, in fact, the discussion that may be going on with Iatan would actually have additional work done on Iatan?

A. Yeah, similar to the kind of work I spoke of with respect to Asbury.

Q. This is probably HC. If I get there, just say and we'll go into closed whenever it's most convenient for the judge. I'd like to know what Empire's plans are in regard to the current fuel mix that you have going forward, whether or not there is any intent by Empire to change it.

A. I don't believe that is HC. I believe --

Q. Just as long as you can keep going, keep going with it. I know you sort of touched on it, but I want to go --

A. Well, we spoke of that this morning with Commissioner Clayton as well. I think he asked me a very similar question, and our intent is to continue to have a mix of resources, both coal-fired, natural gas fired and renewable resources that we believe best balances the risk in that kind of portfolio. I think Commissioner Clayton went on to ask me specifically where I would like to target natural gas-fired resources from a -- what I gave him was from an energy delivered standpoint. And I reported to him something less than 20 percent in the long term.

Q. On delivered energy?

A. Yes, energy that is produced by that fuel source.

Q. Can you give me something in the way of a number on capacity?

A. You know, our capacity is going to -- even that kind of target, our capacity is still going to be 50 percent or greater in units or megawatts of capacity that's fired by natural gas or oil.

Q. Is that --

A. Simply because --

Q. Yeah, I want you to explain that.

A. -- of the load characteristics of our particular service area. We are a -- a very unusual, I think, utility in terms of the -- if you compare the load shape, not only does it peak rather rapidly in the summer, it does the same thing in the winter. So we have not only an unusual peak with respect to air conditioning, but because of the absence of natural gas as a home heating fuel in our particular area, we have a similar-looking peak that is a very rapidly ascending peak in the wintertime.

Q. So let me go back to --

A. So when you try to find units to fit that kind of load shape --

Q. Yes.

A. -- you don't want to spend a lot of capital costs on a unit that you're not going to run very many hours in a year and that lends itself to quick start natural gas-fired or oil-fired natural resources.

Q. Well, in regard to your resource planning, do you need to add any more gas units in order to meet your demand going forward in the next five to ten years?

A. Yes. And we are currently negotiating. This part may be HC. If I don't mention the name of the company, I think I can stay clean here.

Q. Go ahead.

A. We are currently negotiating with a company to buy a turbine. It will be natural gas fired, and that is to maintain our capacity requirement as members of the Southwest Power Pool. We intend at this juncture to install that for commercial operation in mid 2007.

Q. Okay.

A. It will be a peaking unit as well.

Q. What type of a peaking unit? What type of a unit is it? Can you give me more specific information?

A. A natural gas-fired combustion turbine.

Q. More specific, unless that goes HC. Large frame, small frame?

A. Large frame.

Q. Large frame?

A. Large frame.

Q. Now, you said your mix of actual megawatt energy delivered, 20 percent was what you wanted to move toward --

A. Yes.

Q. -- is that correct?

A. Yes.

Q. How soon would you see yourself, the company, getting to that goal?

A. I think it depends on a couple of things.

Q. Okay.

A. One is the timing upon which we can get other coal-fired resources built, and the other depends on the growth in the service area. With this addition of wind energy as a part of our mix, that's going to have an impact beginning in early 2006, and that's a 25-year contract.

Q. Where does that fit into the mixture, as I wanted to go down that road with you, but what -- I -- I'm not sure if you -- you may have answered my question.

When do you see yourself arriving at the 20 percent on gas?

A. I can't give you a date on that.

Q. Do you have any -- is there a goal?

A. There's a goal to get there.

Q. By a certain date?

A. I haven't -- I haven't set a date on that.

Q. All right. So that means it hasn't been set if you haven't set it, right?

A. That's correct.

Q. Now, in regard to the -- to the whole portfolio then, if 20 percent is -- you'd like to get to 20 percent gas, what's the rest of the 80 percent?

A. Hopefully something on the order of 10 percent from renewable resources, namely wind, and the remainder from coal.

Q. Okay. Now, wind, you're bringing wind capacity on, what is that intended --

A. Commissioner, wind energy. I'll get no capacity credits for the wind energy.

Q. That's right. I forgot about that. And why is that?

A. It's a non-firm resource.

Q. In fact, when you're looking at the ratings on wind in comparison to other more traditional generation, what percentage of credit do you actually get for wind? You get some, don't you?

A. For capacity, that's really not been determined by the power pool that we're members of. I believe some of the power pools or regional transmission organizations have been forward-looking enough to make that determination. It's my understanding that the SPP has not reached a decision in terms of the capacity factor that they're going to assign for wind resources.

Q. They are looking at it, though, are they not?

A. My understanding is they are.

Q. And it would be fair to say that it would be a fraction of what, say, a gas turbine or a coal-fired plant would be?

A. Certainly a gas or a coal-fired facility is going to be at name plate capacity, so anything less than name plate would be a fraction.

Q. How does the wind fit into your energy needs in looking at your picture here? I'm not -- I'm not trying to get into an argument one way or the other about -- I mean, we can all agree that this is a good goal for many reasons, but just with regard to taking care of your load requirements, how does it fit into that picture?

A. We think that it's going to fit pretty well, especially when you combine that with a -- you know, a -- if you look at this wind and peaking unit gas situation, one in each hand you've got the capacity that you've built as a gas fired, relatively economical capacity that you have in your portfolio. The energy that you derive from that resource is very expensive to generate. You combine that on the other hand with half a million megawatt hours from a renewable resource that is, with the extension of the production of tax credit by Congress, an economical resource when compared to virtually any resource, that that makes a good balance.

Now, in terms of the dispatch of the unit, we're going to have to learn how to operate in that kind of environment. This is a non-firm resource. There are points along that load duration curve that I spoke of earlier that is going to be difficult to fit that kind of resource into our mix. We've analyzed that in great detail and believe that there are -- well, there are going to be some days when it's going to be difficult to fit into the mix, that for 95 percent of the year it's going to be very attainable.

And what I'm speaking of there is in periods when we don't have a lot of demand on the system, that's when the wind blows the hardest in south central Kansas.

Q. Right. So is this a long-term contract on the wind? Is that how --
A. 25 years. 20 years. 20 years.
Q. 20 years. With?
A. PPM Energy.
Q. And do you have a contract for certain -- for certain take? Do you take it when it's available?
A. We take it every day the wind blows.
Q. Okay. And then you just adjust your other generation?
A. That's correct.
Q. To --
A. We'll also be seeking to take a -- execute a -- an off-take arrangement with Western Resources. It's in their control area for periods when we're not able to take it.
Q. I see. What's your -- if this is HC, tell me. What's your cost on that?
A. First of all, can I? If I gave you a gas equivalent, would that --
Q. Might help me. Tell me what it is, then maybe I'll know if that's translated enough for me.
A. In the furthest -- the way we've priced this is in blocks, and if I can compare that to a typical combined cycle generating unit, in the early years it

would be comparable to about $3.60 gas, and in the outer years comparable to about $4.85 gas.

Q. Okay. On a combined cycle?

A. Uh-huh. Yes, sir.

Q. It would really help me if you could translate that into megawatt.

A. I could HC.

Q. We may do that in a minute. If somebody else goes into it, maybe we'll come back so we don't disrupt this part of it right now.

Is the transmission built for that resource satisfactory to avoid congestion issues?

A. We will provide interconnection with Western Resources or PPM. There is a short leg of transmission to be built to the transmission line. We've received the estimates from the Southwest Power Pool with respect to the upgrades necessary.

Q. Okay. When you say short stretch, give me an idea.

A. Two miles.

Q. Two miles?

A. Or less.

Q. Is there congestion on the transmission to deliver it?

A. We have applied for firm transmission service, and the reports that we have back, while preliminary at this juncture, don't appear to be -- require extensive upgrades in order to deliver that on a firm basis.

Q. Where did you say these windmills were?

A. Near Beaumont, Kansas.

Q. Where is that?

A. Butler County.

Q. Near Butler County, Missouri or near Butler County, Kansas?

A. Kansas.

Q. Where is that, southeast, southwest?

A. It's east of Wichita.

Q. East of Wichita. Okay. I know approximately where you are then. Thank you.

A. They haven't been built.

Q. They have not been built?

A. They have not been built.

Q. When will they be up?

A. The press release, I believe, indicated that we should begin taking delivery in December 2005. We intend -- or they intend to construct the facilities in 2005.

Q. Okay.

A. They have to be built before the end of

2005 and online or they don't qualify for the production tax credit.

Q. Have they renewed the tax credit?

A. They did, through 12/31/05.

Q. Thank you. All right. Now, let me switch to another topic for a moment. I know everybody's enjoying comparing ROEs around the country. I'd like to have just maybe similar comparison with rates.

Do you know how Empire compares on industrial rates with the other regulated utilities in the state?

A. I'd say probably about average. It would depend on the -- on the kind of industrial consumer you were looking at, but our typical industrial consumer is going to be in the 1 to 5 megawatt range, and around a two and a half, three-shift operation. And in those particular applications we compare pretty favorably.

Q. Do you know how it compares to average rates in Kansas and Arkansas, Oklahoma?

A. I know in Arkansas our rates compare pretty favorably, at least with Intergen. I'm not familiar with any comparisons with the other companies. In Oklahoma our rates compare pretty favorably with OG&E, but I believe the AEP or PSO operation has a better rate structure than we do.

Q. How about with residential rates?
A. Our residential rates in Missouri are right about average, both in terms of in the state and when you compare nationally. Maybe on a national level, maybe just a little bit below average.
Q. About what are they, do you know?
A. I think our residential rate is something on the 6.9 or 7 cent range, on average.
Q. And commercial rates, how do you compare?
A. I'd have to really look at the data on that. Again, it's -- we kind of lump commercial all in one classification, and of course, there are varying degrees of commercial facilities, but I think on average it's in that five and a half, five and a half cent range, on average.
Q. Mr. Gipson, I have three graphs here, and I don't know whether or not they're representative. Could you look at them and tell me -- and they may need to be -- I don't know if you need anything marked for ID purposes, Judge, but one of them has -- they're all graphs of comparables.
And I'm not going to say they are until you've looked at them, because I don't -- I'd just like to know whether you think they're accurate or not. They do have supposed comparables between companies and also with

the states I mentioned.

A. The one that depicts the residential rates appears in line with -- with what I -- what I think I represented to you. The one that deals with industrial I think gets to the issue that I was -- that I was talking about, and that is if you take a look at -- it depends on what kind of industrial customer you want to take a look at. This -- this would yield a number that is higher than my recollection in this particular graph.

Q. Okay.

A. And the commercial rates look out of line to me.

Q. Would it be possible for you to provide that information --

A. Certainly.

Q. -- a little later --

A. We would be able to provide it.

Q. -- so I would know what rates are that are actually out there.

A. Certainly.

Q. I'm curious about that. And when you do that, then maybe you could come back up and explain that to me at that point in time.

A. Certainly we can.

JUDGE THOMPSON: Why don't we reserve some numbers for those?

CHAIRMAN GAW: Whatever they are, Judge, whatever you need.

THE WITNESS: Judge, I'll be able to do it in one exhibit.

JUDGE THOMPSON: Very well. I'm going to reserve No. 124 for that exhibit. Thank you.

BY CHAIRMAN GAW:

Q. And if you don't have access to those other entities that are on there, perhaps some of the other parties would have access to that. And whatever needs to be HC, I don't know if they do it or not.

A. No, those records are --

Q. I wouldn't think they would be.

A. Those are public.

Q. Now, let me turn to another issue, and that is your policy regarding dividend. Help me to understand the rationale for Empire to pay out the same -- basically the same amount of dividend year after year, at least appearing to not be tracking with the actual earnings of the company.

A. How far back do you want me to go?

Q. Well, I don't know. Tell me when it -- if you can tell me when it started, that might be of help. If there is a beginning date or if it's always been the policy of the company, you can tell me that.

A. First of all, let me clarify so Mr. Krueger doesn't ask me the question. We do not have a written dividend policy. The dividend that is paid by our company to its shareholders is a very important piece of the reason by which investors invest in this company. We had some discussion about that this morning with Mr. Krueger as to whether or not this is an income-related stock, and I characterized that it is an income-related stock.

I think generally individuals buy stock in Empire based on their understanding that there is income related to that, to owning that security versus holding a company like Microsoft, which over several years was a growth-related stock. You didn't buy the stock because of dividend that it paid. You bought the stock because you anticipated a growth in the share price.

Having said all that, our shareholders are long-term investors. You know, about 70 percent of our shareholders are mom and pop or the traditional widows and orphans, 30 percent of which are Missourians. They didn't buy the stock based on some appreciation in the value of the stock. They did it because they expect that the company will pay dividend yield. I don't think that's a lot different, though, than a number of other utility stocks, given a Kansas City Power & Light or an AmerenUE or a Western Resources, any vertically integrated or pure play utility company.

We have over the past several years been in a construction mode, beginning in the late 1990s when the deregulation of the wholesale energy market began, and the prices for energy available transitioned from a cost-based resource to a market-based resource. At the same time -- and so this economical purchased energy both from a capacity and energy standpoint sort of dried up because there were greener pastures ahead for those companies in terms of selling that energy on a market-based rate.

At the same time, we experienced some significant growth in our service area and began to build a number of resources, peaking resources and combined cycle resources. That took a lot of money. We don't generate the kind of cash flows through either -- well, any resource, but funds from operations through the depreciation and through net income to fund those resources all internally. So we've done a lot of financing over the past few years.

Given all of what I've said, it is difficult for me to imagine that I'll have any luck in selling common stock to shareholders who anticipate a dividend or an income from that investment without continuing to pay that dividend in these difficult times.

I don't believe the level of the dividend is the issue. I believe the issue is the capacity to recover our costs of delivering safe and reliable electric power service to our consumers.

Most notably is the cost of fuel and purchased power. Second to that would be what we've seen in terms of significant change in employee welfare expense, most notably pension expense, followed by health care expense. Those are the top three line items. If I exclude those from our expense horizon or our expense, total expenses, if I exclude those, going back to about the year 2000, we are virtually flat, just a little bit below the rate of inflation in terms of the other controllable expenses.

I don't -- if I take the -- if I take the common equity that's on the balance sheet at 6/30/2004, June 30, 2004, which is the true-up date in this case, and take that multiplied by an average or just sort of a run of the mill or middle of the road after-tax return of 10.75 percent, that would yield an earnings level of $1.59 per share, which compared then to our dividend would mean an 80 percent payout ratio, which is right in line with where I believe the capital markets expect to see a vertically integrated electric utility of our size.

So again, the issue is not the dividend.

The issue is the capacity to earn an authorized rate of return and recover the expenses associated with delivering the service.

Q. When did you say that the policy started?

A. The policy that's not written?

Q. Yes.

A. We've paid this same level of dividend in terms of dollars and cents since 1992.

Q. What happened before that?

A. It was on a track record, if not annual increases, fairly regular increases in the level dividend.

Q. How did that compare with earnings, if you know?

A. I don't know.

Q. Okay.

A. But I will tell you that it had to be pretty much on par with earnings or there wouldn't have been the capacity to raise the dividend.

Q. Okay. So you think earnings were increasing during that time frame?

A. Yes.

Q. It is accurate, would it not be, Mr. Gipson, that the shareholders have more transparency as to the success of the company when earnings track -- or excuse me -- when dividends track earnings? There is another -- there is another delivery of that message about how the company is doing whenever those dividends track earnings?

A. I don't understand your question. Are you asking me if I -- if we fixed a payout ratio of, let's say, 75 percent and in years where we earned $1.28, that we would only pay out 75 percent of that $1.28? Is that what you're asking me?

Q. Well, I am, although I'm sure that that would not be practice for most companies, but if there was a consistency over time for earnings to drop, that dividends would somehow drop off that would create -- or it increased, the dividends might increase, that that would create another level of transparency to the shareholders about how the company was doing?

A. I think our investors are not looking for an investment that fluctuates with respect to earnings. There are a number of things that can impact earnings that are beyond management's control. We've spoken of a couple of those things. You know, I was asked a similar question to that in my deposition -- and I don't remember who asked the question -- with respect to, you know, is this issue that you have with respect to earning the dividend, isn't that something that is a long-term issue?

And my response is, I don't believe it is a long-term issue, because it has popped up in only the recent years. I believe that we're taking great strides in this particular case to address the most notable of the issues that I think is impacting that, namely fuel and purchased power. I was asked what I considered to be the long-term, and my response was, we build assets to last 30 and 40 years in this business. I don't think something that has occurred in recent years and from what I can see should not be a long-term situation should impact -- I don't believe those issues should impact a long-term investor's -- you know, what their expectations are.

Q. It just doesn't appear to me that anything that the company does impacts the investor on their dividends from what I've gathered. There just doesn't seem to be any transfer of information on the dividend side to the investor about how well the company's doing based upon the late track record since '92 or whenever it was, and I -- and I guess I'm asking you whether or not there's some reason to believe that it's something different than that, just looking at the dividends?

A. I think it depends on the outcome of this case, and I think that there have been a number of analysts that have opined on such.

Q. That that might impact what you do on dividends next time?

A. (Witness nodded head.)

Q. Did you say yes?

A. I did say yes. If the Order from this Commission is -- is the Order that I believe it will be, I believe that in the long term we've made the right decision with respect to the dividend.

Q. I'm not sure you answered my question, but I'll leave it alone, because I think I'm done with it.

How many times has Empire been in with a rate case in the last four years?

A. We had a case in 2001 that concluded, I believe, in the -- in December, or the Order was effective in December 2001. We had another case in 2002, and I remind you that as a result of the '01 case, there was an error in the reconciliation with respect to the cost of off-system sales that was omitted. And also the -- there was an issue of not getting equity that had been issued in 2001 into the cost of capital emission. So there was a case that was settled, I believe, in October of 2002, and then we filed this case in April of this year.

Q. Was the 2002 case confined just to the issue of the supposed error in the '01 case?

A. It was the error in the '01 case and the addition of common equity that was sold in late 2001 and some equity that was sold in the spring of 2002.

Q. Did the '01 case result in a rate increase?
A. Yes, it did.
Q. How much were rates increased?
A. I believe the base rate increase in 2001 was $17 million. And then there was an interim energy charge that was authorized as a part of that litigated case that was roughly $16 million on an annual basis. It was subsequently entirely refunded, and then the 2002 settled case was a base rate increase of $11 million.
Q. 11 mil. Okay. In looking at your case today in the big picture --
A. Yeah.
Q. -- is the entire case based upon change of circumstance -- is every element of the case based upon a change of circumstances from the last '02 case?
A. Nearly all of the case is based on change of circumstance.
Q. All right.
A. If I understand your definition, or at least I understand my definition.
Q. Go ahead and tell me what your definition is in general.
A. Well, the bulk of the case is based on the change in fuel and purchased power. Then we have built a couple of quick-start peaking units, about 100 megawatts,

that came online in --
Q. Right.
A. -- April of 2003. We've had numerous other capital additions that totaled about $100 million in total. That includes the peaking units.
Q. Oh, okay.
A. So we've got some rate base additions. We've also had another round of equity that we sold late last year, late 2003, early 2004, and -- and then a request to return to more standard, if you will, depreciation rates. So those are the top three items in the case. If I take out those three items, the rest of the items are fairly immaterial.
Q. Tell me -- what was the depreciation issue again that you just said?
A. We approached the deprec-- you'll be able to get into that the next three days.
Q. Very soon.
A. I'll not try to step on my witness, but essentially it is with respect to service lives and the salvage issue.
Q. So that's a -- that's not a change in circumstance issue, it's a -- it's a renewed argument over that issue; would that be accurate?
A. I'll take your definition on that.

Q. Okay. I think we're talking on the same page. All right. If Empire had a -- let me get your answer on this, and I don't think you've answered it, because I don't think you've been asked. If there's a choice here on the fuel adjustment -- well, it's not fuel adjustment. Whatever you want to call it, interim energy charge are not that the Commission would order without the consent all of parties here, does Empire view it as in its best interests to have that order done with the risks of appeal that could be filed, that could follow or not have one? And maybe you have answered that question.
A. I have not been asked that question today.
Q. Okay.
A. We'll be filing a response tomorrow that will give this in greater detail. From a philosophical standpoint, from a policy standpoint, we believe that a company should be afforded an opportunity to recover its prudently incurred costs of delivering service. To that end, we would support a properly drafted interim energy charge.
However, the risk of litigation is not insignificant. We cannot live with that kind of risk. You will find in our response tomorrow that we have asked State Senator Gary Nodler and Representative Ron Richard to introduce legislation. They have done so. We believe

that legislation will provide the Commission the authority to implement interim energy charges without the risk of litigation.

We would ask the Commission to support that legislation, because we believe the Commission needs that tool to properly implement rates in this case. Absent that, I believe the Commission has a responsibility to recognize the -- what I believe is the credible and competent evidence in the case with respect to fuel and purchased power. And that's the company's number.

Q. You lost me on the very last part.

A. I believe the Commission, absent the implementation of interim energy charge in this case, which is what we would prefer, I believe the Commission has the responsibility to utilize the number for fuel and purchased power that is represented by the competent evidence in this case.

Q. In other words, you're saying -- you're telling me that the Commission should not order an interim energy charge?

A. With the -- unless the risk of litigation has been mitigated.

Q. But at this point, with the parties' positions being what they are, are you telling me that you don't want the Commission to enter an interim energy charge order?

And I'm really not tying you down, Mr. Gipson, to an answer other than I really want to know when we're done here what the company's desire is on this issue, based upon the current status of the law and the current status of the parties' positions.

A. The current status of the law and the current status of the parties' positions, you'd have to go with our number on fuel and purchased power.

Q. Did you say you didn't want us to order an interim energy charge?

A. Given the current state of the law.

Q. The answer is yes, you don't want us to order an interim energy charge; is that what you're telling me?

A. No.

Q. Okay.

A. What I'm telling you is --

Q. Try it again.

A. -- given the current state of the law and the risk of litigation, that I don't believe the Commission can implement an interim energy charge.

Q. Ah, okay. So is that a legal position --

A. I'm not a --

Q. -- the company is taking?

I'll ask your counsel.

MR. SWEARENGEN: Thank you for that.

CHAIRMAN GAW: Mr. Gipson, I'm just trying to relieve you of that responsibility by asking that.

MR. SWEARENGEN: I think the company's position is the interim energy charge that we've discussed in concept does not run afoul of the UCCM case and ultimately would be determined to be lawful by a court. However, what the company cannot stand is the risk that litigating that question over several years and having the money collected under the interim energy charge tied up and paid into court.

CHAIRMAN GAW: That's what I thought the company's position was, is the way you just stated it, and my question to Mr. Gipson was that, but --

THE WITNESS: Well, he answered it better than I did.

CHAIRMAN GAW: But I want to make sure that that's what you're telling us here today, is that rather than -- because I heard a little bit different statement, I thought, out of you.

MR. SWEARENGEN: Absent resolution of that question prior to your decision, I think what Mr. Gipson is saying is our fuel number should be in base rates.

CHAIRMAN GAW: And that's what I want to

see if Mr. Gipson agrees with what you just said.

THE WITNESS: And that's what I said. Absent accomplishing that, in other words, absent mitigating the risk of litigation through legislation, then I believe -- and that's going to be staked out in our pleading tomorrow -- that you've got to go with the company's number.

BY CHAIRMAN GAW:

Q. That's what you would ask us to do?

A. That's correct.

Q. Without a change in the parties' positions or a change in the law?

A. That's correct.

Q. Okay. That's what I was trying to get to. All right. So I think that I'm about done. Maybe I am done. Hold on just a second.

Oh, when you come back with -- with the rates, would you give me Empire's rates in -- for those three categories in Oklahoma and Arkansas as well?

A. Yes.

CHAIRMAN GAW: I may have more, but I'm going to defer right now. Thank you, Judge. Sorry to take so much time.

JUDGE THOMPSON: That's quite all right, Mr. Chairman. We are at the moment where we need to take a break for the reporter. Why don't we take 10 minutes and come back for further questions from the Bench.

(A BREAK WAS TAKEN.)

JUDGE THOMPSON: Further questions from the Bench. Commissioner Clayton, do you have further questions for this witness?

COMMISSIONER CLAYTON: No questions.

JUDGE THOMPSON: I don't know whether Commissioner Davis has any questions for you or not.

THE WITNESS: Judge, Commissioner Gaw, Chairman Gaw asked me some questions with respect to pricing on the wind energy, and if there's a way that we can do this --

JUDGE THOMPSON: You have an answer for him now?

THE WITNESS: I have an answer.

JUDGE THOMPSON: Let's go ahead and give that answer.

CHAIRMAN GAW: Is it HC?

THE WITNESS: Yes.

JUDGE THOMPSON: It is HC. Okay. We'll go ahead and go into closed session then.

(REPORTER'S NOTE: At this point, an in-camera session was held, which is contained in Volume 13, pages 1402 through 1411 of the transcript.)

JUDGE THOMPSON: Okay. We're back public session. You may inquire.

MR. CONRAD: Thank you, Judge. I'll try to be brief.

RECROSS-EXAMINATION BY MR. CONRAD:

Q. Mr. Gipson, I appreciate your standing up to all this questioning with your cold.

I believe it was originally Commissioner Appling's question that got me thinking about this, but since then I think Commissioner Clayton and Chairman Gaw have also touched on this area. But what I had in specific thought was the exchange you had with Commissioner Appling about the efforts that Empire was expending to address the fuel mix. And I'm thinking specifically of a case that -- it's not really a case. I'm not sure what it is. But I believe you are participating in which involves Kansas City Power & Light and the Iatan plant, and recalling the admonition of the judge for us to try to stay out of HC material, what is the status of your discussions, if you can share them along that line on that Iatan 2?

A. I'll tell you what I can.

Q. Please.

A. We have had a number of meetings with Kansas City Power & Light and with the management of

Aquila in terms of us taking an active -- or a position in that plant from a couple of different perspectives. Most interest -- where our interest lies, I should say, is in an ownership position with respect to that -- that second unit at Iatan, and we've had a number of meetings with them. We do have a confidentiality arrangement between the parties, so that's probably about as much as I can tell you.

Q. Those discussions are continuing or have they stopped or --

A. They seem to come in starts and spurts or spurts and starts, however -- however you want to say it, but yeah, we've had a number of meetings. I think the last meeting we had was -- my memory is in September. It's been -- it's been a bit. But we've had -- you know, at different levels of the organization, we've had a number of people in our organization working with different people in their organization to understand the different aspects of not only that workshop process but any information that we've been able to glean about expected cost of construction, expected cost of operation, things of that nature.

Q. Chairman Gaw and Mr. Clayton both asked you about the fuel mix. Think outside, if you would, with me for a moment the box and make assumption that you were starting all over again and you could construct with the snap of your fingers whatever fuel mix you refer to as a fleet, whatever fuel mix you could have. What would you -- if you had your druthers, as they used to say in Al Capp's strip, pushing the age barrier again, what would you have?

A. Well, I don't think that it would be unlike what -- what we would like to target, you know, as the optimal. A significant portion of that, you know, something on that 80 percent, maybe -- maybe a little greater than 80 percent of the energy would be derived from a coal-fired resource. We think that that is a stable resource, albeit as Dr. Vander Weide suggested in his testimony or testified, there are certain uncertainties with respect to coal-fired resource, most notably the environmental concerns.

I think you still have to have a mixture of gas resources or oil-fired resources in your mix to balance that -- that -- the capacity cost with the fuel cost so that you're looking at -- you know, when we dispatch a unit, we want to dispatch it based on all factors, not just the cost of the fuel. And in addition to that, I think it's important going forward that a company have a good deal of their resource mix that's derived from renewable resources such as wind energy.

So I guess the answer to your question, Mr. Conrad, would be similar to that answer that I gave both Commissioners Clayton and Gaw, is I'd like to be something on that 70 to 80 percent coal-fired, about as much renewables as I can get the dispatchers to stomach, and then the remainder on gas-fired resources, gas or oil-fired resources.

Q. Now, in discussing -- thank you for your answer. In discussing the wind situation with Chairman Gaw, I picked up on the phrase that you used that in March and April when I think your phrase was the wind blows like a bat out of hell.

A. Well, I said that in HC.

Q. Excuse me. Not anymore. I'm sorry.

A. My mother may be watching.

Q. But you used the phrase you were not able to take it, and I wanted to unpack that, if you would, just a little bit. Now, I understand as chief executive officer, Mr. Gipson, that you don't decide for the employees which end of the nail the point is on and stuff like that, but to the extent that you can give us a 10,000-foot view from where you sit, when you say you're not able to take it, what do you mean?

A. Well, our dispatchers -- and I think I kind of referred to this a minute ago. Our dispatchers make decisions on an hourly basis, on a minute-by-minute basis, if you will, matching the resources with the demand of the system. There may be some instances, we believe there will be some instances, a handful of instances throughout the year when the demand for the system will not be sufficient to draw upon that resource, and in those instances we'll either have to sell the power onto the market if the market is available or have some other off-take arrangement.

Q. Now, would that -- would that be in that circumstance because you still -- the energy from those resources would either not be sufficient in itself to carry your system load or the capacity which would be as we --

A. No.

Q. -- discussed?

A. I think what I was trying to explain was the demand on the system won't be there to accommodate the resource. If it were a -- if it were a resource that had a -- that had a throttle, if you will, you just back the unit off. But in this particular kind of resource and the particular kind of contract that we have written and those few times through the year, we will have to find another place to unload the energy.

Q. One question did come up, and I think it is with respect to this same set of wind turbines and I would seek some guidance from you about this. We have been told that the wind turbines that are installed need to be culturally sensitive. Do you have any insight that you can give me as to what a culturally sensitive wind turbine might look like?

A. No, I don't have any guidance for you there, Mr. Conrad. The company that we have contracted with will build, own and maintain these facilities. We'll be the -- we're the off-take partner in this partnership. They have extensive experience in this country building wind energy resources, and to my knowledge they've not had any issues that arise in that context of cultural sensitivity.

MR. CONRAD: Okay. Thank you, Mr. Gipson.

THE WITNESS: Thank you.

JUDGE THOMPSON: Mr. Krueger?

MR. KRUEGER: Thank you, your Honor.

RECROSS-EXAMINATION BY MR. KRUEGER:

Q. Good afternoon, Mr. Gipson.

A. Good afternoon.

Q. Chairman Gaw asked you a couple of questions about the dividend payout ratio. Do you recall that?

A. Yes.

Q. And I believe you said the issue is not the level of dividend, the issue is the capacity to earn the authorized rate of return; is that correct?
A. I did say that.
Q. Okay. Does the level at which the Commission sets the allowed ROE determine whether the company's able to achieve that ROE?
A. I think it's a component. The other components would be the recovery of costs associated with delivering the service.
Q. Okay. Some matters over which the Commission does not have control, correct?
A. No. I think the Commission does have control over the level of rates that are reflected in the tariffs that are intended to reflect revenue requirement, which is made of a couple of components, at least a couple of components. One of those is the return on the common equity, and the other component is largely the cost of delivering that service.
Q. I acknowledge that the Commission has control over the rates. My question is whether the Commission has control over the company's ability to achieve the ROE that the Commission allows?
A. No, the Commission does not have the -- try me again. Say that again.

Q. Does the Commission have control over the company's ability --
A. No.
Q. -- to achieve the ROE that the Commission allows?
A. No.
Q. That depends on other things such as your ability to control costs, sales and various other things over which the Commission has no control?
A. I agree.
Q. Would you classify Empire's dividend policy or dividend practice as conservative?
A. Can you define conservative?
Q. Well, one of the expert witnesses, I believe Dr. Vander Weide, said that Empire's policy could not be more conservative. I'm not sure how he meant that. Do you think that it is conservative?
A. I think I'd better agree with my expert.
Q. Okay. So you think it is conservative?
A. Yes.
Q. In his rebuttal testimony, Mr. Murray cited a report from Stifel Nicolaus in September of this year in which Stifel Nicolaus said that Empire currently has the highest dividend yield out of 114 companies that Stifel Nicolaus follows. Do you believe that to be true?

A. I have no reason to doubt that.

Q. Okay. And according to the same report, Empire had the second highest payout ratio out of the same 114 companies, based on the last 12 months of earnings per share. Do you believe that to be true?

A. I have no reason to doubt that.

Q. Okay. And in light of that, you would still consider Empire's dividend policy or practice to be conservative?

A. Yes.

Q. And for what reason?

A. You know, I think it gets back to what we talked about a bit with Commissioner -- Chairman Gaw, a bit about what we talked about in the deposition, and that is seeing through a particular issue and the short term, not making decisions on the short term, making decisions on the longer term. I view the position that the company is in today as a short-term issue. I think there are factors that have impacted the level of their earnings over the past few years that are short term in nature, and I'm proud of the fact that we have not taken short-term actions that affect the -- that impact long-term investors. So in that kind of context, I think it's conservative.

Q. So the decisions that you're making on the long term is the decisions on how much dividend to pay; is that correct?

A. I didn't follow your question.

Q. Okay. I believe you talked about making decisions on the long term was a conservative -- a conservative way of doing it. Is that --

A. No. I think what I tried to characterize that you need to -- you need to align your decisions with respect to this particular issue, particularly the dividend paid by this company to its shareholders with the expectations of the investors of the company. Our investors in my view are not short-term investors. They are long-term investors. They expect the company to make decisions with respect to that investment as if it is a long-term investment.

MR. KRUEGER: Thank you.

JUDGE THOMPSON: Mr. Coffman?

RECROSS-EXAMINATION BY MR. COFFMAN:

Q. Good afternoon. I just wanted to ask a couple questions following up on this idea that in your opinion an Empire investor tends to be a long-term investor.

A. That is my opinion, yes.

Q. What is the basis of your opinion? Do you have data or information that --

A. Well, John, you know, one of the -- excuse me. Mr. Coffman, one of the most -- one of the best demonstrations of that is to come to our annual shareholders meeting that will be held in April of this year in Joplin, Missouri.

Q. Are you inviting me to that?

A. I am. I'd love for you to come. You will definitely be the youngest one in the room. In fact, Mr. Swearengen said at the break he was 120 years old. He'll be the youngest one in the room. It is a group of individuals that have been investors for a long period of time, as I suggested earlier. 70 percent of our retail sharehol-- 70 percent of our shares are held by the retail investors. Only 30 percent are held by the institutional investor.

Q. Okay. Just make sure I'm understanding your earlier testimony. When you stated earlier that you believe 70 percent of your investors are mom and pop investors, is mom and pop a reference to what you call retail investors?

A. Yes.

Q. And that is non-institutional investor?

A. Non-institutional.

Q. Okay. And where do you -- would one find the data that supports that percentage?

A. That is data that we have internally, data that we gather from the various brokerages in view of that split.

Q. Do you have an opinion about how that compares to the electric industry average?

A. You know, I don't know how it compares to the average. I have had some discussions with some of our peers in this state with respect to their split between the retail investor and the institutional investor, and we are much more heavily a retail investor organization than say an AmerenUE or a Kansas City Power & Light, and certainly these days much more than Aquila.

Q. Is it independent from this split that you have formed your opinion that your investors are more interested in long-term results from their Empire stock?

A. I think I testified earlier that over the past three years, we've had three instances where we've issued common stock. As a part of those offerings, we visit with both institutional and retail holders. Mr. Coffman, I haven't -- it is direct to me from those investors that they are not investing in this company for its growth aspect. They are not investing in this company on the short-term horizon. They are long-term investors. They are buy and hold investors.

MR. COFFMAN: Thank you very much.

JUDGE THOMPSON: Does that complete your questions?

MR. COFFMAN: That does, thank you.

JUDGE THOMPSON: Very well. Redirect?

MR. SWEARENGEN: Just a couple.

REDIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Mr. Gipson, did you say earlier for a number of years prior to 1992 that the company had a history of increasing its dividend on a regular basis?

A. I did.

Q. And since 1992, is it true that the company's dividend has not been increased?

A. That's correct.

Q. And what is the current dividend that you're now paying per share?

A. 1.28 annually.

Q. And that's the same dividend per share that you were paying back in 1992?

A. I believe it was last increased in 1992.

Q. Would you characterize not having increased your dividend over the last 10 years as a conservative approach to your dividends?

A. Can you clarify that question for me, Counselor?

Q. Based on a history of increasing your dividend prior to 1992, which I think you said was consistent with what a lot of other electric utilities are doing, and then starting in 1992 maintaining a flat dividend and not increasing it, would you call that a liberal or a conservative approach to your dividend policy?

A. I don't know that I can characterize it either way.

MR. SWEARENGEN: Okay. Thank you.

JUDGE THOMPSON: You may step down, and you are excused, Mr. Gipson. Thank you very much for your testimony today.

Mr. Knapp. Good afternoon, Mr. Knapp.

THE WITNESS: Good afternoon.

JUDGE THOMPSON: I will remind you you are still under oath. Questions from the Bench, Chairman Gaw?

CHAIRMAN GAW: I'll pass for now.

JUDGE THOMPSON: Commissioner Davis?

COMMISSIONER DAVIS: Pass.

JUDGE THOMPSON: Commissioner Appling?

COMMISSIONER APPLING: No questions, Judge.

JUDGE THOMPSON: Since there were no questions from the Bench, redirect?

MR. SWEARENGEN: No redirect.

JUDGE THOMPSON: You may step down,

Mr. Knapp. You are excused.

THE WITNESS: Thank you.

JUDGE THOMPSON: Thank you for your testimony today.

Mr. Murray. Mr. Murray, good afternoon. I'll remind you that you're still under oath. Questions from the Bench, Chairman Gaw?

CHAIRMAN GAW: I'm going to pass right now. Hopefully Commissioner Davis has some questions.

JUDGE THOMPSON: Commissioner Davis?

COMMISSIONER DAVIS: Thank you, Judge.

CHAIRMAN GAW: I do have one question.

COMMISSIONER DAVIS: Go ahead.

DAVID MURRAY testified as follows:

QUESTIONS BY CHAIRMAN GAW:

Q. Mr. Murray, when you did your assessment on an appropriate ROE, how did you factor in whether or not there would be an interim energy charge in your numbers?

A. Actually, because I did a company-specific DCF analysis, that takes Empire's stock price, which when you use the stock price of the company that is going to be the subject of say an IEC, that -- investors' expectations are going to be reflected in that stock price.

I know that Empire didn't file their case until April of this year, but I used stock prices from

January through June of this year. So more or less once investors see that an IEC or some other type of adjustment clause has been proposed by the company and also a similar proposal has been accepted in a previous Aquila case, those investors are already taking that into consideration, and that's going to be reflected in the stock price, which is an input into the DCF model.

Q. Well, there isn't any certainty in regard to whether or not that's going to be approved by the Commission, though, from an investor's standpoint, is there?

A. No. There's never any certainty, but I believe from the fact that Empire had an IEC in 2001 and we just recen-- excuse me -- the Commission recently approved the settlement that included an IEC from Aquila, that investors, regardless of some folks' perceptions that this Commission will help the company out if it has a -- you know, if it has a situation such as Empire has right now.

Q. Well, if you make that assumption that there was some -- there may be already adjustment in there with an assumption that an interim energy charge would be granted, and if at the conclusion of this case no interim energy charge is granted, would that have an impact on your assessment of an appropriate ROE for this company?

A. I believe that -- this is a -- that's a very good question. It's going to depend a lot on what's going to be built into that base rate, and I think that that question has been asked already. And I think it was the counsel asking Travis Allen, the company counsel was asking Travis Allen if there would be any more risk if the base rate was set at a higher level or at the highest level possible or if there was a situation where the base rate was set 10 million less and then the rest of it was an IEC.

You know, if you set permanent rates as high as possible and it's at that level that the IEC would go up to, then obviously the company can recover everything. So if that's the case, you know, I would say that that would be viewed as favorably by the investment community. If -- you know, if the base rate is set something, say, less than what they recovered in an IEC, if those rates go -- if the gas rates should go higher, then they may view that negatively.

Q. So it would depend on what was set in the base rate, in your opinion?

A. Exactly. I apologize, but that's a moving target right now, as far as I know.

Q. That's not something that you -- your testimony involves, is it?

A. No. I didn't try to quantify that, because I -- like I said, I was pretty sure that an IEC was going to come out of this, and now that's maybe a little more questionable.

Q. I'm not sure whether that's -- what the end result is there, but I guess my question is, who on Staff is -- would have an understanding of the fuel cost model of Staff? Who's the witness on that? And if you don't know, I'll ask somebody else.

A. As far as the IEC, I know that John Cassidy and Leon Bender were the two main witnesses that were discussing that issue last week.

Q. Okay. And so if you were looking at this, then you can't give me today any kind of a general adjustment that might be made to your ROE if no interim energy charge is granted, because you don't have enough information about what the price or the fuel cost might be set at in the -- in the case?

A. No. That would be a very arbitrary number to try to set something ahead of time on that -- on that very issue.

Q. But if you had the numbers, could you do it or not?

A. If I had the numbers?

Q. If you had the fuel cost numbers and the

Commission had made a decision on what those would be.

A. That's something I really haven't even thought about trying to measure, to be quite honest with you. I don't -- as much as the rest of rate of return is an art, that would be probably more of an art than just coming up with the base rate of return. I know that there's frequently some roundabout adjustments of 50 basis points here and there, but I think Dr. Murry himself indicated that he thought about 11.5 to 12. He thought about a couple of factors and he went up to 12, because that was his professional judgment. Obviously that's not scientific.

Q. There's been several criticisms as I understand of the DCF model in regard to the fact that the dividends have been flat and that that somehow causes a problem with that model, if I understand it correctly. Is that right?

A. I believe that's the criticism that's been -- been alleged.

Q. And you don't see that as an appropriate criticism or not?

A. No, I don't, because there's a list of, say, 8, 9, 10 assumptions in the DCF model, and in the real world most of those assumptions never hold true. I think if you went through the comparable companies of all the witnesses, myself and Vander Weide and Travis Allen and Dr. Murry, and I'll talk about Murry specifically because I do recall that he commented on the fact that some of his comparable companies have flat dividends.

Now, it wasn't because their earnings level couldn't sustain those dividends. It was because they were conserving cash for future investment. But regardless, Dr. Murry applied that model and used that model for his analysis in this case.

And I know that Dr. Vander Weide has a group of 30 -- I think it's 19 electric companies, and just reviewing those companies just basically by looking at the name of those companies, I can tell you that a lot of the things there aren't holding true as well. Their return on equity is not the same year in and year out. Some of those companies have diversified into non-regulated businesses. I'm sure they're retaining more of their earnings instead of paying them out in dividends, so they don't have a constant payout ratio. The required rates of return as we know is not constant over time. That's why we have so much of a dispute on this issue. And interest rates obviously are not constant over time. I think that's why this issue is -- can be quite contentious and can have a very wide range of results, because a lot of it is based on theory, and obviously we live in a real world.

Q. Well, do you believe that the criticism that they have levied invalidates the DCF model in any case if there could be a case where it would be inappropriate to use that model?

A. I think if it's used without any critical judgment, it's a model that -- you know, that can have illogical results. All you have to do is look at -- just take a look up there on that easel. Obviously I don't think this Commission is going to recommend a 5.7 percent or a 7.53 percent or a 5.8 on down the line. Those are DCF results from Dr. Murry's testimony, and Dr. Murry used judgment in determining, and I think his judgment was a little optimistic obviously, but he used judgment to discard some of those results. Those are mechanical DCF calculations.

I think if one uses judgment as to what appropriate growth rate should be when you're applying the DCF model, you can accurately and reliably estimate the cost of equity. And let me just note that there -- I've done a little bit of talking to other counterparts in other states, because I know that is an issue for this Commission, especially because we just had this last MGE rate case and I'm aware that in Arkansas they primarily rely on the DCF model. I'm aware that in Colorado they primarily are relying on the DCF model. Kansas looks at the DCF model. Oklahoma, they have about three DCF. They do CAPM. But predominantly states are still relying on DCF model. FERC relies on the DCF model. FERC has indicated it is the preferred model.

COMMISSIONER DAVIS: Mr. Chairman, can I interrupt and ask one question?

CHAIRMAN GAW: Sure.

COMMISSIONER DAVIS: You said Oklahoma runs three DCF models, correct?

THE WITNESS: Yes, I did.

COMMISSIONER DAVIS: How many do you run?

THE WITNESS: I run one on the -- on the -- excuse me -- the sample company and then I run the DCF model on the four comparables.

COMMISSIONER DAVIS: Okay. But you only run one model; you just run it on the company and the proxy groups, correct?

THE WITNESS: Yes. The difference is in Oklahoma, he used a -- projected growth rates from three different source -- three different sources, so he used three models, where what I did in my DCF model is I looked at all the sources of growth and then put that into one model. So he could -- if he had averaged all the growth rates initially in his analysis instead of --

COMMISSIONER DAVIS: Wait. Did you say the term averaging?

THE WITNESS: Yes, I had.

COMMISSIONER DAVIS: Mr. Krueger, weren't we averaging here yesterday? Wasn't that a bad thing for you yesterday?

MR. KRUEGER: I don't believe I'm testifying at this moment, your Honor.

THE WITNESS: If I can explain what they did down in Colorado, he looked at three individual DCF results and then he averaged it to come to a 9.6 percent. That's no different than if somebody took three projected growth rates, averaged them and came to a final estimate. That's the only difference there.

COMMISSIONER DAVIS: But you only take one projected growth and plug it in; is that correct?

THE WITNESS: No. You can average three projected growths. Like I said, he came up with the 9.6 percent based on a DCF result of a low 9, of about a mid 9, 9.5, and a result of a little over 10, and came up with a result of 9.6. Now, if he'd have just averaged those three projected growth rates before he came up with his final results, his final result still would have been 9.6.

COMMISSIONER DAVIS: Okay. No further

questions.

JUDGE THOMPSON: Go back to you, Mr. Chairman.

BY CHAIRMAN GAW:

Q. Help me to understand a little better about the growth rate issue.

A. Yes.

Q. Start at the very basic level, define it for me.

A. Okay. The -- the original theory, once again, of the DCF model is your capital appreciation of your stock is going to be derived from the cash flow from the company. You -- obviously the investor invests hoping to eventually receive the cash, some cash flow back with a return on that cash flow in the future, both for your time value of money and then the risk you're subjected to when you invest that money. And the original theory -- and this was probably more true in history when you had companies that were -- the dividend yields were higher even on average for non-regulated companies. But if you had a company that were -- that was growing its earnings and dividends in lock step, which is almost impossible to do because of events that can occur, the theory is that the dividends and earnings are going to grow at the same rate.

Obviously, you know, that does not -- that does not happen in the real world. For the most part, like in those first -- I think it's the first two examples up there, the reason why Dr. Murry's results are so low is because he did just look at the dividends per share growth rate and they were flat.

Q. When you say the first two, you're talking about what?

A. DAM-13 and DAM-14.

Q. I just wanted to make sure that was clear in the record.

A. Let me look at his testimony just to make this very clear. Yes, in his DAM-13 he's looking at a 1997 to 1999 average dividend, and then he's looking at a 2006 to 2008 estimated dividend. And then for a couple of those companies, the growth rate of three of those companies, the growth rate of dividends per share is below 1 percent. So that confirms that he does have other companies in his comparable group as well that are not growing their dividend as much as they're growing their earnings. And I haven't had a chance to look at that in detail with Vander Weide's testimony, but because of the fact he has so many diversified companies in there my hypothesis would be the same thing occurs there as well.

And once again in the DAM-14 up there, the dividend is based -- well, that's the basis -- that's the same dividend growth rate, but he does it on current stock prices. And then it's after that that he gets into using earnings per share growth as a proxy for growth in the model. And that's primarily what he relies upon in the rest of his mo-- in the rest of his schedules is earnings per share growth.

Q. Okay. So when you're examining this in regard to Empire, if you just looked at Empire, what would the growth value be?

A. That's his Schedules DAM-17 and DAM-18 there, and in that Schedule DAM-17 his low -- his low estimate there of 7.7 percent is based on his low proxy growth rate from S&P, which is 2 percent, which actually in essence he used S&P in the last case because it was a higher growth rate. So he comes up with a low cost of capital of 7.7 percent, based on the low dividend yield of 5.7 percent. He's using 52 weeks of stock prices, a low and a high over that entire year. So obviously that catches, you know, the extreme low cost equity and extreme high cost equity. So that's not really an accurate measure of what the stable cost of equity is going to be for a company going forward.

And then on top of that, he uses the -- for his high estimate, he uses the ValueLine growth rate of

6 percent, and as Mr. Gipson was indicating earlier, investors invest for the long run, and because Value -- the way ValueLine calculates its growth, the -- right now they have an anomalous year in their base period, and then they look at their estimated earnings per share in 2007 to 2009, they average that out, and that -- because you have that low base period, which I can't remember what the average is, but it's somewhat below $1 per share that results in that 6 percent growth rate.

And if you look at the fundamentals of the company, which is the demand growth of 2.4 to 2.5 percent, and look at a more normal year for this company where it earns -- let's just say it earns $1.28, because I know they want to at least be there, if you project that out and use their earnings per share projection in 2007 to 2009, you're going to come up with about a 3 percent growth rate. And in actuality that makes a lot of sense because that's their organic demand growth, and that's what people expect in growth from utilities nowadays is anywhere from 2 to 3 percent for an integrated regulated electric utility.

Q. And when you say that's what people expect, where do you get that?

A. That's just from looking at, like I said, the fundamentals of the company and looking at -- with

A.G. Edwards has an estimated growth of 3 percent on -- for this company. At one time Lehman Brothers had as low as a 1 percent earnings per share growth for this company. I think some of this may have to do with dilution in their earnings per share with issuing stock. I've seen that comment in some of their reports. And then also S&P has 3 percent.

And then once again -- and this is something that was done, I looked at the my counterpart down in Arkansas. He normalized what was going on in 2001 to 2003 and looked at how he -- he calculated his own growth rates on a more normal period, and he was coming up with about a 3 percent growth rate, too. I think he came up a little bit higher because he was trying to project out for 2004 as well.

Q. And in your calculations, your growth rate was what again?

A. It was 2.25 and 3.25.

Q. And what was your CAPM conclusion?

A. The capital asset pricing model based on the long-term period which I think is the most appropriate -- I do the short term just to kind of give everybody an idea what's going on with the market recently because I think that's informative, but my long-term capital asset pricing model, the result is 9.35 percent.

Q. What was the short term, by the way?
A. Short term was 7.04 percent. Like I said that has -- you know, we had of the down stock market for 2000 to 2003, but it's still interesting to note that the returns on stocks over risk-free rates has come down quite a bit.
CHAIRMAN GAW: I'll pass for now, Judge. Thanks.
JUDGE THOMPSON: Thank you, Mr. Chairman. Commissioner Davis?
QUESTIONS BY COMMISSIONER DAVIS:
Q. Mr. Murray, you just referred to your counterpart down in Arkansas. Who is your, quote, counterpart down in Arkansas?
A. His name's Johnny Brown.
Q. And what does Johnny Brown do for a living?
A. He's a senior financial analyst for the Staff in Arkansas.
Q. Okay. And when did you have these conversations with him?
A. I think I first talked to him during the FRI, Financial Research Institute, that we had -- when was that? I believe that was in the fall. And then I talked to him within, oh, about a week or two ago.
Q. Okay. So that was subsequent to your

testimony in previous cases that you didn't talk to analysts and staff in other states, correct?

A. Yes, because I realize it's an issue you guys are wanting to know a little more about now.

Q. And when did Empire have their last rate case in Arkansas, do you recall?

A. They're currently filed in Arkansas.

Q. Okay. But do you remember what their last rate case dispute -- know when their last rate case decision was in Arkansas?

A. No, I do not.

Q. I mean, would it surprise you if, you know, the ROE decision or stipulation in that case was, you know, 11 percent or more?

A. I'm not surprised to find that somebody authorized ROEs that are higher than Staff's recommendations in other states. I found that in talking with a couple other people, too.

Q. Okay. And when you talked to your, quote, counterpart down in Arkansas -- I can't remember his name -- did he tell you what their -- what their -- what his ROE rec-- did he describe any ROE recommendations to you that they had made in any cases?

A. In the Empire case right now, he's recommending a 9.7 percent return.

Q. 9.7. Is that the midpoint, the low, the high?
A. That's the mid. I think his range here, I think it's -- he has 9.4 to 10.3.
Q. 9.4 to 10.3. So he's a full point above you.
A. Yes.
Q. Correct?
A. Yes.
Q. And can you explain the differences between his analysis and your analysis?
A. Yes. He looks a lot -- he really looks pretty well only at ValueLine for his growth rates, and -- but he does normalize it, as I was doing, because he realizes that that 6 percent growth rate is not sustainable, and he --
Q. Is normalizing, does that mean averaging?
A. No. It means trying to determine what, you know, if this has been a normal year for the company, if not, what do we expect to happen in the long term with the fundamentals of the company. So he looked at, I believe, 2002 and 2003 and did a -- you know, it's a simple compound growth rate based on the earnings per share projection.
Q. Well, let me ask you this: Does Arkansas

have a fuel adjustment clause?

A. Yes, they do.

Q. So you would describe Arkansas as a less risky or a more risky state for Empire to do business in?

A. I don't know all the details of Arkansas, but if you were just looking at that one item, obviously that increases the risk from Missouri.

Q. And what was Arkansas' -- what was your counterpart's ROE recommendation in Arkansas again?

A. He said it 9.3 to -- or excuse me -- 9.4 to 10.3.

Q. 9.4 to 10.3. What about Oklahoma?

A. Oklahoma, I -- I found that in the -- and the reason why I was very interested in that case was because of the fact it's been brought up in this proceeding of 11.27, and this is one thing that I also found out was that the Public Utilities Fortnightly survey, I think I found about six or seven cases that were actually settled cases and they weren't indicated as such in Public Utilities Fortnightly. So I'm very concerned about putting too much weight on that without digging into that in a little more detail.

Q. Oh, okay. What are you quoting from Public Utilities Fortnightly?

A. They had an ROE survey.

COMMISSIONER DAVIS: Judge, do you want to hand this to the witness?

JUDGE THOMPSON: Yes, sir.

BY COMMISSIONER DAVIS:

Q. Is that the article you were referring to?

A. That is one of them. I looked at both the 2004 and 2003 survey.

Q. Okay.

A. But as far as -- well, obvious -- well, this isn't obvious because you guys -- this is not an Empire case, but Arkansas Western Gas, because I talked to Johnny Brown down in Arkansas, that doesn't have an asterisk on it and he told me that was settled.

Q. So that was --- let me ask you, so that was settled at 9.9, correct?

A. That's correct. And then the Colorado Aquila, I decided I had -- I called a few companies, mainly the ones that were contiguous states to Missouri and some states that had utilities that were owned by companies that owned Missouri utilities, because I thought that would be somewhat informative. I found that in the Colorado Aquila case, which it doesn't have an asterisk on, but that was settled at 10.25. I believe the witness in that case for Staff had recommended a 9.25 to 9.75. So obviously they didn't go with the Staff, but it wasn't --

they didn't follow the Staff recommendation.
Q. Have any of your counterparts in Arkansas or Colorado or anywhere else offered anything in the 8s, that you're aware of?
A. In the 8s? I don't know. I don't recall that their range went down in the 8s.
Q. Do you know anything looking here at -- if you look at page -- or I guess page 2 of the document that you've been handed, or page 50 at the bottom left-hand corner, if you look at Illinois, you would see -- well, those are gas, but it looks like Ameren's consistently in the 10s.
Let me ask you this, Mr. Murray. I mean, can you refresh for my recollection what your view of Staff's role is supposed to be here?
A. I think I'll speak for Staff financial analysis department, but as far as my role and the financial analysis department's role is to recommend a rate of return in a rate case proceeding at least -- within a rate case proceeding that is equivalent to the cost of capital to the utility, and that is actually very consistent with the principles of the cost of service recovery. Capital costs are as real of a cost just as maintenance expenses, salaries, et cetera.
Q. But looking at this document that I've just

handed you here, this survey of recent rate cases, their ROE decisions it looks like the commissions generally tend to give more than -- more than that recommendation. Is that a fair assessment?

A. There's -- there's some that are higher. I totally agree with you that it looks like this is something that is taking a while for it to be recognized. I think in the front of this article it indicates that -- it talks about the lower interest rate level. And I think Dr. Murry himself discussed an article that he co-authored in 1993 that discussed that some commissions are not comfortable, you know, really following the trend of a cost of capital based on interest rates, that they more or less, if you will, act like the Federal Reserve and smooth things out themselves. That doesn't mean that there may not be recommendations out there that, you know, reflect a lower cost of capital.

Q. Mr. Murray, you recall your direct testimony that you gave on or about September 17th?

A. Yes. September 20th, to be exact, yes.

Q. Okay. Do you have a copy of that testimony in front of you?

A. Yes, I do.

Q. Do you have a copy of your affidavit?

A. Yes, I do.

Q. Does your affidavit say the 20th or the 17th?

A. It may have been earlier. I mean, it was filed the 20th. You're probably right on that. It says the 17th. You're correct. Sorry.

Q. Early on in your deposition or your direct testimony you cite four cases, Munn, Bluefield Waterworks, Natural Gas Pipeline Company, the Hope case. Have you ever read those cases in their entirety?

A. It's been a while, but yes, I have.

Q. Okay. And you did that since the last case where you testified that you haven't --

A. No.

Q. -- had not read those cases in their entirety?

A. It was actually my very first case when I started here, MGE case. Not this last case, but the very first MGE case back in 2000. I will admit that I just read the excerpts at that time, but after having that deposition in my first MGE rate case, I got on that real quick.

Q. Pages 4 through approximately page 7 look, you know, strikingly similar to the testimony that you've given in other previous cases. Is that a fair analysis?

A. Yes. The legal precedent, we're pretty --

we don't have to -- see a reason to change that.

Q. You say we. Who is we?

A. Well, until -- my boss was mobilized in April of this year, and he obviously ran the department before he was mobilized.

Q. And that's Ron Bible?

A. That's Ron Bible, correct. And he was the manager, so we talked about what -- you know, what type of consistency we wanted to have out there. This is something, the legal precedent that sets up the principles for determining a fair and reasonable cost of capital, it does not change. Just like the theory of the DCF or the CAPM, the explanation of that does not change.

Q. Back in May 2001, you gave a deposition -- I apologize. I can't remember what particular case it was in. Maybe it was in MGE's gas rate case. I think you gave the response, quote, I would say we have a department policy and some of those policies were followed. That was in response to a question that said, Would I be correct if I said that for the most part your direct testimony in this case is very similar if not almost word for word identical to Mr. Bible's testimony in Case GR-98-140? Do you recall making that statement?

A. I recall that very well.

Q. Okay. Is this department policy in

writing?

A. No, I don't believe there's anything in writing about using a template for testimony. That was under the guidance of my manager at the time.

Q. Well, I'm a little confused here because you're talking about we, and then I go back and look at your prior deposition testimony and you say, well, there was a department policy. I'm just trying to get to the bottom. So there's no department policy in writing, correct?

A. Not on using a template for testimony, no.

Q. Okay. What is there a department policy on?

A. I think general approaches on how to -- you know, on how to analyze a finance case or a merger case.

Q. And is that in writing?

A. Yes, it is.

COMMISSIONER DAVIS: And, Judge, do I need to make a Data Request for that, or what's the appropriate way to request that information?

JUDGE THOMPSON: I think you simply request that counsel provide it to you.

BY COMMISSIONER DAVIS:

Q. Mr. Murray, can you provide that to me?

A. I'm sure.

Q. Do you happen to have it on you?
A. No, no.
Q. But it is a document that is readily obtainable?
A. It's in the building, yes.
Q. So we can have that at the end of the day today perhaps?
A. If I can find a clean copy. Obviously the copy I have I make marks in it and notes to myself.
Q. Can you furnish us that copy?
A. Sure, if you can read -- I don't think any of you'll be able to read my handwriting. It's not too good.
Q. What different forms or types of the DCF model are out there?
A. In my mind there's really only one DCF model, but there are different variances to the DCF model. Obviously you -- you know, from this case you know that there's the annual form of the DCF model, which just assumes that dividends are paid on an annual basis. Dr. Vander Weide uses the quarterly form of the DCF model which basically recognizes time value of money and the quarterly payment of dividends.
There's also something the FERC uses, the FERC abides by is the DCF model, but they use a two-stage

growth form of the DCF model. They give about two-thirds weight to five-year earnings projections and about a third weight to long-term growth in the -- in the economy such as GDP. They have very specific guidelines on that.

There's also basically the plain -- I'll borrow some terms from some of our Ph.D.s that we've had here -- the plain vanilla form of the DCF, which does not use expected dividend for the next year. It's just current dividend divided by price to get your dividend yield. That's another form. There's -- those are forms that come to mind right now.

Q. And which, quote, variation of the DCF model do you use?

A. I use the annual constant growth form of the DCF model.

Q. Mr. Murray, how much of your direct testimony in this case was just a rehash of other previous testimony given in other cases? I mean, I'm assuming that you just took a filing of direct testimony and plugged in the numbers; is that correct?

A. I would differ with your analogy of just plugging in the numbers.

Q. Well, tell me what you did differently.

A. There are a lot of parts of my testimony that are standard parts of testimony that --

Q. What parts are standard?
A. I can look through right now, if you'd like.
Q. Sure.
A. I haven't counted it up, you know, since I think the last MGE deposition. It's pretty safe to say that the economic and legal rationale, that's page 3, page 4, page 5, page 6, through the top of page 7. And obviously there's, you know, a little tweak here and there. We do have attorneys that look this over and decide they think something reads a little bit better. As far as --
Q. Let me ask you this: Did you change your testimony in response to anything that the attorneys said to you in substance?
A. Nothing in substance. I mean, the most important thing to me is really the analysis and the explanation of the analysis, but no, there was really nothing of substance that was changed.
Q. Now, what else in your testimony was canned?
A. Some of the standardized parts of my testimony.
Q. I know we've already covered the fact that the, quote, legal analysis section is canned. Anything

else?

A. The cost of common equity and fair rate of return is something I've added in the last couple cases, just because I think there's some confusion on -- you know, on the fact that an earned return is not necessarily going to be the cost of equity, because if a company is forever in an overearnings situation, it's entirely inappropriate to look at that past return as a measure of what's appropriate. Hence, the complaint case we have had with AmerenUE.

Historical economic conditions, a lot of that explanation I changed some things on the last part of page 8, just to reflect some changes that have occurred at the Federal Reserve, such as their changing of their discount window policy. At the beginning of -- on line 8 on page 9, as far as discussing some of the economic events since 1982, you know, those economics events haven't changed, so I really didn't see any need to change that much, except for updating the current numbers to give a reflection on what's going on with either the current economy and the interest rate environment.

As far as -- and that occurs -- same thing for page 11. I discuss some of the things that the Federal Reserve has recently done, which is new. Something I've added -- I can't remember when I started to add it -- but on page 12, starting with line 4 through 16, I discuss what's going on with the various indexes in the stock market to give everybody an understanding of what -- what the recent capital markets have been doing.

On page 12, line 17, that's -- you know, that's stuff that's been in my testimony before. Page 13, we get to economic projections. What's reported is -- the sources reported isn't any different, but the numbers obviously are updated as the economy changes. Interest rate estimates on page 13, starting on line 13, those -- obviously those numbers change and gives you an idea what's going on with the economy. Growth rate expectations for GEP, that obviously changes with the economy, so that has to be updated.

Economic conditions, the predictions for the next few years on page 14, that -- you know, those things are something that's updated and it's new language. Obviously the quotations, the sources, I wouldn't want to switch sources from case to case, because that wouldn't be real consistent. Business operations from Empire on page 16, obviously that's quoted from their 10K and gives the description of Empire. That's going to change from company to company.

Q. So is it fair to say that you follow a template?

A. Oh, without a doubt.
Q. And do you know who prepared that template?
A. I don't know. That template was there before I started with the department.
Q. Okay. And who's the person that actually gave you that template?
A. My boss, Ron Bible, or my previous boss.
Q. Who supervises you now that Ron Bible is off serving our country?
A. My supervisor right now is Bob Schallenberg. He's my acting supervisor.
Q. Okay. You gave testimony in the Empire rate case in 2002, didn't you?
A. Yes, I did.
Q. Do you recall what your ROE recommendation was in 2002?
A. It was 9.16 to 10.16.
Q. What were the four companies that you used in your proxy group again?
A. The four companies I used in the proxy group in this case are DPL, DQE, Hawaiian Electric and Enstar.
Q. And can you refresh for my recollection why you chose those four companies?
A. I'll refer you to the schedule where I go

through the criteria. On Schedule 19 attached to my direct testimony, I set out a column of eight different criteria. And obviously we have to have information that is available, so it's important to have that information available from ValueLine. Column 3, that's -- you've got to have at least 10 years available, so if the company hasn't been in existence for that long, then it's going to be -- you know, make it a little harder to have some reliable historical estimates.

Column 4, I'm trying to do a pure play analysis, which I now will say gets harder and harder every passing month. It may get easier and easier once we have the back to basics issue, but -- so I use that to try to get pure play electric utility company, because I believe business risk is very important. That's the whole idea of doing a comparable group analysis, especially when you get into capital budgeting. Actually in your finance textbooks, they indicate one of the ways to estimate the cost of capital is to try to find companies that are in the same line of business as the project you're looking at, because that's going to give you the most accurate reflection of the cost of capital and a discount rate you should use to determine whether or not you should move forward with that project.

In Column 5 your total cap, less than

5 billion, that's just trying to limit the size of the companies because Empire is a smaller company. No nuclear operations, that's a -- you know, that's a risk factor that's still cited by S&P because if you had -- it's not necessarily -- I don't even know that it's the possibility of an accident. It's more if the plant goes down that, you know, they'd have to buy a lot of power in a purchased open mark.

And then no Missouri operations. I explained that earlier just to kind of like to get an idea of what the cost equity are in other states, but it doesn't mean it wouldn't be informative to find -- you know, to look at cost of equity for companies in this state as well. And that's basically -- I mean, the primary criteria I think that's important, of most importance is trying to get electric utility companies, a pure play company.

Q. Okay. I'm not familiar with Enstar. What is Enstar?

A. Enstar is what state? I think they operate up in Pennsylvania. It's a fairly regulated electric utility.

Q. Do you recall what their last ROE decision was up there?

A. No, I don't.

Q. Did you look at that for any of these companies?

A. No, I did not.

Q. In your analysis, have you ever run across any information that may have characterized Missouri utilities as being at greater risk because of the way this Commission decided to calculate depreciation a few years ago?

A. You don't even have to look any further than this case, Empire. It's in the S&P report. They have a concern about low depreciation allowances.

Q. Did you factor in anything in your ROE recommendation to account for that increased risk?

A. No. That's the beauty of the DCF model, because you're looking at the stock price of the company. When investors buy Empire stock, they are very well aware of all the risks that are implied in Empire's -- in Empire's operations and also the macroeconomic events that may affect the value of Empire's stock. So investors' expectations are fully reflected in the price that people, investors are willing to pay for Empire's stock. And that's why, you know, I believe it's the preferred method to go with to estimate the cost of equity, because you get away from arbitrary adjustments.

Q. So would it be fair to characterize Staff's application of the DCF model as a fairly rigid mechanical exercise where you just plug in the numbers and get whatever spits out?

A. Not at all.

Q. So you do make some arbitrary valuations of some of the variables?

A. I believe I explained earlier that because of ValueLine's situation, where they have -- they used a base period from 2001 through 2003, that includes an anomalous year, that that --

Q. Okay. What was the anomalous year and why was it an anomaly?

A. Well, it's about half of what they usually earn, so obviously it's anomalous.

Q. Can you describe how that happened? I mean --

A. It's been explained a little bit earlier in the hearing, but I'll talk about what I -- how I understand it, that there was a merger with Aquila. So there was that failed merger, and there's expenses associated with that, and also I believe that one of their plants went down and they got exposed to the purchased power market at that time, and that resulted in earnings per share of 59 cents.

Q. When you ran your DCF model, what did you use for the current dividend?

A. $1.28.

Q. $1.28. And what was the stock price that you used?

A. Let me refer to the specific schedule.

Q. What schedule is that?

A. The schedule is Schedule 13. I don't have the average attached to direct testimony.

Q. Okay.

A. It's just a roundabout average is going to be right around 21, $21. If you want me to calculate a specific average, I can.

Q. Okay. And so let me ask you this: What was the raw percentage that that gave you?

A. 6.04.

Q. 6.04. And then you added in how much was it, 2.25 to --

A. 3.25.

Q. -- 3.25 expected growth?

A. Yes.

Q. Okay. And is that a combination of growth in dividend and share value or what is -- what is that again?

A. Well, I mean, you're kind of right on -- trying to go the right direction there. The idea is to try to determine what the depreciation is going to be in the share price, and earnings per share can be one of the proxies. The 3.25, and if I can just refer you to -- right to specific page in my testimony --

Q. Sure.

A. -- I explain exactly how I calculated the 3.25 growth rate.

It's on page 30, beginning on line 9. I indicate the range of growth as the range I use in these -- first of all, I indicate that 2.25 to 3.25, and then I indicate range of growth is the range I used in the DCF model. And I said I determined the upper end of my range growth by recalculating ValueLine's projected earnings per share growth without the inclusion of Empire's anomalous year in 2001. This resulted in a projected earnings per share growth of 3.22 percent, and I just rounded up to 3.25.

So as a result, that was the highest projected growth rate out there once you actually analyzed and put some thought into why the 6 percent growth was so high. And the 2.25 is I just gave some weight to the fact that there was a -- you know, there was a low estimate of 2 percent and I -- I just had a range of 2 to 3 percent projected growth for Empire, so I gave a little bit of weight to some of those lower projections. And I found that Lehman Brothers actually at one time projected a growth rate as low as 1 percent for Empire.

Q. So let me ask you this: Those low projected growth rates, is that -- I'm trying to think of a way to phrase this question. How do you think that low projected growth rate affects the investors' view of this company?

A. Actually, I think it accurately reflects what investors are pricing into Empire's stock. Investors may tell you they expect -- I mean, I would love to expect to have a 12 percent return on a stock, a utility stock, but that may not be necessarily what I'm pricing into the stock. Once I buy that stock, that DCF result is going to show you actually what I'm requiring. Now, you can -- you know, there are times when expected returns may be higher than the required return. That's what I -- you know, I think investors --

Q. Okay. Let me -- your testimony earlier was that return on equity should be equal to cost of capital, correct?

A. Yes, and I think every witness in this case agrees with that.

Q. Okay. Back to page 30 of your testimony, you say, quote, I determined the upper end of my range of growth by recalculating ValueLine's projected EPS growth without the inclusion of Empire's anomalous year in 2001.

A. Yes.

Q. We heard testimony from one of Empire's witnesses yesterday. I can't remember the gentleman's name at the present moment. He was saying that 2004 could be another, quote, anomalous year for earnings, or at least that was my impression of what he testified to. Do you have any feelings about using 2004?

A. Yes. I don't think it would be appropriate, because investors look forward. Investors don't -- obviously they realize that these are years that are not normal, and as CEO, Mr. Gipson indicated himself, these are buy and hold shareholders. And if you have that in mind, it's just like everybody's told this when they're investing for the long term, you don't focus on the volatility of the stock from year to year, and you don't focus on the volatility of the earnings per share from year to year.

You're trying to look at the long-term trend of the growth and look at the fundamentals of the company. And if the fundamentals of the company are telling you that they can have 3 percent organic growth and that's what you're going to expect over the long term, you're not going to pay attention to all the noise.

Q. Okay. ROE should equal cost of capital. I think we've already established that. Do you think that ROE is the -- is that -- let me ask you this: Is that ROE the actual ROE the company is supposed to make or is that the opportunity to obtain that ROE?

A. When I set the allowed -- or when you set allowed rate of return obviously, and I recommend a rate of return, that that is not necessarily going to be, you know, what they earn. It's the opportunity to earn that rate of return. That's why I'm a little curious about saying, well, you set the allowed rate of return a little higher so we can meet our allowed rate of return.

Well, if you set the allowed rate of return higher, they may be able to earn their actual cost of equity because you build in a cushion. But setting an allowed rate of return higher is not going -- they're still going to have -- there's still something going on there in, you know, in the earnings that's not allowing them to get up to that allowed return that we've authorized.

Q. And have you looked at why Empire has never been able to achieve their allowed rate of return?

A. That's -- I know that's a very good question, because I know there's been six rate cases since 1990. I think they've had a rate case in 1990, 1994, 1995, 1997, 2001, 2002, 2004. And I think in only one there's been -- this is the second case that's gone to litigation, and I believe all the accounting issues in this case have settled, so obviously there's somebody walking away or thinking that they have a fair decision here, because otherwise I wouldn't think those cases would settle.

And so I -- and the dividend payout ratio's been a problem since 1992, and that's actually why I looked at what has the rate case activity been since 1990 because there is that -- there is that, quote, you know, position out there that the reason why this company has a high payout ratio is because it can't earn its allowed return. Well, obviously, if they already had that many rate cases throughout that process, what's going on there? I mean, that's before your time and my time.

Q. Right.

A. So there's an issue there.

Q. Mr. Murray, I certainly get the impression from some of the testimony that we've heard here this week that there are at least some members of Staff who think that every utility ought to come in here every two years for a rate case. I mean, do you agree with that assessment?

A. Oh, I -- a utility company should come in here whenever it deems that it's not recovering its cost of service. Do I enjoy sitting through rate case procedures? No, I don't. I just know what my duty is, and it's to recommend the cost of capital. I don't know what's going to happen to the level of interest rates for sure two years from now. If they go up, then -- you know, then they'll have a higher recommended rate of return. I don't know if it's going to -- if it's going to stay at the same level and they'll be able to diversify their fuel mix. Those are all things that I think we're all very uncertain about.

Q. Let me ask you this: How did your ROE recommendation differ from witness Travis Allen's ROE recommendation?

A. The main difference in our ROE recommendation is in the dividend yield. It's not in the growth. He has a 3 percent growth in his recommendation. He used six weeks of stock prices which actually captured that down period, which would raise the dividend yield up, and -- excuse me. I believe his dividend yield was about 30 basis points higher than my dividend yield. I prefer to use a longer six-month average, because you can capture more cycles of an up and down period in a stock price.

Q. Did you -- did you listen to the testimony we had here yesterday?

A. Yes, I did.

Q. Do you recall Mr. Krueger cross-examining Empire's witnesses about the possibility of reducing their dividend to, I guess, free up cash?
A. Yes, I do.
Q. Do you have an opinion as to whether or not that would affect Empire's stock price?
A. I believe it's in my testimony. I think in the short term, you know, an immediate effect, you definitely have the clientele effect. There are investors that invest in Empire's stock for the dividend. And I think that's going to be true for any regulated utility that you invest in to the stock for its dividend. It's not necessarily the fact that they have a -- you know, have a high payout ratio. It's the fact that the payout ratio is over 100 percent.
I would like to maintain, you know, a standard of living for myself, you know, that -- that is more than I make, but sometimes you have to react to the reality of the situation. And I think if you have a company that has a need to make future investments, then I think they would at least look into a little more detail. I just -- I'm concerned about the fact that they haven't looked at different scenarios as to how to optimize retaining some earnings for future investment needs.
This is not something that -- this is

not -- I'm not pointing this out to, you know, to say this company is -- I'm not pointing this out to badger the company. I'm pointing it out because it's not a practice that you would normally see. I think a common sense investor, if you see payouts over 100 percent, the message has already been sent. There's a signaling theory of cutting a dividend. The signal's already out there that this company cannot sustain that dividends per share unless -- we'll see what happens in this rate case.

Q. At one time -- now, do you still -- you provided testimony in a few telephone cases, correct?

A. A while back, yes, I did.

Q. So you haven't done any of those recently. I'm sorry if I'm being redundant here.

What do you anticipate Empire's needs for capital to be here in the next few years?

A. As I understand it, they're going to have to ramp up construction and just basically, from my understanding, I think in the next two years they're not going to have a lot of capital outlay, but in coming up to 2010, obviously they've indicated that they have to look at ways to replace maybe the expiration of their contract that comes due in 2010. I believe there was some discussion about Riverton 2008. Just basically --

Q. Have you had any discussions with anybody on Staff about the availability of long-term purchased power agreements?

A. No.

Q. Okay. So let me ask you this: Are you familiar with the term "used and useful"?

A. Yes, I am.

Q. And do you want to describe that concept for me?

A. Basically, since we're on the topic of generation plant, once it's up and running, that's when it would be included in -- included in rate base. It's used and useful for current customers.

Q. And so it's -- based on what I'm hearing from you, it sounds like it's your position that Empire should -- their shareholders should bear all of the risk of building a new power plant. Is that a fair assessment?

A. I don't believe that's my view. I believe that's something in public -- or at least Missouri regulation for some time.

Q. Is that in terms of -- let me ask you this: I mean, so do you think it's a good idea that Empire is so natural gas dependent?

A. No, I don't. We probably wouldn't be here right now if they didn't have this problem.

Q. Let me ask you this: With low returns on

equity, how do you ever break the cycle, by financial
planning and long-term?
A. I don't know. That's a good question, a very good question. I think that's something that we have a small company here that has problems with being able to take on larger projects. They usually have to partner up with other utility companies. The -- obviously there isn't any retained earnings because they're paying out everything in dividends. So I think that there are -- you know, there are a multitude of factors here that, you know, really do need to be looked at. This is not something to be taken lightly. This is -- I think there's more to it than looking at just boosting return on equity and then that's going to solve all the problems.
Q. Well, let me ask you this: I mean, do you think it's realistic with their credit rating that they can just go out and borrow more money to build a coal plant?
A. I think there are many things within corporate finance that have to be taken into consideration to determine how this is going to be done. There needs to be a long-term plan, you know, or maybe --
Q. Don't they work with our Staff every six months or a year to develop a long-term plan?
A. Not on the financing side, as far as I

know. Maybe they talk about the resource planning, which I'm not involved with that much. But like as far as, you know, the capital -- maintaining the capital structure and how that dividend policy might affect the capital structure, I haven't had any discussions with them about that.

Q. So would you be amenable to going over and giving some Empire -- Empire some advice about how they can be better fiscal stewards of their investors' money?

A. I think you'd probably want to hire a corporate consultant to look into things in a little more detail. Plus I guess it might not be appropriate for me.

Q. Okay. I don't think I've got any more questions at this time, but I do want to see the whatever it is -- what do we call that?

A. Policies.

Q. Yes, the policies.

JUDGE THOMPSON: Let's talk about those policies for a moment. When will you be able to supply those?

THE WITNESS: I could provide them by tomorrow morning. Is that fine?

JUDGE THOMPSON: As far as I know, tomorrow morning's okay. Is that sufficient, Commissioner?

COMMISSIONER DAVIS: If it's in the

building and readily available, if it's 4:40, I'm willing to stay here tonight.

THE WITNESS: Sure, I can get them to you tonight.

JUDGE THOMPSON: Very well. Commissioner Appling, did you have any questions?

QUESTIONS BY COMMISSIONER APPLING:

Q. Mr. Murray, one question, please. Taking a look at your direct testimony and listening to what you've had to say here today, in your cost of capital, do you still stand by your recommendation?

A. Yes, I do.

COMMISSIONER APPLING: Thank you very much.

THE WITNESS: Thank you.

JUDGE THOMPSON: Further questions from the Bench, Chairman Gaw?

CHAIRMAN GAW: Just briefly.

FURTHER QUESTIONS BY CHAIRMAN GAW:

Q. You may have done this earlier, but you ran the -- you looked at the 2000 -- was it the 2002 case, 2001 case?

A. I looked at both cases, yes.

Q. And there was a Staff recommendation in both cases?

A. Yes, there was.

Q. Both cases settled?

A. No. 2001 went to hearing on rate of return and, I believe, depreciation.

Q. All right.

A. And the Commission authorized a 10 percent return on equity in 2001.

Q. In 2001. All right. And then in 2002?

A. Yes.

Q. Was there any adjustment on the ROE?

A. My recommendation in 2002 was 9.16 to 10.16.

Q. So you were recommending something that was less than what had been done before?

A. Based on dividend yield and lower growth rate estimations, yes.

Q. Do you know what Staff's recommendation was in the '01 case?

A. It was -- I think it was actually -- they went with OPC, and it was below 10 percent. I don't recall the specifics.

Q. Staff went with OPC?

A. No. Staff was below 10 percent, so it was below OPC, I believe.

Q. All right. Oh, I see what you're saying. The Commission went with the OPC recommendation?

A. Yeah. That was the low end. I think OPC was 10 to 10.25, and the Commission ruled on 10 percent.

Q. Now, in looking at -- did the -- did your running of the DCF model in this case, was it consistent with the running of that model by Staff in the '01 case and the '02 case?

A. It was consistent in the fact that we used -- or I used the same process of looking at the growth rates and determining what appear to be reasonable in the 2002 case, which is the case that I did. I can't speak so much for the 2001 case because I didn't do that case. But in the 2002 case I was looking at IBES and S&P growth rates, but at the same time ValueLine had the same problem with their -- with their projected growth rate, actually from one quarter, because at the end of -- at that time 2001 was an estimate, so it wasn't included in the base period for their first quarter estimate, so they were estimating about a 4.5 percent growth.

And then the next quarter, once that 2001 earnings per share figure went in there, their projection went all the way up to 9.5 and the stock price did not increase with that increased projection. So in my mind that shows you that investors are smarter than that. They don't just accept a 5 percent increase in growth estimation because they're investing for the long term.

So I had that same situation and I tried to evaluate that in that case, and there was, I think, a low estimate of 3 and a high estimate of 4 as well. And I believe I looked at A.G. Edwards. They had an estimate of 3 percent growth there, too. So I went with 3 to 4 in that case.

Q. So there was a -- in that case, were you the witness in that case?

A. In the 2002 case, I was.

Q. And in the -- in the 2002 case, you said 3 to 4?

A. Yes.

Q. Okay. All right. Now, if in looking at the numbers that plug in to the DCF model now as compared to where those numbers would have been in the '01 case and in the '02 case, have those -- would those numbers be trending the result upward or downward?

A. If I plug 3 to 4 in?

Q. Well, and what has occurred since then.

A. I'm not -- I'm sorry. I'm not sure --

Q. Well, that's not a very good way of asking the question. I'm trying to understand what the trends have been that impact the DCF model since those two cases have occurred in regard to the outcome that you get on the DCF model. Is that clear?

A. I think I understand. The dividend yield decreased slightly in this case to the last case, but most of that has to do with my revision of the estimate -- estimated growth. Like I said, the last case I had a growth rate of 3 to 4. If I plug 3 to 4 into this DCF on the 6 percent dividend yield I had in this case, I would come up with a 9 to 10.

Q. And why did you move it down in this case from where it was in the last case?

A. Because the growth rate estimations are down from IBES and S&P. I believe S&P had a 4 in the last case. They have 3 in this case. IBES has 2 to 3. Not only that, at the 2001 time, Empire had projected a 2.8 kilowatt hour demand growth. Now they're down to 2.4 to 2.5. So there have been some fundamental changes. So that was my rationale.

Q. Were there CAPM models run in those two cases?

A. Yes.

Q. So do you know what the results were for that?

A. I'd have to look that up for you. I don't recall.

Q. Would that be possible to get?

A. Yes, I could.

Q. Did -- does Empire have -- have a pension fund?

A. Yes,

Q. Do you look at the pension fund?

A. No, not -- no, not on a regular basis, but that is interesting to bring that up. When I did look in the Arkansas case, they -- I believe it was their Attorney General witness looked at some of the assumptions they had for their expected stock market returns, and I believe he --

Q. Well, I don't want to get too far.

A. I'm sorry. Sorry.

Q. We've been doing this so much, I'm beginning --

A. I apologize.

Q. Thankfully -- I'm not sure if I'm thankful or not that no one's objecting to that, but I do want to -- I would be curious about, if you haven't looked at it, whether or not any Staff, any Staff is familiar with what the expectations are.

A. Sure, I can find out.

Q. Do you know?

A. I don't know. I can find out who did the pension issue and if they looked at that specifically.

Q. Is that matter settled?

A. It settled.
Q. But there was somebody that looked at that?
A. Yes, as far as pension expenses.
Q. And they would be available if I wanted to ask them a question?
A. I'm sure -- I'm sure they could be made available.
Q. Or maybe I could ask a company person. I don't care. But I'll let that go, but I would -- I would be interested in knowing that, whether that's from you, Mr. Murray, or from counsel, who would be available.
CHAIRMAN GAW: That's it. Thanks.
JUDGE THOMPSON: Thank you, Mr. Chairman. Additional questions from the Bench?
(No response.)
JUDGE THOMPSON: Okay. We're going to recess for the day at this time, and we will return here tomorrow at 8:30 in the morning. That's 8:30 in the morning, one half an hour before nine o'clock in the morning, and we will attempt to go back on the record and move forward with the case at that time. We are in recess.
WHEREUPON, the hearing of this case was recessed until December 15, 2004.

I N D E X

RATE OF RETURN

EMPIRE'S EVIDENCE:

STAFF'S EVIDENCE:

OPC'S EVIDENCE:

EXHIBITS INDEX