BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric Company of Joplin, Missouri for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company.	)))))	**Case No. ER-2008-0093** Tariff File No. YE-2008-0205

DISSENTING OPINION OF COMMISSIONER KEVIN GUNN

This Commissioner concurs with many of the majority positions contained in the Report and Order. However, the majority's authorization of a 10.8 percent return on equity (ROE), rather than an ROE of 10.5 percent or less, forces this Commissioner to respectfully dissent. While the record supports most of the findings made by the majority in reaching their ROE recommendation, the record does not support the majority finding that Empire remains more risky than the proxy groups used by Vander Weide, Gorman or Barnes following the implementation of the authorized fuel adjustment clause. Accordingly, the majority's upward adjustment to its ROE recommendation to compensate Empire's share holders for the risk associated with the company's BBB- bond rating, as opposed to the BBB+ average bond rating of each proxy group was inappropriate. The more credible evidence supports a ROE of no higher than 10.5 percent and demonstrates that a 10.8 percent ROE is simply too high.

The evidence supports, and this Commissioner agrees with, the following majority findings. First, some of the underlying assumptions in both Gorman's single-stage and two-stage DCF models were arbitrary and flawed yielding recommended ROE recommendations that were over 200 basis points apart. Second, although each may be individually flawed, Gorman's single-stage and two-stage DCF models do not need to be discarded, but can reasonably be averaged in that combining the results of the two models mitigates their individual weaknesses thereby producing a reasonable and balanced ROE recommendation. And finally, a ROE of 10.5 percent, taken from averaging Gorman's single-stage and two-stage DCF models is an appropriate ROE for Empire provided Empire's level of business risk is comparable to that of the proxy groups.[1]

The flaw in the majority opinion is that the majority's 25 basis point upward ROE adjustment to compensate for Empire's lower bond rating is not supported by record evidence. In determining the appropriate ROE for Empire, it is appropriate to consider whether the calculated ROE should be adjusted to take into account a higher or lower level of operational risk Empire faces compared to the companies in the proxy groups. If the calculation does not take into account additional risk faced by Empire that is not faced by the proxy group companies, it is appropriate to adjust the ROE slightly upward. However, if, as in the present case, the ROE calculation already takes any such risk differential into account, then an adjustment is not necessary.

The majority found Empire riskier than the companies contained in the proxy groups because the average bond rating of each proxy groups is BBB+ while Empire's current bond rating is only BBB-. The majority further found the risk difference associated with having a BBB+ verses a BBB- bond rating is worth 25-50 basis points and adjusted their starting ROE of 10.5 up to 10.75 based upon that perceived risk differential.

The majority's addition of 25 basis points to Empire's authorized ROE to account for Empire's higher level of risk compared to the proxy group companies based upon Empire's

[1] Although not relevant to this dissent it is worth noting that other record evidence not cited by the majority further supports a ROE of 10.5 percent for Empire provided its business risk is comparable to that of the proxy groups.

inferior bond rating would have been reasonable, but for their subsequent reduction to Empire's business risk through the authorization of a fuel adjustment clause. Empire's BBB- bond rating is based upon the level of risk it faced in the environment in which it operated on the date it received that rating. On the effective date of the majority's Report and Order a significant change occurred in Empire's level of risk. Specifically, the majority, with the support of this Commissioner, authorized Empire to adopt a fuel adjustment clause. In the environment where Empire received its BBB- rating, Empire did not have a fuel adjustment clause. As found by the majority, the implementation of a fuel adjustment clause will reduce the level of operating risk that Empire faces.

For Empire's proposed test year revenue calculation, the cost of fuel and purchased power equals 37.63 percent of the company's revenue requirement. Over the past 5 years, Empire's fuel costs have increased by seventy percent. Staff estimated that between 2002 and 2006, Empire's shareholders had to absorb approximately $85.5 million of fuel and purchased power costs between rate cases. Due to rising fuel costs, Empire's actual earned ROE in 2006 was about nine percent, and that number dropped to about seven percent in 2007. The fuel adjustment clause authorized in this case will allow Empire to recover ninety-five percent of these costs going forward. Clearly the reduction in Empire's operational risk following the implementation of a fuel adjustment clause will be significant.

The majority also notes that most of the companies included in the proxy groups used by the analysts already operate under a fuel adjustment clause, and on that basis analysts Vander Weide and Barnes agreed no adjustment to their recommendations would be necessary to recognize the implementation of a fuel adjustment clause in this case. However, Barnes' position that his recommended ROE did not need to be adjusted downward if Empire received a fuel adjustment clause, was based upon his position that the reduced risk Empire would face with an fuel adjustment clause was comparable to the risk level of the proxy group companies that already had fuel adjustment clauses. He did not support raising Empire's ROE to account for its higher level of risk compared to the proxy group companies as reflected by the difference in bond ratings, reducing that risk difference by authorizing Empire to implement a fuel adjustment clause, and then failing to account for that risk reduction in its ROE calculation.

The majority's circular logic on this point is flawed. Although the majority found the implementation of a fuel adjustment clause will reduce Empire's business risk, they ignore the impact the higher level of risk Empire faced prior to such authorization would have had on Empire's bond rating.

The record supports, and this Commissioner agrees with, the majority finding that a quarterly DCF model more correctly equates the present value of future dividends to the current stock price for the companies, like Empire, that pay quarterly dividends. However, the mere five basis point difference between the results obtained using the two models is too slight to be of real significance and does not justify making an adjustment in a ROE calculation.

In addition to the points above, this Commissioner also agrees with other findings by the majority. First, that a larger proxy group is preferable, if such a group consists of companies with similar risk. Second, the proxy groups used by Vander Weide, Gorman and Barnes are all, on average, less risky than Empire, at least prior to the majority's decision in this case given that each proxy group had an average bond rating of BBB+ verses Empire's BBB- bond rating.

The evidence further supports the finding that it is appropriate to utilize an average of recently authorized returns on equity for vertically integrated electric utilities, excluding wires-only utilities, in a risk-premium analysis because Empire is a vertically integrated company and, as such, its risks are more in line with other vertically integrated electric utilities. The evidence shows that integrated electric utilities are generally more risky than wires-only electric utilities because, unlike wires-only electric utilities, they must make large investments in electric generation plant, operate generating plants and buy fuel to run those plants. The evidence further shows that increased risk generally translates into an increased allowed ROE and regulatory agencies around the country have recognized that increased risk by allowing integrated electric utilities higher returns on equity.[2]

This Commissioner also believes that the calculations performed by and ultimately the ROE recommendation of Empire witness, Vander Weide were seriously flawed. Specifically, Vander Weide's risk premium analysis was inflated due to his use of unreasonably high DCF return estimates. Further, Vander Weide's capital asset pricing model (CAPM) analysis resulted in an unreasonably high ROE estimate due to his inappropriate use of the 2007 average yield to maturity on 20-year Treasury bonds as his estimate of a risk-free rate. The record also supports the finding that the yield on 30-year Treasury bonds is the best measure of the risk-free rate for use in CAPM and risk premium analysis because common stock is generally viewed as a long-term investment where the dividends last indefinitely.

While most of the Report and Order is based upon the record evidence, in making their findings the majority seem more driven to justify a desired ROE than to analyze and accept the evidence presented in this case. This Commissioner believes the evidence

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[2] It is worth noting that the Regulatory Research Associates reported the average return on equity allowed in 2007 to integrated electric utilities, excluding wires-only electric utilities, was 10.51 percent. See: Vander Weide Surrebuttal, Ex. 30, Page 10, Lines 3-11.

supports a ROE of 10.5 percent or less and does not support the 10.8 percent ROE authorized by the majority. Therefore, this Commissioner must dissent.

Respectfully Submitted,

K. P. G

Kevin Gunn
Commissioner

Dated at Jefferson City, Missouri,
on this 12th day of August 2008.