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July 20, 2001

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Missouri Public Service Commission

Mr. Dale H. Roberts
Secretary/Chief Regulatory Law Judge
Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: The Empire District Electric Company
Case No. ER-2001-299

Dear Mr. Roberts:

Enclosed for filing in the above-referenced case please find the original and eight copies of **INITIAL BRIEF OF THE OFFICE OF PUBLIC COUNSEL.** Please "file" stamp the extra-enclosed copy and return it to this office.

Thank you for your attention to this matter.

Sincerely,

John B. Coffman
Deputy Public Counsel

JBC:jb

cc: Counsel of Record

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In The Matter Of The Empire District Electric Company's Tariff Sheets Designed to Implement a General Rate Increase for retail Electric Service Provided to Customers in the Missouri Service Area of the Company.	)))))	Case No. ER-2001-299 Tariff No. 200100518

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Missouri Public Service Commission

INITIAL BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

John B. Coffman (#36591)
Deputy Public Counsel

July 20, 2001

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I. INTRODUCTION

This Initial Brief contains arguments in support of the Office of the Public Counsel's (Public Counsel's) recommendations regarding the issue of the appropriate capital structure and return on common equity that should be used for the calculation of Empire District Electric Company's (Company's) rate of return in this rate case.

There are other issues for which Public Counsel has testified or has advocated a position were ultimately resolved by unanimous settlement prior to the conclusion of the evidentiary hearing held in this matter on May 29, 2001 through June 7, 2001. These issues include a prudence adjustment proposed by the Commission's Staff (Staff) regarding the construction of the State Line Power Plant, as well as fuel and purchase power issues and recommendations regarding rate design. Public Counsel fully supports these settlements pursuant to the terms of the respective Stipulation and Agreement documents filed with the Commission. Unanimous Stipulation and Agreement Regarding Fuel and Purchase Power Expense and Class Cost of Service and Rate Design, filed on June 4, 2001, Exh. 118; Unanimous Stipulation and

Agreement As to State Line Combined Cycle Unit Capital Costs, filed on May 25, 2001, Exh. 82. It is Public Counsel's hope that the parties have satisfied any Commission question or concern regarding these settlements. If the Commission is inclined to reject either of these settlements, it would respectfully request that the Commission notify the parties of this fact and permit additional hearing dates soon to permit cross-examination on these matters.

There is the possibility that additional contested issues could develop pursuant to the true-up procedure in this case. Any such issues will be identified in prepared direct and rebuttal testimony to be filed with the Commission on August 7 and 13, 2001, respectfully. As is discussed in this brief, Staff and Public Counsel have also recommended that Company's actual capital structure be updated as of June 30, 2001 and revised through the true-up procedure in this case, which would ultimately impact the rate of return calculations.

II. ARGUMENT

A. What capital structure is appropriate for Empire?

1. Public Counsel's Recommendation

Public Counsel believes that the Commission should recognize Company's **actual** capital structure for ratemaking, as the Commission has traditionally done in almost every past-litigated utility rate case. Both Staff and Public Counsel recommend utilizing Company's actual capital structure as of the end of the approved test year in this case, and updated through the true-up process to June 30, 2001. (Tr. 599). At the end of the approved test year in this case, which consists of the twelve months ending December 31, 2000, Company's actual capital structure was as follows:

	Amount	Percent
Common Stock Equity	$ 240,152,911	41.86%
Long Term Debt	$ 333,603,856	58.14%
	$ 572,756,767	100.00%

Burdette Direct, Exh. 86, Schedules MB-2 and MB-5.

The actual capital structure and weighted average cost of capital are shown on Schedule MB-10, contained in Exh. 86. These numbers are likely to change pursuant to the true up, and should, in order to use the most reasonably up-to-date data. The most important principle to which the Commission should adhere regarding the capital structure issue is that an *actual* level should be recognized.

Company, however, is recommending that the Commission utilize a hypothetical capital structure for the purposes of this case, which would assume that Company had a ratio of 52.5% debt and 47.5% common equity. The result of hypothetically adding more common equity than Company's actual capital structure included would be to directly and inappropriately increase the rate of return and the revenue requirement in this case.

It is true that Company's capital structure is more currently debt-heavy than it has been in the past. See historical capital structures on Schedule MB-1 attached to Exh. 86. However, it was Company's management that voluntarily chose to retire its preferred stock, it was management that chose to issue additional long-term debt, and it was management that chose not to issue additional common stock. Exh. 86, p. 5. It was also Company's management that chose to initiate a rate case at this time while the test year capital structure was in place. Consumers have no ability to influence a utility's capital structure nor do consumers have any ability to influence the timing of rate increase requests.

In order for the Commission to appropriately set just and reasonable rates, it must calculate new rates based upon the interrelationship of a utility's investments, expenses and all other relevant factors within a prescribed test year period. Not only is Public Counsel's capital structure recommendation consistent with the actual capital structure of this electric company, it is also fair based upon a comparison of similar companies. Company's common equity ratio is currently very similar to the average level of common equity for the comparable groups analyzed by Public Counsel Financial Analyst Mark Burdette in his Discounted Cash Flow (DCF) Analysis. Mr. Burdette explains:

> Based on Value Line's methodology, Empire's common equity ratio was 40% for year 2000, compared to an average level of 40.8% for my comparable group. According the Value Line's Composite Statistics, Empire's levels of common equity for 1999 and 2000 were lower than the average common equity ratio for the electric industry overall (Schedule MB-4). The 29 Electric Utilities covered by C. A. Turner Utility Reports have an average common equity ratio of 38% - actually lower than Empire's level.
>
> Exh. 86, p. 5.

Similar levels of common equity imply similar risks. Mr. Burdette's comparison companies, like Company, are all relatively small utilities with similar risks. Id.

Empire's actual capital structure is certainly within the zone of reasonableness for an electric utility and is the most appropriate capital structure to use for the calculation of Company's overall rate of return. Exh. 87, p.2.

2. Company's Recommendation

Company witness Donald A. Murry recommends that the Commission utilize a hypothetical capital structure (52.5% debt and 47.5% common equity) based on the contention the current capital structure is temporary. Tr. 404. The problem is that Company's management is under no obligation to alter Company's capital structure. Mr. Murry's hypothetical "pro forma" capital structure is not currently representative of Company's actual financing, and there is no way to know that it will represent Company's capital structure in the near future.

Company made alterations to its capital structure presumably because of Company's involvement in the ultimately unsuccessful merger it proposed with UtiliCorp United, Inc. in Case No. EM-2000-369. Exh. 87, p. 3. Regardless of the reason Company changed its capital structure to its current level, it does not justify using hypothetical numbers. Public Counsel believes that consumers should not pay higher rates as the result of a failed merger (anymore than they should have to pay higher rates as a result of a successful merger). The best policy to use when determining capital structure is one that recognizes the reality of Company's actual equity ratio during the test period being analyzed in this case.

All parties filing rate of return testimony made recommendations regarding the embedded cost of long term debt that falling within a range of three basis points. Exh. 87, p. 4. Staff calculated this embedded cost at 7.88%, Company calculated the embedded cost at 7.91%, and Public Counsel calculated embedded cost of 7.895%. Public Counsel is essentially in agreement with Staff's methodology for calculating the embedded cost of Company's debt. Id.

B. What return on common equity is appropriate for Empire?

1. Public Counsel's Recommendation

Public Counsel Financial Analyst Mark Burdette performed a DCF analysis, substantiated by a Capital Asset Pricing Model (CAPM) analysis, which suggests a return on common equity (ROE) recommendation in a range of **10.0% to 10.25%** for this case. Burdette Direct, Exh. 86, pps. 7-19. The DCF analysis generates a cost of equity of 10.06%. Id., p. 17. Company's growth rates tend to be higher than comparable companies, but its dividend yield is higher.

Mr. Burdette's performed a standard DCF analysis in the manner that the Commission has approved in countless prior rate cases for determining a proper return on common equity for regulated utilities. The DCF model is represented by the following equation: $k = D/P + g$ where "k" is the cost of equity capital (i.e. investors' required return), "D/P" is the current dividend yield (dividend (d) divided by the stock price (P) and "g" is the expected substantial growth rate. Exh. 86, p. 7. Assumptions and procedures for implementing the DCF analysis are explained in detail in Mr. Burdette's prepared testimony. Id., pp. 7-9. A concise explanation of the theory behind traditional rate of return regulation and a discussion of how the cost of capital components fit into this regulatory theory can be found in appendices to his direct testimony. Id., Appendices A-C, pp. 21-27.

The growth rate variable included in the DCF analysis represents the growth rate that investors expect into the indefinite future—the sustainable growth rate. Id., p.9. The sustainable growth rate for Company was calculated by Mr. Burdette using both historical and projected rates for 1) earnings per share (EPS), 2) dividends per share (DPS), and 3) book value per share (BVPS). Id., pp. 12-16. This analysis was performed on a group of six comparable companies that were carefully selected. Id., pp. 3, 13. Three of these six companies were also selected by Company for use in its DCF analysis, but three of the companies used by Company were not in fact comparable, as is discussed below. Mr. Burdette's calculations for each of the comparable companies are shown in Schedule MB-6 to Exhibit 86. (Note that a correction was made to Schedule MB-6 at the hearing and, for the Commission's convenience, replacement pages for this schedule were accepted into the record as Exhibit 105.)

Based upon this analysis, Mr. Burdette included a growth rate of 3.5%, which is greater than the calculated overall average, but similar to the projected rate. Id., 16. It should be noted that Company's growth rates were generally lower than the averages for comparable companies. Id. Public Counsel's recommended growth rate winds up squarely in the middle of Staff's recommended range for a growth rate (3%-4%). Tr. 608.

The appropriate dividend yield for Company in this case is 6.56%, based upon the stock price and expected dividend yield. Exh. 86, p. 16. As Mr. Burdette explained in response to a question from Commissioner Gaw at the hearing, an appropriate dividend yield calculation is based on a current stock price. Tr. 610-612. Mr. Burdette utilized a stock price of $19.52 by averaging Company's stock price over the most recent six weeks to reduce daily variability in the stock price. Tr. 612. By comparison, Staff utilized a stock price over $24, which was based upon a monthly high/low average market price for a long historical period (October 1, 2000 through March 4, 2001). McKiddy Direct, Exh. 61, p. 23. This difference in how the stock price was determined is the primary reason that Staff and Public Counsel differ in their return on equity recommendations. Tr. 613.

Mr. Burdette substantiates his DCF analysis with a CAPM analysis. The CAPM should not be a primary cost-of-capital analysis tool because it of its limitations in its ability to take into account certain risk factors. Exh. 86, p. 18. However, many investors continue to rely on CAPM and it can be a good secondary check of reasonableness. Mr. Burdette used a risk free interest rate of 4.76% and a market premium of 7.8% in his analysis, resulting in a CAPM cost of common equity for Company of 8.66%, clearly supporting Public Counsel's return on equity recommendation. Id., p. 19. The CAPM cost of equity for the DCF-comparison group ranges from 8.66% to 9.44%. Id.

2. Company's Recommendation

Company witness Murry also performed a DCF analysis. However, Mr. Murry's analysis is flawed largely because it focuses only on the larger calculated growth rates and inappropriately ignores rates on the lower end of his range. Ex. 13, Schedules DAM-7 through DAM-14. This deficiency in Mr. Murry's growth rate choices flows directly through the DCF model (1 percentage point of growth rate translates into 1 percentage point of ROE), resulting in an unreasonably high recommended return on common equity of 11.5% to 12.0%. Mr. Murry's chosen growth rate is unsupported by his analysis or any evidence on the record in this case. While it may be appropriate to exclude particular calculated growth rates (i.e. negative growth rates or growth rates for a company that had a pay ratio of greater than 1.0), but excluding growth rates merely because they don't support an ROE that is as high as desired is unreasonable. (Ex. 87, p. 5). If Mr. Murry had considered the full range of his very own calculated growth rates, his recommended return on equity for Company would be significantly lower than 11.5%. Id.

Company's DCF is also faulty because of the "comparable" companies it analyzes. Three of the companies Mr. Murry chooses for his DCF analysis are insufficiently comparable for an appropriate analysis. Two of these companies, UIL Holdings and C.H. Energy Group derive a significant amount of its energy generation from nuclear power plants. Tr. 386. Mr. Murry acknowledges that, to some degree, the business risk is different for a company that relies on a nuclear power plant as opposed to an electric company like Empire District Electric Company, which does not rely on nuclear power plants. Tr. 384-385. Mr. Murry also claims that one criteria for choosing his comparable companies was a requirement that 50% of the previous year's total revenues had to be derived from electricity. Ex. 13, p. 7. Public Counsel believes that allowing up to 50% of unregulated revenues for a company to be compared to Empire District Electric Company is setting the bar too low. It permitted Mr. Murry to include UIL Holdings, a company that derives 46% of its total revenues from sources other than regulated electric service. Tr. 387. Company's unregulated revenues total more than 90%. Tr. 388.

Mr. Murry's CAPM analysis should also be rejected. Mr. Murry utilized two different interpretations of the CAPM model. Ex. 13, Schedules DAM-15 and DAM-16. Mr. Murry failed to explain his various applications of the CAPM. His two CAPM schedules include various calculations and adjustments, but the record contains no supporting quantitative or qualitative evidence to support his methodologies.

III. CONCLUSION

Public Counsel respectfully requests that the Commission approve Company's actual capital structure at the end of the true-up and utilize a return on common equity in its ratemaking calculations for Company somewhere in the range of 10.0% to 10.25%. Company's return on equity recommendation is based upon faulty or unsubstantiated analysis. Staff's return on equity recommendation is somewhat low, primarily as a result of using a stock price that was not sufficiently current.

Respectfully submitted,

OFFICE OF THE PUBLIC COUNSEL

BY: [signature]

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CERTIFICATE OF SERVICE

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