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Empire District Electric Rating Placed on CreditWatch Negative

Publication date: 28-Sep-2004

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Credit Rating: BBB/Watch Neg/A-2

Rationale

On Sept. 28, 2004, Standard & Poor's Ratings Services placed its 'BBB/A-2' corporate credit rating on Empire District Electric Co. on CreditWatch with negative implications. The CreditWatch listing reflects prospects for erosion of Empire's pressured financial condition if recent testimony by the Missouri Public Service Commission (MPSC) staff in Empire's pending general rate case is ultimately endorsed by the MPSC. Hearings begin in early December with a final order due by March 27, 2005.

Joplin, Mo.-based Empire has about $400 million in long-term debt outstanding.

Empire is seeking a $38.3 million (14.8%) rate increase that is predicated on a return on common equity (ROE) of 11.65%. The utility is also requesting a five-year interim energy charge (IEC) to help manage risk and recover fuel costs. The MPSC staff has recommended an ROE range of 8.29% to 9.29% with 8.79% as the midpoint which would result in a revenue increase of only $9.5 million at 8.29%, $12 million 8.79%, and $14.4 million at 9.29%, inclusive of the IEC period. Furthermore, the staff has proposed that the IEC be adopted for a period of only 24 months, owing to the extreme volatility of natural gas prices. Because there is no fuel djustment clause in Missouri, reinstatement of the IEC for a longer period would provide for more predictable and stable earnings.

Although the staff's recommendation is not binding on the commission, an MPSC order that mirrors the staff's recommendation would harm Empire's creditworthiness. The requested rate hike is needed to recover capital additions, including two peaking units that were installed in 2003, higher operating and maintenance expense, escalating pension and health care costs, and rising fuel and purchased power costs.

Empire's credit quality reflects an average business profile and a financial position (adjusted for off-balance-sheet, purchased-power obligations) that remains somewhat weak, albeit improving, for the current ratings. Empire benefits from a service territory with a well-diversified business mix, below-average rates due to the low embedded cost of its coal plants, and adequate liquidity. However, the company remains challenged by its regulatory environment. Empire is a public utility involved in the generation, purchase, transmission, distribution, and sale of electricity primarily in Missouri (89% of electric operating revenues), Kansas (6%), Oklahoma (3%), and Arkansas (3%).

Empire's business profile is supported by a healthy service area with little industrial concentration. The territory consists primarily of small, rural customers that benefit from Empire's below-average rates, which the company derives from low-cost coal plants. The company does conduct some higher-risk, nonregulated activities, but they are extremely limited and Empire has demonstrated its willingness to exit ventures if financial performance does not materialize.

A challenging regulatory environment tempers the strengths of Empire's business profile. Under the jurisdiction of the MPSC, Empire suffers from relatively low allowed ROEs, receives low depreciation allowances, and lacks a fuel-adjustment clause to help shield the company from its markedly increased natural gas dependence. The absence of a fuel-adjustment clause exposes Empire to potential fuel and purchased-power price volatility, which concerns Standard & Poor's. Timely recovery of prudently incurred fuel and purchased-power expenses is important for Empire's credit quality.

Regarding its financial profile, Empire is focused on improving its earnings and cash flow protection measures by hedging fuel expenses and controlling other costs. As long as the company continues to aggressively hedge its forecast natural gas needs (as of April 2004, Empire had hedged about 65% of its remaining expected gas burn for 2004 with rates at or below those budgeted in its rate structure) and receives timely and adequate rate relief, key financial measures should fall be marginally suitable for the established risk profile at the 'BBB' level.

Empire's credit facility is rated one notch below the corporate credit rating to reflect its subordination to Empire's secured debt. Because the loan is unsecured, Standard & Poor's expects that lenders will fare the same as senior unsecured creditors in the event of a default.

Short-term credit factors.

The short-term rating on Empire is 'A-2'. For the short term, Standard & Poor's expects cash flow from operations to fully fund maintenance capital expenditures and dividends, assuming continued, timely recovery of regulatory-related costs. Future actions by the MPSC will weigh heavily on Empire's credit profile because of the lack of conventional regulatory support (no fuel-adjustment clause and no construction-work-in-progress recovery). The current short-term rating incorporates additional rate relief over the near term, given currently strong natural gas and coal prices. Empire's primary coal supply contract expires in December 2004, and current coal prices exceed those in its existing fixed-price contract. The ``ck of adequate rate relief would adversely affect the company's ..ofitability.

Empire's adequate liquidity is supported by access to a $100 million unsecured revolving credit facility that matures in April 2005 and limited, long-term debt maturities in the next five years. As of June 30, 2004, the facility was fully available and adequate for working-capital needs, assuming Empire continues to prudently hedge its expected natural gas burn. The facility includes no rating triggers, but requires total debt (excluding trust-preferred securities) to be less than 62.5% of total capital, and EBITDA to be at least 2x interest charges (including distributions from trust-preferred securities). Empire safely met the debt-to-capital requirement (46.5%) and the EBITDA-to-interest covenant (3.34x) as of June 30, 2004.

Other points of note include:

- The company annually distributes about $30 million in common dividends, which would provide flexibility in a liquidity crunch.
- Restrictions in Empire's mortgage bond charter, particularly an interest coverage requirement, would limit the issuance of new first mortgage bonds to roughly $213 million as of June 30, 2004. However, no such restrictions exist on unsecured debt issuances.
- Empire has limited room for capital expenditure reductions, as projected generation outlays are required to maintain reserve margins. Projected growth expenditures will require external funding.
- Although the company operates various diversified businesses, Standard & Poor's believes that their sale would generate few proceeds.

Ratings List

	To	From
Empire District Electric Co.		
Corporate credit rating	BBB/Watch Neg/A-2	BBB/Stable/A-2
Senior secured debt	A-/Watch Neg	A-
Senior unsecured debt	BBB-/Watch Neg	BBB-
Preferred stock	BB+/Watch Neg	BB+
Commercial paper	A-2/Watch Neg	A-2

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