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Witness: Gregory A. Knapp
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Before the Public Service Commission
Of the State of Missouri

Rebuttal Testimony

Of

Gregory A. Knapp

November 2004

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THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
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I Introduction

Q. Please state your name, position and business address.

A. Gregory A. Knapp. I am Vice President – Finance and Chief Financial Officer of The Empire District Electric Company ("Empire" or "Company"). My business address is 602 Joplin Street, Joplin, Missouri.

Q. What are your responsibilities in your position with Empire?

A. I am responsible for the accounting, tax, budgeting, financing and treasury activities of the Company.

Q. Please state your educational background and professional experience?

A. I hold a Bachelor's degree in Business Administration from Missouri Southern State University and an MBA from Southwest Missouri State University. I am a licensed Certified Public Accountant in the State of Missouri and a member of the Missouri Society of Certified Public Accountants and the American Institute of Certified Public Accountants.

In March, 2002, I was appointed to my current position. From July 2000 until rejoining Empire in January 2002 I served as Controller for the Missouri Department of Transportation. For 22 years prior to that I was employed at

Empire first as Director of Auditing and then as Controller and Assistant Treasurer. Prior to joining Empire in 1978 I worked first for an international public accounting firm and then a regional electric utility.

<u>II Purpose and Summary of Testimony</u>

Q. Please state the purpose of your rebuttal testimony?

A. In this testimony, I will discuss the financial impact on the Company of the low depreciation allowance recommended by Staff and OPC as well as discuss certain related energy policy issues.

Q. Please explain the purpose of depreciation in utility ratemaking.

A. Depreciation distributes long-lived asset costs by the assignment of depreciation rates to the individual accounting periods during the property's life, resulting in an allocation of costs to individual accounting periods. Included in this cost, in accordance with standard accounting / ratemaking principles, is a calculation of net salvage. Positive or negative net salvage is the value of the asset at the end of its life less the cost to remove and dispose of the asset. This allows for all of the costs associated with the asset, including net salvage, to be recognized by the customers that actually benefit from the use of the property.

Q. Does the Company support the depreciation rates that are reflected in the original filing?

A. Yes, The testimony of Company witness Donald Roff will support these calculations. Mr. Roff will also discuss the technical concepts of depreciation and why Empire can not support the rates proposed by Staff and OPC.

Q. Is the Company recommending the full impact of the depreciation rates to

be implemented from the original filing?

A. No. Empire filed schedules supporting the need for a $52.4 million revenue increase. However, the Company believes the magnitude of this increase would be too drastic for our customers. The Company determined to lessen the impact by approximately $14.1 million resulting in a $38.3 million revenue increase. The reduction was attributed to deprecation as explained by Company witness Roff in his rebuttal testimony.

Q. Why was there such a significant impact on deprecation expense?

A. The primary reason for the substantial increase is the fact that existing depreciation rates, as established in rate case ER-2001-299, are simply too low. Also having an effect are the retirement dates used to calculate the depreciation rates for production plant coupled with new investment and the effect of negative net salvage value.

III Financial Impact

Q. What are the financial impacts of a low depreciation allowance?

A. Technical and theoretical arguments aside, depreciation is a source of cash to partially fund the construction of new utility infrastructure. Our business model is straight forward; cash to run the business is either provided by the customers through rates or the cash is obtained in the capital markets. When this model is working properly, customers pay for the cost of providing utility service, including an appropriate depreciation allowance, plus the opportunity for the owners of the business to earn a fair return on their investment. When out of balance and customers are not fully paying the cost of service, the company is required to borrow more money to finance infrastructure requirements.

This is the situation in which Empire finds itself. Annual capital expenditures, excluding new generation additions, have been in the $40 to $45 million range in the last several years. This is a level of capital expenditures commonly referred to by the rating agencies as a "maintenance level" of expenditures, meaning this is the year in – year out level to fund the usual utility needs of providing safe and reliable service to customers. Contrast that to the annual depreciation allowance of around $28 million and it is easy to see that we are not even close to funding normal wear and tear replacements and new services without repeatedly going to the financial markets.

This unhealthy cycle ultimately results in increased costs because borrowing money is more expensive than using funds generated internally.

Q. What factors cause borrowed funds to be more expensive than internally generated funds?

A. First and most obvious there is a transaction cost to access the financial markets. Second, a utility suffering from a less than full recovery of cost will be assessed a higher cost of borrowing in the financial markets.

Q. Does the depreciation allowance ordered by the Commission impact the view of Empire by the financial markets?

A. Yes. This was very directly shown by Standard & Poor's in July 2002 when it lowered its credit rating on Empire to BBB from A-. S&P specifically cited Missouri's "low plant depreciations allowances" as one of three factors in the downgrade. (See Exhibit 1).

And on September, 28, 2004, S&P again took action as a result of concerns over Missouri regulation by placing Empire on “Creditwatch with negative implications”. S&P again referred to the “low depreciation allowances” (along with low allowed Return on Equity and a lack of a fuel adjustment clause) as a primary factor in the action. (See Exhibit 2).

Q. Are you aware of any other rating action taken against a Missouri utility where depreciation was cited?

A. Yes. I understand Moody’s downgraded Laclede Gas Co. in 2002 related, in part, to concerns over reduced cash flows related to low depreciation accruals. It is obvious the credit rating agencies hold a negative view of Staff’s depreciation methodologies. Staff’s and OPC’s approach leads to depreciation rates that are significantly lower than levels allowed in other states. Composite depreciation rates of 3.00% are more the norm and, as discussed by Empire witness Mr. Roff on pages 6 and 7 of his direct testimony in this case, the rates proposed by Staff and OPC are significantly below that. The unfortunate result is that infrastructure additions now and in the future will cost more to finance than might have been the case. These costs will ultimately be passed on to future customers.

<u>IV Other Energy Policy Issues</u>

Q. Are there other Empire specific concerns with Staff’s approach to depreciation?

A. Yes. Staff’s approach imposes additional risks on both Empire and our customers. Depreciation expense and thereby customers rates are certainly lower under Staff's approach, at least in the near term. However, our business and responsibility, as well as, the State's business and responsibility go beyond the near term and extend far into the future to assure adequate utility infrastructure in the years to come. Unreasonable deferral to some future period of net salvage on assets being consumed today increases the risk of recovery for the utility and certainly increases the cost to future customers. And to the extent credit ratings are damaged, costs will be even higher. Additionally, I do not believe it is appropriate to saddle future generations of customers with the cost of removing and disposing of assets (net salvage) that are being used today. Inter-generational equity is the ratemaking concept whereby the customers receiving benefit from service pay for that service. Standard depreciation practices and Empire's proposal both reflect net salvage in a manner that charges customers with their fair share of this cost. The approach advocated by Staff and OPC is counter to this basic principle.

Q. Are there other concerns with Staff's approach to depreciation?

A. Yes. Staff's approach imposes additional risks on the economy of the State of Missouri. Regulatory policy that does not support necessary and prudent utility infrastructure investments places Missouri at a disadvantage to most other states when businesses consider expansion in or relocation to Missouri. Today's business and industry demand strong, dependable and expandable utility service. Artificially low rates today will not be much of a comfort if timely investments are not made or if rate shock is the future product of today's short sighted decisions. Missouri's economic viability and energy security are linked to a sound utility infrastructure.

V Concluding Remarks

Q. Do you have any final remarks?

A. Yes. I believe the Commission should not adopt a depreciation policy that is as far out of the mainstream as Staff's and OPC's approach to net salvage. Empire is in a growing area of the state and requires significant cash to fund infrastructure additions. Squeezing a sound source of funding at this time imposes additional risks on both Empire and our customers. These risks are manifested in the form of lower credit ratings. Future costs will rise as a result or infrastructure will not get built in a timely fashion. I can see this in Empire's future and it is very easy to see this in the future of all Missouri utilities if Staff's and OPC's unreasonable position is adopted.

Q. Does this conclude your testimony?

A. Yes.