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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

SHANA ATKINSON

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2011-0004

Jefferson City, Missouri
April 2011

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Q. Please state your name.

A. My name is Shana Atkinson.

Q. Are you the same Shana Atkinson who has previously filed rebuttal testimony in this proceeding for the Staff of the Missouri Public Service Commission ("Staff")?

A. Yes. I filed rebuttal testimony on April 18, 2011.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Dr. James H. Vander Weide and the rebuttal testimony of William L. Gipson, both of whom sponsored testimony on behalf of The Empire District Electric Company ("Empire" or "Company").

EXECUTIVE SUMMARY

Q. Please summarize your surrebuttal testimony.

A. Dr. Vander Weide addresses issues in his rebuttal testimony ranging from the size of Staff's proxy group, the Discounted Cash Flow (DCF) model, and projected growth rates, to an alleged adjustment that should be made to Staff's CAPM analysis results because of Empire's size. In his rebuttal testimony, Mr. Gipson addresses the disallowance of certain debt costs recommended in Staff's Cost of Service Report. I will address each of these points.

RESPONSE TO DR. VANDER WEIDE'S REBUTTAL TESTIMONY

Q. On page 6 of his rebuttal testimony, Dr. Vander Weide discusses his concern with Staff's proxy group selection criteria. What is Staff's response?

A. Staff's criteria for proxy group selection are as follows:

1. Classified as an electric utility company by Value Line;
2. Publicly-traded stock;
3. Followed by the Edison Electric Institute (EEI) and classified as a regulated electric utility;
4. Followed by AUS and reporting at least 70% of revenues from electric operations;
5. Ten-years of Value Line historical growth data available;
6. No reduced dividend since 2007;
7. Projected growth data available from Value Line and Reuters;
8. At least investment grade credit rating;
9. Company-owned generating assets; and
10. No significant merger or acquisition announced in the last three years.

Staff used these criteria to improve the risk comparability of its proxy group. Companies incur two types of risk, business risk and financial risk. The financial risk of an entity is driven by the amount of fixed obligations created by issuing debt. Some analysts will attempt to screen their comparable companies for financial risk by selecting companies with a certain common equity percentage in their capital structure. I controlled for this type of risk by selecting companies that have at least an investment grade credit rating. The business risk of an entity is primarily driven by the dominant operations of the company. The best way to select companies that face similar business risk is to select companies that are in the same business as the operations being evaluated. Most finance textbooks commonly refer to this approach as the "pure play method." Because we are attempting to determine the appropriate cost of capital for the risks inherent in Empire's regulated electric utility operations, it is important to select companies for the proxy group whose stock prices

1 are primarily influenced by risks consistent with regulated electric utility operations.
2 Consequently, Staff chose companies that were classified as a "Regulated" electric utility by
3 EEI and received at least 70 percent of their revenues from their electric utility operations.
4 The combination of these two criteria ensures the selection of companies with both a large
5 asset base and revenue base from electric utility operations.

6 Q. On page 7 of his rebuttal testimony, Dr. Vander Weide criticizes Staff's
7 comparable company criteria of only selecting companies classified as "Regulated" by EEI.
8 Did Staff provide evidence that the stock prices of companies in EEI's "Regulated" asset
9 group perform differently than companies in EEI's "Mostly Regulated" and "Diversified"
10 groups?

11 A. Yes. Staff discussed the stock performance of the different EEI categories in
12 the Rate of Return ("ROR") Section of the Cost of Service Report as follows:

> 13 For the twelve months ended December 31, 2010, the total return on the Dow
> 14 Jones Industrial Average was 14.1%, the total return on the S&P 500 was
> 15 15.1%, and the total return on the Edison Electric Institute ("EEI") Index of
> 16 electric utilities was 7.0% (*see* Appendix 2, Attachment B). More specifically
> 17 on a non-market capitalization weighted basis, the total return for the twelve
> 18 months ended December 31, 2010 was 15.8% for EEI "Regulated" electric
> 19 utilities, 8.5% for EEI "Mostly Regulated" electric utilities and -5.2%
> 20 for "Diversified" electric utilities.
>
> 21 Typically, utility indices tend to lag behind broader market indices that are
> 22 increasing or decreasing. Regulated utilities are not expected to be as cyclical
> 23 as the broader markets because of low demand elasticity; however, utilities
> 24 with significant non-regulated operations are likely to be more affected by
> 25 general economic trends. The higher total return for "Regulated" electric
> 26 utilities compared to broader markets and "Diversified" electric utilities
> 27 implies that investors do not expect a significant economic recovery in the
> 28 near future. Consequently, assuming investors in "Regulated" electric utilities
> 29 have not increased their growth expectations for the regulated utility sector,
> 30 these higher returns imply a decrease in the cost of equity for "Regulated"
> 31 electric utilities.

1 Considering that regulated utility company stocks are considered to be a close
2 alternative to a bond investment, it is not surprising that EEI's "Regulated" electric utility
3 index did well during the 2010 calendar year. Corporate bond yields in general, and utility
4 bond yields specifically, dropped to all-time lows during the second half of 2010. Regulated
5 utility stocks reacted accordingly. Because the stocks of "Regulated" companies perform
6 differently than other more diversified companies, it is important to eliminate these more
7 diversified companies rather than rely on an average of external financial rating scores of a
8 large group of companies as Dr. Vander Weide does.

9 Q. On page 10 of his rebuttal testimony, Dr. Vander Weide states that Staff
10 estimated Empire's cost of equity using both a single-stage annual DCF method and a multi-
11 stage annual DCF method. Which methodology was the primary driver of Staff's estimated
12 cost of common equity in this case?

13 A. Staff relied primarily on its multi-stage annual DCF model in estimating
14 Empire's cost of equity. Staff attempted to estimate the cost of common equity for Empire
15 by initially performing its traditional constant-growth DCF analysis. However, due to Staff's
16 concerns about being able to reliably estimate a single constant-growth rate based on the
17 analysis of historical and projected growth rates for the proxy group, Staff decided a multi-
18 stage DCF analysis better addresses the current characteristics of the electric utility industry.

19 Q. On pages 12 through 15 in his rebuttal testimony, Dr. Vander Weide discusses
20 a variety of matters regarding the growth rates Staff analyzed when performing Staff's
21 constant-growth DCF analysis. What is Staff's response?

22 A. Staff clearly explains in the ROR Section of the Cost of Service Report in this
23 case that the historical and projected data Staff reviewed made it difficult to estimate a

1 reliable constant-growth rate for a single-stage DCF cost of equity estimate. Consequently,
2 Staff decided that a multi-stage DCF analysis would provide a more reliable cost of common
3 equity estimate.

4 Q. At page 16, line 22 through page 17, line 7 of Dr. Vander Weide's rebuttal
5 testimony, he criticizes Staff's opinion that analysts' projected growth rates for electric
6 utilities are not sustainable in the long run. What is Staff's response?

7 A. Dr. Vander Weide believes that Staff should use equity analysts' five-year
8 earnings per share ("EPS") growth forecasts whether or not investors consider these growth
9 forecasts as "sustainable". He also believes that Staff fails to recognize that investor growth
10 forecasts affect stock prices so Staff should adjust the stock prices for the companies in
11 Staff's DCF analyses, as well as the growth forecasts, if Staff believes that five-year EPS
12 growth forecasts are irrational. In contrast, Staff believes that if a growth rate estimate does
13 not reflect rational investor expectations of long-term sustainable growth, then an analyst is
14 justified in rejecting that growth rate estimate. According to *The Cost of Capital-A*
15 *Practitioners Guide* by David Parcell, pg. 8-5, "The DCF method assumes that investors
16 evaluate stocks in a classical economic framework and buy and sell securities rationally at
17 prices which reflect that value assessment. Classical economic, or valuation, theory
18 maintains that the value of a financial asset is determined by its earning power, or its ability
19 to generate future cash flows. As a result, DCF theory assumes that the stock price of a firm
20 fully considers and reflects the return expected by stockholders." This assumption implies
21 that the current stock price reflects investor expectations, which includes not only near-term
22 growth, but also more rational long-term constant growth. Dr. Vander Weide is incorrect in

assuming that rational investors would rely on equity analysts' five-year EPS forecasts for a sustainable long-term growth rate in valuing a stock.

Near term projected growth rates for the electric industry are higher than the projected long-term economic growth rates provided in the Congressional Budget Office's, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021.* These lower expected long-term growth rates are also consistent with many of the perpetual growth rates used by equity analysts when performing DCF analysis for purposes of determining a fair price to pay for electric utility stocks. Goldman Sachs generally assumes a perpetual growth rate of 2.5% when performing a DCF analysis of regulated electric utility companies (*see* Appendix 2, Attachment E of Staff's Cost of Service Report).[1]

Q. On page 18 of his rebuttal testimony, Dr. Vander Weide states "Thus the average analysts' EPS growth forecast is virtually the same as the six percent long-term growth forecast the Commission accepted in the Ameren Order." Did the Missouri Public Service Commission ("Commission") specifically incorporate this six percent growth rate into their allowed ROE in that proceeding?

A. No. In the Report and Order in Case No. ER-2010-0036, the Commission adopted expert witness Daniel J. Lawton's ROE recommendation of 10.1 percent. Mr. Lawton's ROE recommendation of 10.1 percent was not premised specifically on a 6 percent long-term growth forecast. Mr. Lawton relied on the following methodologies in recommending a 10.1 percent ROE: constant-growth DCF, two-stage DCF, risk premium and CAPM.

[1] Michael Lapides, Zac Hurst, Jadieep Malik and Neil Mehta, *United States: Utilities: Power – Electric Utilities,* "Powering On: Tiliting to commodity oriented utilities and IPPs," September 29, 2009, p. 20.

Q. On page 11, line 1 through 9, in his rebuttal testimony, Dr. Vander Weide criticizes Staff for not using the quarterly compounding version of the DCF model as he did. How do you respond?

A. Value Line does not publish quarterly projected dividends. It provides projected dividends on an annual basis. The dividend yield provided by Value Line in its Ratings and Reports tear sheets is based on the expected dividend for the next year without quarterly compounding. The following definition of "dividend yield" is contained in the *Value Line Investment Survey for Windows: User's Manual,* © 1995 through 2002:

> The common dividends declared per share expressed as a percentage of the average annual price of the stock. Dividend yield = common dividends declared per share divided by the average annual price of a stock. The year-ahead estimated dividend yield (shown in the top right-hand corner of the Value Line page) is the estimated total of cash dividends to be declared over the next 12 months, divided by the recent price of the stock.

Staff believes that investors make their investment decisions primarily based upon the annual dividend assumption, and for that reason it is appropriate to estimate investors' required returns based on that assumption.

Additionally, it is interesting to note that Dr. Vander Weide determined that currently there is no need to make an upward adjustment to his annual DCF cost of equity estimate for purposes of quarterly compounding. Dr. Vander Weide stated on page 22, lines 15 through 18, of his direct testimony that he employs the quarterly DCF model throughout his calculations, even though the results of the quarterly DCF model for his companies are approximately equal to the results of a "properly" applied annual DCF model.

Q. On page 11, line 17 through page 12, line 4, in his rebuttal testimony, Dr. Vander Weide criticized Staff's use of Value Line to estimate the expected dividend

1 per share ("DPS") over the next year in order to calculate the dividend yield in Staff's DCF
2 analysis. What is Staff's response?

3 A. Dr. Vander Weide claims that Staff's approach is not consistent with the
4 assumption that dividends will grow at the same constant rate forever. Empire is a good
5 example of why Dr. Vander Weide's argument in this case is not consistent with the reality
6 of investor expectations. In Staff's opinion, it is unreasonable to believe that investors expect
7 to receive an annual dividend next year that is higher than Empire's current annual dividend
8 of $1.28. Empire has paid this same dividend amount since 1993 and has been unable to earn
9 this dividend in twelve years since 1993. The inability of Empire to earn higher than its
10 dividend is evidence that investors are not likely to expect Empire to have the earnings
11 capacity to allow it to increase its DPS. Value Line does not anticipate that Empire will
12 increase its dividend next year, and this is most likely investors' expectation as well, which is
13 what rate of return witnesses should be trying to evaluate.

14 Q. On page 23, lines 1 through 8, in his rebuttal testimony, Dr. Vander Weide
15 claims an adjustment should be made to Staff's CAPM result because of Empire's small size.
16 What is Staff's response?

17 A. Dr. Vander Weide's provided evidence for his suggested small size
18 adjustment is an Ibbotson Associates study that was based on all of the stocks in the New
19 York Stock Exchange, the American Stock Exchange and the NASDAQ National Market,
20 which is not a utility specific study. If Dr. Vander Weide was concerned about small size in
21 estimating the cost of equity for Empire, then Dr. Vander Weide shouldn't have followed his
22 standard methodology of estimating the cost of equity by using market-weighted cost of
23 equity averages, which gives large company cost of equity estimates more weight in his

1 recommendation. Also, Dr. Vander Weide does not make a small size adjustment to his own
2 CAPM equation as he suggests Staff should.

3 Q. On page 24, lines 10 through 12 in his rebuttal testimony, Dr. Vander Weide
4 states "Staff recommends a thirty-five basis-point risk premium because Staff recognizes that
5 Empire is significantly more risky than the average company in Staff's proxy group of
6 electric utilities." Did Staff state that Empire was "significantly more risky"?

7 A. No. Staff explains in the ROR section of Staff's COS Report that because the
8 average credit rating of the comparable companies is 'BBB+' and the credit rating of Empire
9 is 'BBB-', Staff increased the approximated midpoint ROE estimate by 35 basis points to
10 reflect the higher risk implied by this credit rating differential, which would also address any
11 concerns about the effect of Empire's smaller size on perceived risk.

12 However, Empire has shown that they can issue long-term debt at favorable rates
13 despite the fact that its Standard & Poor's ("S&P") corporate credit rating of 'BBB-' is only
14 one notch above non-investment grade. Empire issued 10-year First Mortgage bonds at a
15 coupon of 4.65% last May and issued $50 million of 30-year First Mortgage bonds at a
16 coupon of 5.20%, which was used in part to redeem debt with a coupon of 7.05% maturing in
17 2022.

18 Q. On page 24, line 13, through page 25, line 9 of his rebuttal testimony,
19 Dr. Vander Weide criticizes Staff for not comparing their recommended cost of equity
20 for Empire to the cost of equity the Commission authorized for Ameren in Case No.
21 ER-2010-0036. What is Staff's response?

22 A. The Commission recently filed, on April 12, 2011, a Report and Order for the
23 Kansas City Power & Light Company (KCP&L) case, Case No. ER-2010-0355. The

1 Commission decided KCP&L should receive an allowed ROE of 10.0%. Although Staff
2 believes its estimate of Missouri electric utilities' costs of equity are reasonable and
3 consistent with cost of equity estimations used to in the practice of investing and valuation,
4 Staff understands that it may be helpful to consider a possible fair allowed ROE for Empire if
5 it were judged based on the Commission's recent decision in the KCP&L rate case. Staff
6 believes the cost of equity has decreased by approximately 25 basis points since the time
7 Staff performed its cost of equity study for the KCP&L case. Therefore, if the Commission
8 were to consider this reduced cost of equity in estimating a fair and reasonable allowed ROE
9 for an electric utility with risks equivalent to that of Staff's proxy group, then a 9.75%
10 allowed ROE would be consistent with the Commission's most recent decision (10%-.25%).
11 However, because Staff considers Empire to be slightly riskier than the average of its proxy
12 group, Staff would add 35 basis points for the higher risk implied by the credit rating
13 differential between Empire and Staff's proxy group. Therefore, Staff believes an allowed
14 ROE of approximately 10.1 percent can be justified if compared to the Commission's most
15 recent KCP&L decision.

16

17 **<u>RESPONSE TO MR. GIPSON'S REBUTTAL TESTIMONY</u>**

18 Q. Mr. Gipson's rebuttal testimony addresses the disallowance of certain debt
19 costs presented by Staff in the Cost of Service Report. What is Staff's position regarding this
20 debt disallowance?

21 A. Staff disallowed the remaining unamortized expense balance of approximately
22 $1,133,570 associated with Empire's $1.6 million of debt expenses incurred to amend its

1 mortgage bond indenture in order to allow it to maintain its current dividend per share of
2 $1.28.

3 Q. Mr. Gipson's position is that the amendment was executed in support of the
4 Company's overall financing plan, not just to benefit shareholders, and that the amendment
5 was done in order to provide investors some comfort that Empire understood the importance
6 of the dividend to shareholders. What is Staff's response?

7 A. Empire stated that they had to amend the Indenture because the retained
8 earnings balance had dropped to $17.2 million and the Indenture, before the amendment, did
9 not allow Empire to pay dividends with essentially a negative retained earnings balance. As
10 previously discussed, Empire has not earned their dividend in twelve of the past eighteen
11 years. Ratepayers should not be burdened with explicit costs associated with Empire's desire
12 to continue to pay the current dividend level to its shareholders.

13 Q. Mr. Gipson states on page 2, line 22 through 23, "The equity markets are
14 attracted to Empire as an income stock, not as a growth stock." What is Staff's response?

15 A. Considering that expected long-term nominal GDP growth is approximately
16 4.5%, which is driven by output from companies in both growth stages and mature, income
17 oriented stages, this statement provides another reason why a perpetual growth rate of
18 approximately 6%, as implied by Dr. Vander Weide in his constant growth DCF, is
19 unreasonable. Quite simply, Mr. Gipson is confirming Staff's opinion that Empire is more or
20 less viewed by investors as a close alternative to bond investments. As evidenced by the
21 inability of Empire to grow its DPS over the last 18 years, it is quite possible that investors
22 are investing in Empire purely for the yield with little expectation of growth in DPS.

1 Q. Mr. Gipson implies in his rebuttal testimony that if Empire were unable to pay
2 its dividend that Empire's cost of equity would be higher. Have any other Missouri utilities
3 requested a higher cost of equity after reducing their dividends?

4 A. No. In fact, according to an S&P summary analysis of Ameren Corp. in
5 August 2009 after Ameren reduced its dividend in February 2009, S&P stated "The financial
6 profile of the consolidated entity is maintained as 'significant', enhanced by the company'
7 decision to reduce its dividend by $1 per share, which we view as **credit supportive**." Also,
8 in a September 2009 S&P summary analysis of Great Plains Energy Inc., (the parent
9 company of KCP&L) after they reduced their dividend in February 2009, S&P stated
10 "Additionally, the company has taken concrete measures to **improve its credit quality**.
11 These include the issuance of equity, a 50% dividend reduction, and the operational
12 improvement of its existing power plants."

13 **<u>SUMMARY AND CONCLUSIONS</u>**

14 Q. Please summarize the conclusion of your surrebuttal testimony.

15 A. Staff continues to believe its testimony provides a reliable estimate of the cost
16 of common equity. Dr. Vander Weide's criticism of my smaller proxy group is misplaced.
17 A larger proxy group should not come at the expense of comparability. Staff's multi-stage
18 DCF growth assumptions are consistent with actual experience in the utility industry and also
19 with perpetual growth rates used by investment analysts.

20 Also, Staff believes that its debt disallowance is necessary and appropriate at this
21 time. Mr. Gipson's rationale for not reducing Empire's dividend is inconsistent with the goal
22 of maintaining Empire's credit quality.

1 Q. What does the Commission need to include in its Report and Order to
2 effectuate Staff's recommendation on ROR?
3 A. The Commission needs to include a recommendation for ROE in the range of
4 8.60 percent to 9.60 percent and an overall ROR recommendation in the range of
5 7.46 percent to 7.96 percent. This is based on a capital structure of 49.36 percent common
6 equity and 50.64 percent long-term debt. This recommendation reflects Staff's opinion for a
7 just and reasonable rate that is fair to the investors and fair to the ratepayers.
8 Q. What does the Commission need to include in its Report and Order to
9 effectuate Staff's recommendation on capital structure?
10 A. A capital structure of 49.36 percent common equity and 50.64 percent long-
11 term debt and an embedded cost of 6.36 percent needs to be included. This recommendation
12 reflects the disallowance of the remaining unamortized expense balance of approximately
13 $1,133,570 associated with Empire's $1.6 million of debt expenses incurred to amend its
14 mortgage bond indenture in order to allow it to maintain its current dividend per share
15 of $1.28.
16 Q. Does this conclude your surrebuttal testimony?
17 A. Yes, it does.

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	))))	File No. ER-2011-0004

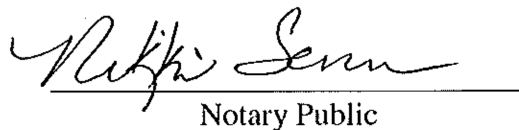
AFFIDAVIT OF SHANA ATKINSON

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Shana Atkinson, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 13 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Shana Atkinson

Subscribed and sworn to before me this 28th day of April, 2011.



Notary Public

NIKKI SENN
Notary Public - Notary Seal
State of Missouri
Commissioned for Osage County
My Commission Expires: October 01, 2011
Commission Number: 07287016