Exhibit No.:
Issues: Interim Rates
Witness: Shana Atkinson
Sponsoring Party: MoPSC Staff
Type of Exhibit: Interim Rebuttal Testimony
Case No.: ER-2012-0345
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MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION
UTILITY SERVICES – Financial Analysis

INTERIM REBUTTAL TESTIMONY

OF

SHANA ATKINSON

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2012-0345

Jefferson City, Missouri
August 2012

** **Denotes Highly Confidential Information** **

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INTERIM REBUTTAL TESTIMONY

OF

SHANA ATKINSON

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2012-0345

Q. Please state your name.

A. My name is Shana Atkinson.

Q. What is your present position with the Missouri Public Service Commission (Commission)?

A. I am a Utility Regulatory Auditor III in the Financial Analysis Unit.

Q. Would you please review your educational background and work experience.

A. My credentials can be found along with the Commission cases in which I have filed testimony in Schedule SA-1.

Q. What Staff witnesses are providing testimony on Empire's interim rate request?

A. The following witness are providing rebuttal testimony on the issues identified:

Mark L. Oligschlaeger – Overview, Revenues, Policy

Shawn E. Lange – Empire's Customer Numbers, Weather, and Rate Revenues

Shana Atkinson – Empire's Financial Condition

Lena M. Mantle – Empire's Fuel and Purchased Power Costs

Q. What is the purpose of your rebuttal testimony?

A. The purpose of this rebuttal testimony is to respond to the direct testimonies of Robert W. Sager and Brad P. Beecher on interim rates. Mr. Sager and Mr. Beecher sponsored testimony in support of Empire District Electric Company's ("Empire" or "Company") interim rate increase request. They specifically offer testimony on their views concerning the financial impact on Empire of the tornado that struck Joplin in May 2011, in particular they assert that because Empire had very low retained earnings it suspended its dividend for two quarters three days after the tornado struck Joplin.

Q. Would you summarize your response?

A. Yes. In this testimony I point out that Empire's retained earnings were very low because it has for many years been paying out dividends per share ("DPS") that were not supported by its earnings per share ("EPS"). I explain that Empire's high DPS relative to its EPS (payout ratio) has limited its financial flexibility for contingencies such as damages to its system and loss of load caused by storms such as the May 2011 tornado. I show the DPS Empire reinstated at the end of the two-month dividend suspension is better supported by its EPS than the DPS before the suspension. I also point out that neither Moody's nor Standard and Poor's downgraded Empire's credit rating because of the tornado.

Q. What is your understanding of the cause for Empire's request for an interim rate increase in this case?

A. Empire admits that is not requesting an interim rate increase because it suffers from a financial emergency. Empire is not currently facing significant financial uncertainty, instead, Empire is seeking this interim rate relief because it believes it should recover costs associated with the May 2011 tornado faster than the normal general rate case would allow.

Q. Mr. Sager and Mr. Beecher both testify "Given the low level of retained earnings, the expected lost revenue from lost and displaced customers due to the tornado, and the fact that Empire's ability to pay dividends was tied to retained earnings through a covenant in the Company's mortgage indenture, the Empire board met three days after the storm and suspended the dividend for two quarters." Did Empire later reinstate its dividend?

A. Yes. Empire reinstated its dividend in the first quarter of 2012 to $.25 per share on a quarterly basis, or $1.00 per share on an annual basis.

Q. Is Empire's reinstated dividend the same amount as it was before the Company suspended its dividend?

A. No. Empire's dividend was $1.28 on an annual basis before it was suspended.

Q. Did Empire state that it was not reinstating its dividend to the prior $1.28 annual amount because of lingering effects of the tornado?

A. No. Mr. Beecher stated in the May 26, 2011, Empire conference call discussing the temporary suspension of its dividend that "the longer-term goal is to grow this dividend and get to a payout ratio that's commensurate with our peer group…"[1]

Q. Before the May 2011 tornado, did Empire's EPS support the DPS it was paying?

A. No. Empire chose to pay a $1.28 annual DPS from 1993 through 2010. Empire only had sufficient EPS to support that DPS in 12 of these 18 years, and Empire's payout ratio (DPS/EPS) has consistently been close to or above 100 percent of earnings since 1992.[2] The lowest payout ratio Empire has had since 1992 was approximately 84 percent in 1998. According to information from the Edison Electric Institute ("EEI"), between 1993 and 2011 the average dividend payout ratio of a U.S. shareholder-owned electric utility in total was never above 84.2 percent. This illustrates that Empire's payout ratio has

[1] Transcript from the May 26, 2011 conference call held to discuss the suspension of the dividend. Provided to Staff in response to Data Request No. 0105.
[2] Value Line Investment Survey, June 29, 2007 and June 22, 2012. This is not including the year 2011.

consistently been above the average payout ratio of a U.S. shareholder-owned electric utility since 1993.

Q. If Empire had been paying out an annual DPS of $1.00 during the eighteen-year period 1993 through 2010, instead of $1.28, in how many years would Empire's EPS have supported this lower DPS?

A. Fifteen, and its average dividend payout ratio for those 18 years would have been approximately 89 percent.

Q. If Empire had reduced its annual DPS to $1.00 at the start of its heavy construction cycle in 2005, how would have Empire's dividend payout ratio compare to the average for EEI's "Regulated" electric utility index?

A. Empire's dividend payout ratio would have been higher than its peer group. In this scenario Empire's average dividend payout ratio for 2006 to 2010 would have been about 84%, while the average dividend payout ratio for EEI's "Regulated" electric utility index for 2006 to 2010 was 68%.[3]

Q. On pages 4 and 5 of Mr. Sager's testimony, he asserts several factors over the years that have contributed to the low level of Empire's retained earnings. Does a high dividend payout ratio effect retained earnings?

A. Absolutely. Retained earnings are the earnings that a company keeps to reinvest in its business instead of distributing to shareholders as dividends. Therefore, if a company has a dividend payout ratio of 100 percent there is 0 percent left over as retained earnings.

[3] Table IV of Edison Electric Institute's Dividends Q4 2011 Financial Update.

Q. Typically, why should a company set its DPS at a level that allows the EPS to consistently cover the DPS?

A. Because it allows for financial flexibility, which reduces the likelihood the dividend would have to be reduced or suspended in the future due to uncertain events. For example, a company had an EPS of $1.30 in the previous year and paid a DPS of $1.00. The company had $.30 left in retained earnings. In the current year the same company's EPS fell to $.95 and still paid a DPS of $1.00. Therefore, in the current year this company has a retained earnings of -$.05. Since the company had a retained earnings of $.30 in the previous year it has the financial flexibility to cover its dividend. If a company consistently pays shareholders more dividends than it earns there will be very little retained earnings for financial flexibility.

Q. Mr. Beecher states on page 11 of his direct testimony that "the Company indicated in its analyst call on May 26, 2011 that the dividend suspension was the 'prudent course of action for the long-term viability of our company.' Empire's retained earnings balance at June 30, 2011, following the dividend suspension, was a negative $167,000." Did Empire face uncertainty when it decided to suspend its dividend?

A. Yes. In the immediate aftermath of such a major catastrophe, it is very hard to project what the consequences would have been for the entire city of Joplin, let alone the earnings ability of Empire. However, implementation of a more conservative dividend ratio prior to the tornado would have allowed more financial flexibility to deal with the impacts of events like the Joplin tornado—impacts such as damage to its facilities, sudden loss in customers and other financial consequences.

Q. Had Empire renegotiated its mortgage indenture before the tornado because it did not want to reduce the DPS?

A. Yes. In previous Empire rate cases, case No. ER-2010-0130 and case No. ER-2011-0004, Staff discovered that Empire's embedded cost of debt included explicit costs Empire incurred so it could renegotiate its mortgage indenture to allow up to a negative retained earnings balance of $10.75 million. Consequently, Empire has been in this position before regardless of the tornado.

Q. Did Empire consider another amendment to its indenture to allow it to continue to pay its $1.28 dividend in the wake of the May 2011 tornado?

A. Yes. On Empire's May 26, 2011 conference call with investors discussing the temporary suspension of its dividend. Bill Gipson, President and CEO of Empire at the time, stated:

> As you all know, we have a covenant in our mortgage indenture that limits our ability to pay dividends tied to our retained earnings balance. We went to the bondholders in March 2008 following a period of time where we were unable to recover about 100 million of fuel and purchase power costs, and obtained a change in the covenant to allow us to pay dividends up to a negative retained earnings balance of 10.75 million. We studied and analyzed doing that again. The cost and risk of execution proved prohibitive. This is the prudent course of action for the long-term viability of our company.

The retained earnings balance of a negative $167,000 that Mr. Beecher uses to support the interim rate increase is significantly below the negative $10.75 million of retained earnings that Empire had recently negotiated to allow the maintenance of the $1.28 DPS. In fact, in this same conference call Mr. Gipson states that they tried "doing away with the covenant" but "the bondholders just didn't want to go there at all." This demonstrates that Empire was willing to compromise its financial flexibility by continuing to pay the $1.28 dividend, even paying additional bond indenture costs to do so, at a time when it was involved in significant construction activity and during a general downturn in the economy.

Q. Did S&P downgrade Empire's corporate credit rating in the wake of May 2011 Joplin tornado?

A. No, but it did change Empire's Outlook from "Positive" to "Stable" on May 27, 2011.

Q. What was S&P's reasoning for the Outlook revision on May 27, 2011?

A. S&P stated the following in its May 27, 2011 "Research Update: Empire District Electric's Outlook Changed To Stable From Positive After Missouri Tornado Disaster" (*see* Schedule SA-2):

> The outlook revision relates to the financial implications of the destructive storm earlier this week that passed through Joplin, the largest city in the company's service territory. Largely due to an anticipated loss of business that Empire estimates could reach 15% and storm repair costs estimated to be up to $30 million in its service territory, the company suspended its quarterly dividend of 32 cents for the second and third quarters of 2011. This may impair the company's access to equity markets, and along with reduced cash flows and higher expenses, financial measures could weaken.

Q. Did Empire's financial condition weaken in the aftermath of the May 2011 tornado?

A. No. S&P's March 23, 2012 Analysis on Empire stated the following:

> Although Empire's **financial metrics strengthened in 2011** with its capital budget at a low point, we expect its overall financial condition to erode due to rising capital expenditures

> and the additional debt that will be needed to partially fund the construction program. **[emphasis added]**[4]

Consequently, instead of experiencing financial strain during the year in which the tornado occurred, Empire actually had better financial ratios than normal. Empire's Funds from Operations (FFO) Interest Coverage ratio and FFO as a Percentage of Average Total Debt (FFO to Average Total Debt) ratios for Empire steadily improved from 2009 to 2011. Empire's FFO interest coverage ratio was 3.7x in 2009, 4.7x in 2010 and 5.1x in 2011. Empire's FFO/debt ratio was 14.8% in 2009, 20.0% in 2010 and 22.0% in 2011.[5] It should also be noted that this was during the period in which Empire was allowed additional cash flow from ratepayers to help support an investment grade credit rating.

Q. Did Moody's change Empire's corporate credit rating after the May 2011 Joplin tornado?

A. No. In its May 26, 2011 Global Credit Research on Empire (*see* Schedule SA-3), Moody's stated the following:

> ** ____

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[4] Standard &Poor's cash flow ratios such as FFO to Average Total Debt and FFO interest coverage ratio do not adjust for the payment of dividends.

[5] Standard & Poor's Analysis on Empire District Electric Co., March 23, 2012 (*see* Schedule SA-4).

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Q. What is your knowledge of Empire's current ability to access capital?

A. On April 2, 2012, Empire entered into a Bond Purchase Agreement for a private placement of $88 million aggregate principal amount of 3.58% First Mortgage Bonds. The first settlement of $38 million occurred on April 2, 2012 and the second settlement of $50 million occurred on June 1, 2012. Empire also has an unsecured revolving credit facility of $150 million.[6]

Q. Please summarize your rebuttal testimony.

A. Empire has not shown a need for an interim rate increase. While the tornado that occurred in May 2011 was truly extraordinary, the consequences to Empire have not been extraordinary from a financial perspective. While Empire did suspend its dividend for two quarters and reinstated it at a lower level, Empire might not have had to take such action if it had previously reduced its dividend when it needed to retain capital for construction of generating facilities. Pursuant to its Experimental Regulatory Plan, Empire collected additional amortizations resulting in higher rates during the period of construction. However, Empire continued to pay its high dividend to shareholders which gave them less financial flexibility during this period of construction.

Although Empire's corporate rating outlook was changed by S&P due to the initial uncertainty of the possible financial impact the tornado may have on Empire's cash flows, it ultimately did not cause a decline in Empire's financial metrics. In fact, they improved. Empire is currently financially sound. Empire has access to capital, has an investment grade

[6] Empire's 10-Q for the period ended June 30, 2012.

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credit rating, has financial metrics that have improved since the May 2011 tornado and has reinstated its dividend.

Q. Does this conclude your rebuttal testimony regarding Empire's interim rate request?

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 Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company	)))))	Case No. ER-2012-0345

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 Rebuttal Testimony on Interim Rates in question and answer form, consisting of 10 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony on Interim Rates 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

Shana Atkinson

Subscribed and sworn to before me this 20th day of August, 2012.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

D Suzie Mankin

Notary Public

SHANA ATKINSON

Educational and Employment Background and Credentials

I am currently employed as a Utility Regulatory Auditor III for the Missouri Public Service Commission (Commission). I accepted the position of Utility Regulatory Auditor I in December 2008.

In May 2007, I earned a Bachelor of Science in Accountancy and a Master of Accountancy degree from the University of Missouri-Columbia. My accounting degree required an understanding of financial concepts, including the cost of capital.

On June 21, 2010, I was awarded the Certified Rate of Return Analyst (CRRA) professional designation by the Society of Utility and Regulatory Financial Analysts (SURFA). This designation is awarded based upon experience and successful completion of a written examination, which I completed during my attendance at a SURFA conference in April 2010.

I have developed rate of return recommendations for numerous small water and sewer rate cases and have assisted as needed in small water and sewer certificate cases.

SUMMARY OF CASE PARTICIPATION

SHANA ATKINSON

Date Filed	Issue	Case Number	Exhibit	Case Name
4/28/2011	Rate of Return Capital Structure	ER-2011-0004	Surrebuttal	Empire District Electric Company
4/18/2011	Rate of Return Capital Structure	ER-2011-0004	Rebuttal	Empire District Electric Company
2/23/2011	Rate of Return Capital Structure	ER-2011-0004	Cost of Service Report	Empire District Electric Company
4/23/2010	Rate of Return Capital Structure	ER-2010-0130	Surrebuttal	Empire District Electric Company
4/02/2010	Rate of Return Capital Structure	ER-2010-0130	Rebuttal	Empire District Electric Company
2/26/2010	Rate of Return Capital Structure	ER-2010-0130	Cost of Service Report	Empire District Electric Company
1/13/2010	Rate of Return Capital Structure	WR-2010-0111	Cost of Service Report	Lake Region Water & Sewer Company
1/13/2010	Rate of Return Capital Structure	SR-2010-0110	Cost of Service Report	Lake Region Water & Sewer Company
10/20/2009	Rate of Return Capital Structure	GR-2009-0434	Cost of Service Report	Empire District Gas Company

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May 27, 2011

Research Update:

Empire District Electric's Outlook Changed To Stable From Positive After Missouri Tornado Disaster

Primary Credit Analyst:
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Research Update:

Empire District Electric's Outlook Changed To Stable From Positive After Missouri Tornado Disaster

Overview

- Joplin, Mo.-based electric and natural gas utility Empire District Electric Co. expects to incur financial stress from anticipated loss of business and reconstruction costs following the recent tornado disaster.
- We are affirming all ratings on the company, including the 'BBB-' corporate credit rating, and revising the rating outlook to stable from positive.
- An expected improvement in the company's financial condition could be forestalled if the company can't fully recover direct storm costs or if the service territory has near-permanent load losses for an extended period.

Rating Action

On May 27, 2011, Standard & Poor's Ratings Services affirmed its ratings on Joplin, Mo.-based electric and natural gas utility Empire District Electric Co. and revised the outlook to stable from positive. About $700 million of debt is outstanding.

The outlook revision relates to the financial implications of the destructive storm earlier this week that passed through Joplin, the largest city in the company's service territory. Largely due to an anticipated loss of business that Empire estimates could reach 15% and storm repair costs estimated to be up to $30 million in its service territory, the company suspended its quarterly dividend of 32 cents for the second and third quarters of 2011. This may impair the company's access to equity markets, and along with reduced cash flows and higher expenses, financial measures could weaken.

Rationale

Due to the storm damage, the company expects load loss of up to 15% that will reduce revenues. Although the company's initially estimated $30 million of storm repairs may be at least partly recoverable through insurance and through other means such as regulatory mechanisms, a lag will likely occur between ultimate cost recovery and the utility's immediate expenses. According to management, the utility's $150 million credit facility is fully available. Due to legal limitations tied to its retained earnings, Empire had to suspend its 32-cent quarterly dividend payment for two quarters, after which it expects to begin paying dividends at a lower level.

The ratings on Empire District reflect an excellent business risk profile (we categorize business risk profiles as excellent to vulnerable) and an aggressive financial risk profile (ranked from minimal to highly leveraged). Empire's business risk profile benefits from a diverse service territory with limited industrial concentration (about 15% of its total retail load), a straightforward integrated utility business model, and a cost-conscious management team. Tempering those factors are an historically challenging regulatory environment in Missouri, which we view as less credit supportive compared with other states. The Missouri Public Service Commission, however, appears to be becoming more responsive to the company's rate needs. It has approved some settlement agreements and implemented a fuel-adjustment clause that enables the company to recover 95% of changes in fuel and purchased-power costs in a timely manner. This is crucial for Empire's credit quality, given its reliance on a somewhat high level of natural-gas-fired generation and purchased power.

The company's generation expansion plan is winding down with the December 2010 completion of the 850 megawatt (MW) coal-fired Iatan Unit 2 facility of which Empire owns 12% (102 MW) and commercial operation of the 665 MW coal-fired Plum Point Energy Station of which Empire owns 7.52% (50 MW). In 2013, capital outlays will accelerate for environmental upgrades at the Asbury coal-fired station and, to a lesser extent, for its Riverton Unit 12 combined-cycle conversion. We expect timely recovery of costs for the environmental mandates.

Although Empire's overall financial condition has been strengthening, we expect cash flow measures to decline with the significant load loss going into the summer cooling period and upfront costs that it will incur for repairs with no immediate recovery. For the 12 months ended March 31, 2011, adjusted financial measures included funds from operations (FFO) to total debt of 21%, debt to EBITDA of 4.4x, and total debt to total capital of 57%. We believe financial measures should remain at levels suitable for the 'BBB' category.

Liquidity

Empire's short-term rating is 'A-3' and largely reflects the company's long-term corporate credit rating and the stable regulated utility operations that generate essentially all of the company's cash flow. Liquidity is adequate under our methodology, which categorizes liquidity in five standard descriptors. Projected sources of liquidity, mainly operating cash flow and available bank lines, exceed projected uses, mainly necessary capital expenditures, debt maturities, and common dividends, by more than 1.2x. Empire's ability to absorb high-impact, low-probability events with limited need for refinancing, its flexibility to lower capital spending slightly, its sound bank relationships, its standing in credit markets, and its generally prudent risk management further support our assessment of its liquidity as adequate.

Empire's $150 million revolving credit facility expires Jan. 26, 2013 and, according to management, is fully available. The facility requires total debt to be less than 62.5% of total capitalization, and EBITDA interest coverage to be at least 2x. The company has been in compliance. The facility is also subject to cross-default if Empire defaults on more than $10 million in aggregate on its other debt.

Recovery analysis

We assign recovery ratings on first mortgage bonds (FMBs) issued by investment-grade U.S. utilities, which can result in issue ratings being notched above a utility's corporate credit rating (CCR), depending on the CCR category and the extent of the collateral coverage. The investment-grade FMB recovery methodology is based on the ample historical record of nearly 100% recovery for secured bondholders in utility bankruptcies and our view that the factors that supported those recoveries (limited size of the creditor class and the durable value of utility rate-based assets during and after a reorganization, given the essential service provided and the high replacement cost) will persist in the future. Under our notching criteria, we consider the limitations of FMB issuance under the utility's indenture relative to the value of the collateral pledged to bondholders, management's stated intentions on future FMB issuance, and the regulatory limitations on bond issuance when assigning issue ratings on utility FMBs. FMB ratings can exceed a utility's CCR by up to one notch in the 'A' category, two notches in the 'BBB' category, and three notches in speculative-grade categories.

Empire's electric FMBs benefit from a first-priority lien on substantially all of the utility's real property owned or subsequently acquired. Collateral coverage of more than 1.5x supports a recovery rating of '1+' and an issue rating two notches above the CCR.

Outlook

The stable outlook reflects our expectation that management will maintain cash flow protection and debt leverage measures in line with the rating. Specifically, our baseline forecast includes FFO to total debt of at least 15%, debt to EBITDA under 5x, and debt leverage to total capital under 60%. We could lower the ratings if Empire cannot sustain consolidated financial measures of FFO to total debt of at least 13% and debt leverage under 61%. This could occur if load loss is much greater or prolonged than anticipated while incurring repair costs without immediate or full cost recovery. Given the expected load loss and storm repair costs, a ratings upgrade is not expected over our current forecast period.

Related Criteria And Research

Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010
Use Of CreditWatch And Outlooks, Sept. 14, 2009
Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009

Schedule SA-2, Page 4 of 6

2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Ratings List

Ratings Affirmed; Outlook Revised

	To	From
Empire District Electric Co.		
Corp. credit rating	BBB-/Stable/A-3	BBB-/Positive/A-3
Senior secured debt	BBB+	
Recovery rating	1+	
Senior unsecured debt	BBB-	
Commercial paper	A-3	

Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.

SCHEDULE SA-3

HAS BEEN DEEMED

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March 23, 2012

Empire District Electric Co.

Primary Credit Analyst:
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Empire District Electric Co.

Major Rating Factors

Corporate Credit Rating
BBB-/Stable/A-3

Strengths:

- Limited industrial load, which provides some insulation from cyclical volatility;
- Focus on regulated utility business and nominal unregulated operations remaining in the business mix; and
- Fuel-adjustment mechanisms in place in all regulatory jurisdictions.

Weaknesses:

- Historically challenging, though becoming more responsive, regulatory climate in Missouri;
- Heavy construction program;
- Rate relief needs; and
- Elevated adjusted debt levels.

Rationale

Standard & Poor's Ratings Services' ratings on Joplin, Mo.-based utility Empire District Electric Co. reflect an "excellent" business risk profile and an "aggressive" financial risk profile (as our criteria define the terms).

Although Empire is relatively small, its business risk profile is "excellent" given a diverse service territory with limited cyclical industrial concentration (approximately 15% of its total retail load), a straightforward integrated utility business model, and a cost-conscious management team. These characteristics are tempered by a historically challenging regulatory environment in Missouri, which we view as less credit supportive than those in other states. However, the Missouri Public Service Commission (MPSC) appears to be becoming more responsive to the company's rate needs, as demonstrated by approval of settlement agreements and implementation of a fuel-adjustment clause that allows the company to recover 95% of changes in fuel and purchased-power costs in a timely manner.

In addition, Empire's management has done a good job in managing regulatory risk, implementing risk management strategies, controlling expenses, and providing high-quality service, in our view. Furthermore, it has avoided risky unregulated diversified activities and has demonstrated access to the debt and equity markets. Although debt leverage is somewhat elevated, it has come down in recent years, and the company has a clean balance sheet. We believe that management has demonstrated sufficient depth, specificity, and transparency in its financial goals.

On the competitive front, Empire's rates are slightly higher than the regional average, but the company has not lost any load to independent power producers. The company's diverse industrial base accounts for a manageable 15% of revenues, thereby limiting exposure to the advent of retail wheeling. In light of high-quality service, excellent customer relationships, brand loyalty, and the absence of deregulation in Missouri, it is unlikely that Empire would be vulnerable to load loss from competitors over the intermediate term. Over the longer term, however, the utility's relatively small size may be a limiting factor if competition intensifies.

The company's financial risk profile is "aggressive," in our view, based on our expectation that debt leverage will remain somewhat liberal and that Empire's heavy construction program will result in weakened cash flow metrics. In that regard, we expect adjusted debt to total capitalization and adjusted funds from operations (FFO) to hover around 55% and 14%, respectively, during the peak years (2014 and 2015) of capital spending.

Empire's recent performance has been in line with our expectations. The company has re-established the dividend at 25 cents per share following a two-quarter suspension after the May 2011 Joplin tornado, which caused substantial damage to the service territory. Empire estimates up to $30 million in restoration costs, which it will likely recover in rates. Although we expect deterioration in Empire's financial condition, we believe the company will perform relatively well compared with its peers.

Empire's capital program concentrates on electric construction, new generation, and improvements to its gas and electric facilities. Expenditures are accelerating largely due to environmental upgrades at its Asbury plant, the option to convert a 50-megawatt (MW) purchase from Plum Point into an ownership share in 2015, and for its Riverton Unit 12 combined-cycle conversion. While we expect the cost of complying with environmental mandates to be borne by the consumer and recovered through rate increases, the company will need to continue to manage its regulatory risk as it relates to cost recovery of other items. The company intends to file for rate relief by midyear 2012.

Although Empire's financial metrics strengthened in 2011 with its capital budget at a low point, we expect its overall financial condition to erode due to rising capital expenditures and the additional debt that will be needed to partially fund the construction program. Prospectively, we expect adjusted FFO to total debt to hover around 14% to 16%, debt to EBIDTA to be at or slightly above 4.0x, and total debt to total capital to approximate 55%. We believe Empire's financial measures will remain at levels suitable for current ratings--even when capital spending peaks in 2015--because of potential additional rate relief, continuation of a fuel-adjustment mechanism in Missouri and the other jurisdictions in which Empire operates, and credit-supportive actions by management, including future common stock issuances.

Liquidity

The short-term rating is 'A-3' and largely reflects the long-term corporate credit rating on the company and relatively low-risk regulated utility operations that generate essentially all its cash flow. Liquidity is "adequate" under our methodology, which categorizes liquidity in five standard descriptors.

Projected sources of liquidity, mainly operating cash flow and available bank lines, exceed projected uses, mainly necessary capital expenditures, debt maturities, and common dividends, by more than 1.2x. Empire's ability to absorb high-impact, low-probability events with limited need for refinancing, its flexibility to reduce capital spending slightly, its sound bank relationships, its standing in credit markets, and its generally prudent risk management further support our assessment of its liquidity as adequate.

On Jan. 17, 2012, Empire renewed its $150 million revolving credit agreement, extending the termination date to Jan. 17, 2017, from Jan. 26, 2013. The agreement removes the letter-of-credit facility and includes a swingline loan facility with a $15 million sublimit.

As of Dec. 31, 2011, there were no outstanding borrowings under the agreement. However, the company used $12 million to back up outstanding commercial paper. The facility requires total debt to be less than 62.5% of total capitalization, and EBITDA interest coverage to be at least 2x. The company is comfortably in compliance, with total debt to capital of 50.4% and EBITDA at 5.2x at Dec. 31, 2011. The facility is also subject to cross-default if

Empire defaults on more than $10 million in aggregate on its other debt.

Empire's next long-term debt maturity of $98 million comes due in June 2013. Given the magnitude of this upcoming maturity, we would expect the company to address issuance well in advance of the due date.

Recovery analysis

We assign recovery ratings on first-mortgage bonds (FMBs) issued by investment-grade U.S. utilities, which can result in issue ratings being notched above a corporate credit rating (CCR) on a utility, depending on the CCR category and the extent of the collateral coverage. We base the investment-grade FMB recovery methodology on the ample historical record of nearly 100% recovery for secured bondholders in utility bankruptcies and on our view that the factors that supported those recoveries (limited size of the creditor class, and the durable value of utility rate-based assets during and after a reorganization, given the essential service provided and the high replacement cost) will persist. Under our notching criteria, when assigning issue ratings on utility FMBs, we consider the limitations of FMB issuance under the utility's indenture relative to the value of the collateral pledged to bondholders, management's stated intentions on future FMB issuance, and the regulatory limitations on bond issuance. FMB ratings can exceed a CCR on a utility by up to one notch in the 'A' category, two notches in the 'BBB' category, and three notches in speculative-grade categories.

Empire's electric FMBs benefit from a first-priority lien on substantially all of the utility's real property owned or subsequently acquired. Collateral coverage of more than 1.5x supports a recovery rating of '1+' and an issue rating two notches above the CCR.

Outlook

The stable rating outlook reflects our expectation that management will maintain cash flow protection and debt leverage measures in line with the rating. Specifically, our baseline forecast includes accelerating capital expenditures, with adjusted FFO to total debt declining to about 14%, debt to EBITDA hovering around 4.2x, and total debt to total capitalization remaining below 56%. We could lower the ratings if Empire cannot sustain consolidated financial measures of FFO to total debt of at least 13% and debt leverage below 60%. Although we do not envision this, it could occur if the company does not finance its heavy construction program in a conservation fashion, if Empire does not continue to effectively manage its regulatory risk, or if the economy substantially weakens. Given rising capital outlays and our expectations for weakening measures of bondholder protection, we don't anticipate a ratings upgrade during our current forecast period.

Related Criteria And Research

- Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Analytical Methodology, April 15, 2008
- Assessing U.S. Utility Regulatory Environments, Nov. 7, 2007

Table 1

Empire District Electric Co. -- Peer Comparison

Industry Sector: Electric

	Empire District Electric Co.	Westar Energy Inc.	El Paso Electric Co.
Rating as of March 22, 2012	BBB-/Stable/A-3	BBB/Stable/A-2	BBB/Stable/--
	--Average of past three fiscal years--		
(Mil. $)			
Revenues	538.4	2,028.5	874.4
EBITDA	188.6	762.4	257.4
Net income from cont. oper.	47.9	191.8	86.9
Funds from operations (FFO)	164.0	609.0	225.9
Capital expenditures	124.8	599.3	224.2
Free operating cash flow	18.2	(52.0)	7.3
Dividends paid	41.9	131.0	9.1
Discretionary cash flow	(23.7)	(182.9)	(1.8)
Cash and short-term investments	8.5	2.8	59.7
Debt	869.9	3,547.4	1,003.3
Preferred stock	8.3	10.7	0.0
Equity	658.9	2,484.2	764.5
Debt and equity	1,528.9	6,031.6	1,767.7
Adjusted ratios			
EBITDA margin (%)	35.0	37.6	29.4
EBIT interest coverage (x)	2.6	2.5	3.0
Return on capital (%)	7.3	7.0	9.5
FFO int. cov. (X)	4.5	3.9	4.4
FFO/debt (%)	18.9	17.2	22.5
Free operating cash flow/debt (%)	2.1	(1.5)	0.7
Discretionary cash flow/debt (%)	(2.7)	(5.2)	(0.2)
Net cash flow/capex (%)	97.9	79.8	96.7
Debt/EBITDA (x)	4.6	4.7	3.9
Total debt/debt plus equity (%)	56.9	58.8	56.8
Return on capital (%)	7.3	7.0	9.5
Return on common equity (%)	6.4	7.6	9.1
Common dividend payout ratio (un-adj.) (%)	86.0	73.9	10.4

Table 2

Empire District Electric Co. -- Financial Summary

Industry Sector: Electric

	--Fiscal year ended Dec. 31--				
	2011	**2010**	**2009**	**2008**	**2007**
Rating history	BBB-/Stable/A-3	BBB-/Stable/A-3	BBB-/Stable/A-3	BBB-/Stable/A-3	BBB-/Stable/A-3
(Mil. $)					
Revenues	576.9	541.3	497.2	518.2	490.2

Table 2

Empire District Electric Co. -- Financial Summary (cont.)					
EBITDA	209.1	190.8	165.9	160.9	150.5
Net income from continuing operations	55.0	47.4	41.3	39.7	33.2
Funds from operations (FFO)	182.9	177.6	131.7	116.6	120.9
Capital expenditures	105.3	109.7	159.3	214.7	186.4
Dividends paid	26.7	52.0	46.9	45.4	41.1
Debt	832.1	886.4	891.3	877.0	668.2
Preferred stock	0.0	0.0	25.0	25.0	25.0
Equity	694.0	657.6	625.2	553.9	564.2
Debt and equity	1,526.1	1,544.0	1,516.5	1,430.9	1,232.4
Adjusted ratios					
EBITDA margin (%)	36.2	35.3	33.4	31.1	30.7
EBIT interest coverage (x)	3.1	2.6	2.1	2.1	2.0
FFO int. cov. (x)	5.1	4.7	3.7	3.6	3.8
FFO/debt (%)	22.0	20.0	14.8	13.3	18.1
Discretionary cash flow/debt (%)	2.7	(2.1)	(8.4)	(18.8)	(17.7)
Net cash flow/capex (%)	148.3	114.5	53.2	33.2	42.9
Debt/debt and equity (%)	54.5	57.4	58.8	61.3	54.2
Return on capital (%)	7.9	7.3	6.6	6.9	6.9
Return on common equity (%)	8.1	5.9	4.8	5.1	5.1
Common dividend payout ratio (un-adj.) (%)	48.6	109.7	108.5	109.0	117.4

Table 3

Reconciliation Of Empire District Electric Co. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. $)

	--Fiscal year ended Dec. 31, 2011--									
Empire District Electric Co. reported amounts										
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Reported	705.2	694.0	576.9	194.5	131.0	41.3	134.6	134.6	26.7	102.5
Standard & Poor's adjustments										
Operating leases	4.7	--	--	0.3	0.3	0.3	0.7	0.7	--	--
Postretirement benefit obligations	67.5	--	--	6.6	6.6	--	16.8	16.8	--	--
Capitalized interest	--	--	--	--	--	0.2	(0.2)	(0.2)	--	(0.2)
Share-based compensation expense	--	--	--	1.8	--	--	--	--	--	--
Power purchase agreements	46.1	--	--	5.7	2.7	2.7	3.0	3.0	--	3.0
Asset retirement obligations	2.6	--	--	0.2	0.2	0.2	(0.1)	(0.1)	--	--

Table 3

Reconciliation Of Empire District Electric Co. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. $) (cont.)

	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Dividends paid	Capital expenditures
Reclassification of nonoperating income (expenses)	--	--	--	--	(0.7)	--	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	28.2	--	--
Debt - Accrued interest not included in reported debt	6.0	--	--	--	--	--	--	--	--	--
Total adjustments	126.9	0.0	0.0	14.5	9.1	3.4	20.1	48.3	0.0	2.8

Standard & Poor's adjusted amounts

	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Dividends paid	Capital expenditures
Adjusted	832.1	694.0	576.9	209.1	140.1	44.7	154.7	182.9	26.7	105.3

Ratings Detail (As Of March 23, 2012)

Empire District Electric Co.	
Corporate Credit Rating	BBB-/Stable/A-3
Commercial Paper	
Local Currency	A-3
Senior Secured (8 Issues)	BBB+
Senior Unsecured (3 Issues)	BBB-
Corporate Credit Ratings History	
27-May-2011	BBB-/Stable/A-3
10-Mar-2011	BBB-/Positive/A-3
17-May-2006	BBB-/Stable/A-3
Business Risk Profile	Excellent
Financial Risk Profile	Aggressive

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.