Exhibit No.
Issues: Depreciation Data and Unit Train, Capital Structure, Banking Fees, State Income Tax
Witness: Robert W. Sager
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Empire District Electric
Case No. ER-2012-0345
Date Testimony Prepared: January 2013

Before the Public Service Commission
of the State of Missouri

Rebuttal Testimony

of

Robert W. Sager

January 2013

SERVICES YOU COUNT ON

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REBUTTAL TESTIMONY
OF
ROBERT W. SAGER
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
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INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Robert W. Sager, 602 Joplin Street, Joplin, Missouri 64801.

Q. WHO IS YOUR EMPLOYER AND WHAT POSITION DO YOU HOLD?

A. The Empire District Electric Company ("Empire" or "Company") is my employer. I hold the position of Controller, Assistant Treasurer, Assistant Secretary, and Principal Accounting Officer.

Q. ARE YOU THE SAME ROBERT W. SAGER THAT PROVIDED DIRECT TESTIMONY IN THIS CASE?

A. Yes, I am.

Q. PLEASE EXPLAIN THE PURPOSE OF YOUR REBUTTAL TESTIMONY.

A. My testimony responds to the testimony of the other parties on several issues including depreciation, capital structure, debt costs, banking fees and income tax.

DEPRECIATION DATA AND UNIT TRAIN

Q. DO YOU AGREE WITH STAFF'S STATEMENT INDICATING THE COMPANY DID NOT RECORD LEASE INCOME GENERATED FROM THE STEEL TRAIN ON ITS REGULATED BOOKS?

A. No. The lease income generated from the steel unit train was recorded in the Company's regulated books. Specifically, the income was credited to account

151060 “Lease of Railcars”. The amounts included in this account were cleared each month to fuel expense, which was also included in Empire’s regulated books. Under this methodology, customers received the benefit of this income through reduced fuel costs.

Q. DO YOU AGREE WITH STAFF’S ASSERTION THAT THE PROCEEDS OF THE UNIT TRAIN SALE SHOULD HAVE BEEN BOOKED TO THE DEPRECIATION RESERVE?

A. No. Staff indicates that the response to DR No. 0240 “corroborates” that the profit from the sale was reported as a gain. Staff did not mention, however, that the response also included documentation from FERC indicating that Empire was correct in treating the unit train as an operating unit. This is significant because the sale of an “operating unit” would indicate that recording a gain or loss is proper.

Q. DO YOU NORMALLY RECORD ANY NET PROCEEDS FROM A SALE TO THE DEPRECIATION RESERVE?

A. Yes. Staff’s general premise that net proceeds from a sale should be recorded against the depreciation reserve holds true unless the item is considered an operating unit.

Q. WHY DID YOU CONFIRM THIS TREATMENT WITH FERC?

A. We contacted FERC to be sure that our analysis was correct under the FERC guidelines in assessing whether the unit train was an operating unit.

Q. WAS THE SALE NECESSARY?

A. Yes. The sale of the steel unit train was necessary because Empire needed to replace it with an aluminum unit train. This change in transportation equipment was brought about by requirements of the railroads. The railroads were going to impose increased fees/charges on steel trains due to the weight of those unit trains. If Empire had not transitioned to the aluminum unit train, the overall fuel cost to Empire's customers would have increased significantly due to an increase in transportation costs.

Q. DO YOU BELIEVE AN ADJUSTMENT SHOULD BE MADE IN THIS CASE TO ADJUST THE REVENUE REQUIREMENT FOR THE UNIT TRAIN GAIN RECORDED IN 2007?

A. No. I do not. The gain was recorded in the last quarter of 2007 and Missouri Case No. ER-2008-0093 included a true up to 12/31/07 (2/29/08 for certain aspects of the Asbury plant). Empire has filed two other rate cases – Case No. ER-2010-0130 and ER-2011-0004 between then and the filing of the present case. Although we do not believe an adjustment was made in the 2008 case for the gain, Staff's proposal in this case would appear to be retroactive ratemaking if this item were to be included in the current case. As such, I believe an adjustment now would be inappropriate.

Q. TOM SULLIVAN PROVIDED TESTIMONY REGARDING EMPIRE'S DEPRECIATION RATES, BASED ON A DEPRECIATION STUDY THAT WAS FILED IN CASE NO. ER-2011-0004. DURING THAT CASE, STAFF INDICATED EMPIRE'S BOOKS AND RECORDS WERE "INSUFFICIENT" REGARDING ITS PLANT AND EQUIPMENT RECORDS. HAS THIS CONCERN BEEN ADDRESSED?

A. Yes, we met with members of Staff during 2012 to discuss the data, and we demonstrated how Empire's plant and equipment records used in depreciation studies have been accumulated over its history. In addition, we discussed with Staff that Empire has recently invested in new systems, such as PowerPlant, which will allow Empire to be more efficient in maintaining its plant records going forward. We feel these discussions were beneficial for both parties and resolved any previous data issues indicated by Staff.

CAPITAL STRUCTURE

Q. WHAT CAPITAL STRUCTURE ISSUES ARE YOU COMMENTING ON IN THIS REBUTTAL?

A. I address Mr. Gorman's goodwill adjustment to his proposed Empire capital structure and Staff's adjustment related to the cost of debt.

Q. PLEASE DESCRIBE WHAT MR. GORMAN'S PROPOSED CAPITAL STRUCTURE REFLECTS?

A. Mr. Gorman has adjusted Empire's capital structure by reducing Empire's common equity balance based on an amount equal to goodwill that is recorded on Empire's books. This goodwill was created when the Company purchased a segment of the regulated natural gas company assets of Aquila, Inc. in 2006.

Q. WHAT BASIS DOES MR. GORMAN PROVIDE FOR ADJUSTING THE CAPITAL STRUCTURE DUE TO GOODWILL RECORDED ON EMPIRE'S BOOKS?

A. It is unclear, based on Mr. Gorman's testimony, whether he's proposing the goodwill be excluded from the capital structure because of the original investment in the gas company purchase or whether he believes the asset is impaired, so I will address both issues.

Q. WHY DOES MR. GORMAN PROPOSE AN ADJUSTMENT TO EMPIRE'S CAPITAL STRUCTURE BASED ON THE INVESTMENT IN THE GAS COMPANY?

A. Mr. Gorman's adjustment assumes that the goodwill resulting from the 2006 acquisition was financed purely from the equity Empire issued as a result of the transaction, and therefore his adjustment removes the goodwill from the equity portion of his proposed capital structure.

Q. DO YOU BELIEVE THIS IS APPROPRIATE?

A. No. The acquisition was financed through a balanced mix of debt and equity. This is the same financing philosophy that Empire has utilized for several years, such as the overall financing that supported our construction of Iatan 2, Plum Point and other environmental projects from 2006-2011. It is untrue that certain assets, such as non-regulated assets, or the premium paid for the Aquila natural gas assets was specifically financed using one source and not the other.

Q. DOES EMPIRE ROUTINELY TEST THE GOODWILL ASSET FOR IMPAIRMENT?

A. Yes. As Mr. Gorman indicates on page 12 of his testimony, the goodwill value is tested each year and would be written off if the tests indicated an impairment of the goodwill asset. If an impairment of the goodwill asset were to occur, it would ultimately lower Empire's common equity balance.

Q. HAS EMPIRE'S GOODWILL ASSET BEEN IMPAIRED?

A. No. Since the acquisition of the Aquila natural gas assets, the goodwill impairment tests, which are reviewed in significant detail by our external auditors, have indicated the value has not been impaired. Mr. Gorman's adjustment essentially writes-off the goodwill for the Company which is not reflective of the tests that have already been performed.

Q. PLEASE EXPLAIN THE NATURE OF THE COSTS THE STAFF RECOMMENDS BE EXCLUDED FROM EMPIRE'S COST OF DEBT CALCULATION.

A. In the first quarter of 2008, Empire solicited consents from its electric mortgage bondholders to amend its indenture so the basket to pay dividends would increase by approximately $10.7 million. Fees were paid to bondholders in order to obtain the consents needed to amend the Indenture. Staff has argued in its Staff Report - Cost of Service (pg. 27) that these expenses should be disallowed.

Q. HOW DO YOU RESPOND TO THIS PROPOSED DISALLOWANCE?

A. I disagree.

Q. WHY DO YOU DISAGREE WITH THE STAFF'S PROPOSED DISALLOWANCE OF THESE EXPENSES AS PART OF THE COMPANY'S DEBT COSTS?

A. The costs were incurred in order to provide support to Empire's overall financing plan related to the recent (Asbury SCR, Riverton Unit 12, Iatan Unit 1 AQCS, Plum Point, and Iatan Unit 2) construction build. The Staff's disallowance is based on the false premise that costs related to the amendment of the indenture were solely to benefit shareholders.

Q. PLEASE EXPLAIN.

A. Empire has completed the largest construction program in its history which required significant financing from both the equity and debt markets. The equity markets are attracted to Empire as an income stock, not as a growth stock. If Empire had reduced or been unable to pay its dividend, the underlying stock value would likely have eroded, which would have made it even more difficult for the Company to raise the equity funds necessary to complete the construction cycle. If Empire had been unable to raise equity funds, the Company would have been required to increase its debt issuances to support the construction program. Empire's debt to equity ratio would then have exceeded acceptable rating agency guidelines for an investment grade company had the construction been financed in an unbalanced approach. This could have led to a downgrade from the rating agencies which would, in turn, have raised Empire's costs associated with any future debt issuances. Therefore, the amendment to the indenture was accomplished to support the Company's overall financing plan which benefits its customers.

Q. WHAT IS THE RELATIONSHIP BETWEEN THE AMENDMENT COSTS AND THE FINANCING NOTED PREVIOUSLY?

A. The amendment was accomplished in the first quarter of 2008, roughly half way through the recent construction and financing program, in order to provide investors some comfort that Empire understood the importance of the dividend to shareholders. The Company's Indenture, as it previously read, did not allow Empire to pay dividends with essentially a negative retained earnings balance. The Company's retained earnings balance had dropped to approximately $17.2 million (12/31/07), in part because we had absorbed $85.5 million of fuel and purchased power costs in the 2003-2006 period due to the lack of a fuel adjustment clause in Missouri (Staff's Cost of Service Report, Case No. ER-2008-0093). An amendment to the Indenture's retained earnings clause was necessary so investors would continue to be attracted to the Company's stock. Ultimately, Empire was able to complete a successful equity distribution program during 2009/2010 subsequent to the amendment.

Q. WAS THE RATIO OF DEBT TO TOTAL CAPITAL ADDRESSED IN EMPIRE'S REGULATORY PLAN PREVIOUSLY AUTHORIZED BY THE COMMISSION?

A. Yes. The Regulatory Plan approved by the Commission in Case No. EO-2005-0263 outlined three primary financial ratios at Appendix C-1. Debt to total capital was one of the three financial ratios outlined. This debt ratio was to be maintained by Empire through future financing during the term of the Regulatory Plan and was not a component of regulatory amortization (Regulatory Plan-Appendix D). Empire successfully maintained this important financial ratio during the term of the Regulatory Plan through its external financing efforts and our customers benefitted.

Q. HOW DOES ALL OF THIS BENEFIT EMPIRE'S CUSTOMERS?

A. As previously explained, a balanced approach to Empire's financing program was essential to maintaining an investment grade rating. In fact, this has been known and acknowledged since the beginning of the construction program, as the Regulatory Plan (Case No. EO-2005-0263) itself included the following statement: "Empire understands that it is responsible to take prudent and reasonable actions to maintain Empire's debt at investment grade levels and avoid actions that result in a downgrade." This language was included in the Regulatory Plan as an acknowledgement of how important it is to keep financing costs low for customers by maintaining an investment grade rating. The actions taken in 2008 to amend Empire's Indenture were prudent in order to finance the recent construction cycle, and the costs associated with those actions should be included in the debt costs related to the capital structure as it benefited customers and shareholders alike.

BANKING FEES

Q. DO YOU AGREE WITH MEUA'S WITNESS MR. RACKERS THAT BANK FEES SHOULD BE CAPITALIZED?

A. No, I do not. Mr. Rackers suggests that short-term debt costs be capitalized similar in nature to long-term debt costs even though the very nature of the costs, the line of credit, is a current liability.

Q. WHY DO YOU BELIEVE CAPITALIZATION IS INAPPROPRIATE?

A. Common practice has been to assume that the short term line of credit supports CWIP, as Mr. Rackers suggested, and I agree with that. However, considering the Company is not allowed to recover CWIP in rates in Missouri, Mr. Rackers proposal appears to be yet another attempt to delay recovery of a prudently incurred cost. For that reason, the timing of when these costs are incurred compared to when the Company will ultimately recover the costs is inconsistent.

STATE INCOME TAX

Q. STAFF HAS EXCLUDED EMPIRE'S ADJUSTMENT FOR "STATE-INCOME TAX FLOW THROUGH", PLEASE DESCRIBE WHY THIS ADJUSTMENT SHOULD BE INCLUDED IN COST OF SERVICE?

A. The adjustment reflects state income taxes that have not been collected on deferred tax items under the normalization method.

Q. WHAT IS THE BACKGROUND OF THIS ADJUSTMENT?

A. Regulations were enacted in 1969 that required normalization of federal taxes for ratemaking purposes. (The difference between “normalization” and “flow-thru” were described by staff on pages 123 and 124 of “Staff Cost of Service Report”). The federal regulations did not <u>require</u> normalization of state income taxes. Normalization essentially requires companies to record and recover taxes applicable to “current” taxes and “deferred” taxes. The predominant belief now is that normalization is a better ratemaking theory for tax purposes as opposed to flow-through.

Since the 1969 regulation and up until 1994, Empire continued to record federal taxes for both current and deferred components under the normalization rule. The Company also recorded state taxes for the current component of tax; however, absent specific rule making or a Commission order regarding the “deferred” portion of state taxes, this was not recorded as Empire did not collect this from ratepayers. Empire is now seeking collection of these state income taxes.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.

AFFIDAVIT OF ROBERT W. SAGER

STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the __14th____ day of January, 2013, before me appeared Robert W. Sager, to me personally known, who, being by me first duly sworn, states that he is the Director of Financial Services of The Empire District Electric Company and acknowledges that he has read the above and foregoing document and believes that the statements therein are true and correct to the best of his information, knowledge and belief.

Robert W. Sager
Robert W. Sager

Subscribed and sworn to before me this __14th____ day of January, 2013.

ANGELA M. CLOVEN
Notary Public - Notary Seal
State of Missouri
Commissioned for Jasper County
My Commission Expires: November 01, 2015
Commission Number: 11262659

Angela M. Cloven
Notary Public

My commission expires: 11/01/15.