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Research Update: Empire District Electric Downgraded To 'BBB-' On Expected Tight Financials

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Primary Credit Analyst:

Gerrit Jepsen, CFA, New York (1) 212-438-2529;
gerrit_jepsen@standardandpoors.com

Credit Rating: BBB-/Stable/A-3

Rationale

On May 17, 2006, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on The Empire District Electric Co., an integrated electric utility, to 'BBB-' from 'BBB'. The downgrade reflects Standard & Poor's view that Empire's financial measures will be constrained over the next several years by fuel and power costs that continue to exceed the level recoverable in rates, and by Empire's higher-than-historical level of capital spending, including the acquisition of a Missouri gas utility. Also, senior secured debt ratings were lowered to 'BBB+' from 'A-', and senior unsecured debt ratings were lowered to 'BB+' from 'BBB-'. The short-term rating of 'A-3' was affirmed. The outlook is stable.

Joplin, Mo.-based Empire had \$456 million in debt and trust-preferred securities as of March 31, 2006.

Empire's satisfactory business risk profile benefits from a service territory that has limited industrial concentration as well as mostly residential and small commercial customers. In addition, Empire has few competitive operations, and has been willing to sell these unregulated businesses due to financial underperformance. These attributes, however, have historically been moderated by less-than-adequate recovery of O&M expenses and other costs. This will continue to weaken Empire's financial measures during the heavy capital spending phase, which includes the Iatan 2 and Plum Point coal units. Empire's business risk profile is a '6' (satisfactory). (Utility business risk profiles are categorized from '1' (excellent) to '10' (vulnerable).)

To strengthen Empire's cash flow during its planned capital spending for generation and environmental compliance, constructive rate relief will be essential and should include recovery of fuel and purchased power on a timely basis. Historically, Missouri regulation has been restrictive regarding fuel and purchased-power costs because a permanent energy cost recovery (ECR) rider was not statutorily authorized. Under a new Missouri law, utilities operating in the state can seek Missouri Public Service Commission approval of an ECR rider that, if authorized, would provide for the pass-through of rising fuel and power costs. Timely recovery of such expenses, particularly when commodity prices rise rapidly, is important for Empire's credit quality because the company relies on a relatively high level of natural-gas-fired generation and power purchases for its supply. Although Empire filed for a \$30 million electric base rate increase in Missouri that, if authorized, would strengthen creditworthiness, the inability to implement an ECR in the near term weakens credit quality, particularly since fuel and power costs currently exceed the level recoverable through base rates and the company's interim energy charge.

Empire's adjusted financial ratios are mixed for the 'BBB-' rating, with funds from operations (FFO) interest coverage of about 3.9x, FFO to total debt of about 17%, and total debt to total capital of approximately

56%. When calculating these ratios, Standard & Poor's considers Empire's trust-preferred securities as having minimal equity content due to a lack of deferability of dividends, and adjusts ratios for operating leases and purchase-power agreements. Moreover, net cash flow FFO less dividends to capital expenditures is expected to decline to about 50%, so Empire will need to seek external financing to fund its large capital needs.

Short-term credit factors

Empire's short-term rating is 'A-3'. As of March 31, 2006, Empire had \$3.4 million of cash and a \$226 million unsecured revolving credit facility available for working capital and as backup for its CP. The facility was recently increased from \$150 million, with the incremental \$76 million allocated to support an LOC issued in connection with the company's participation in the Plum Point coal unit. As of March 31, 2006, Empire had \$46 million drawn on its revolver and no CP outstanding. Empire currently maintains sufficient liquidity to post additional collateral under a stressed scenario in which the company would experience a materially negative credit event and a simultaneous adverse energy price movement. Empire's next long-term debt maturity is \$20 million in 2009.

Outlook

The outlook is stable and incorporates the expectation of steady financial performance through its construction program and successful integration of the gas utility. In addition, we expect that Empire will finance its capital needs in a manner that is consistent with the current rating. The outlook could be revised to negative as a result of unfavorable regulatory actions or if the financial measures weaken from increased capital spending or higher-than-expected use of leverage over the next several years. The outlook could be revised to positive if rate recovery is supportive during the construction program, if a reasonable energy cost recovery mechanism is adopted, and if financial measures begin to show sustainable improvement.

Ratings List

Ratings Lowered

	To	From
The Empire District Electric Co.		
Corp credit rtg	BBB-/Stable/--	BBB/Negative/--
Sr secd debt	BBB+	A-
Sr unsecd debt	BB+	BBB-
Pfd stk	BB	BB+

Rating Affirmed

The Empire District Electric Co.	
CP	A-3

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