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October 16, 2002

Mr. Dale Hardy Roberts
Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102

FILED 3
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Missouri Public Service Commission

Re: The Empire District Electric Company
Case No. ER-2002-424

Dear Mr. Roberts:

On behalf of The Empire District Electric Company ("Empire"), I deliver herewith for filing with the Missouri Public Service Commission in the referenced matter an original and eight (8) copies of the surrebuttal testimony and schedules of Empire witnesses Brad P. Beecher, Kelly S. Walters, and Donald A. Murry.

Copies of this filing will be provided this date to all parties of record.

Would you please bring this filing to the attention of the appropriate Commission personnel.

Thank you very much for your assistance.

Very truly yours,

James C. Swearengen

James C. Swearengen

JCS/lar
Enclosures
cc: Denny Frey
John Coffman
Stuart Conrad

Exhibit No:_____________
Issue: Cost of Capital
Witness: Donald A. Murry
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Empire District
Case No.: ER-2002-424
Date Testimony Prepared:

THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION

SURREBUTTAL TESTIMONY

OF

DONALD A. MURRY, Ph.D.

October 2002

SURREBUTTAL TESTIMONY
OF
DONALD A. MURRY, Ph.D.
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2002-424

Q. PLEASE STATE YOUR NAME.

A. My name is Donald A. Murry.

Q. ARE YOU THE SAME DONALD A. MURRY WHO HAS FILED DIRECT TESTIMONY AND REBUTTAL TESTIMONY IN THIS PROCEEDING BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF THIS SURREBUTTAL TESTIMONY?

A. I am addressing some issues raised as a result of Commission Staff ("Staff") Witness David Murray's rebuttal testimony and rebuttal testimony of Mark Burdette submitted on behalf of the Office of the Public Counsel ("Public Counsel"), all regarding the cost of capital of The Empire District Electric Company ("Empire" or "the Company").

Q. WHAT ARE THE ISSUES THAT YOU ADDRESS IN YOUR SURREBUTTAL TESTIMONY WITH RESPECT TO STAFF WITNESS MURRAY'S REBUTTAL?

A. Although there are a number of positions taken in Mr. Murray's testimony that I think are analytically unsound, there are three issues that I would like especially to bring to the attention of the Commission.

Q. WHAT ARE THESE ISSUES?

A. They are his arbitrary cutting of earnings growth estimates as though this has any analytical justification; his rather outlandish position regarding Empire's dividend policy; and his defense of including short-term debt in the capital structure. Mr. Burdette makes similar conceptual errors in his use of short-term debt in the permanent capital structure, and I will address these as well.

Q. WHAT DO YOU MEAN WHEN YOU SAY THAT MR. MURRAY IS NOT JUSTIFIED IN RECOMMENDING CUTTING EARNINGS GROWTH RATES?

A. Mr. Murray cites a *Business Week* article to justify reducing Empire's earnings growth estimates by one-third, and then he argues at page 20 lines 12-13 of his rebuttal that this lower number (a 3.5 percent growth rate) is the correct number for a DCF analysis because "many investors do not accept the estimates of Wall Street blindly when evaluating investment alternatives." With this clearly arbitrary adjustment, Mr. Murray throws out any pretext of analysis and makes a mockery of the DCF process.

Q. PLEASE EXPLAIN.

A. The DCF method is based on the ability to take known return estimates and current market prices to calculate a discount rate, which is the cost of capital. Mr. Murray, however, now says that he will <u>assume</u> a growth rate forecast to justify his cost of capital. If this is the procedure he wishes to follow, he could just state his cost of common equity opinion. There is no reason to pretend that what he has done is a DCF analysis.

Q. WHY DO YOU SAY MR. MURRAY'S POSITION REGARDING EMPIRE'S DIVIDEND POLICY IS OUTLANDISH?

A. In Mr. Murray's discussion of Empire's dividend policy he seems to not understand how investor's perceptions of dividends and dividend policy affect the cost of capital. More important, he seems not to comprehend the role of regulation in affecting the true cost of capital.

Q. WHY DO YOU SAY THAT MR. MURRAY SEEMS TO NOT UNDERSTAND INVESTORS' PERCEPTIONS OF DIVIDENDS AND DIVIDEND POLICY?

A. On pages 29 and 30 of his rebuttal testimony, he cavalierly discusses the cutting of the Company's dividend as though there would be no effect upon the perceptions of investors. In short, his testimony reflects a financial naiveté that is dangerous to Empire financially and to the reliability of service for Empire's customers. To not effectively balance the consideration of lower rates for customers, the reliability of service for customers, and the financial viability of the Company is an irresponsible position.

Q. WHY DO YOU CALL MR. MURRAY'S POSITION IRRESPONSIBLE?

A. His casual treatment of the likelihood that Empire will fail to cover its dividend again this year shows a disregard for the financial viability of the Company. He even cites DQE, Inc. ("DQE"), a company fighting to avoid insolvency, as a model for Empire. He cites DQE in a laudatory manner as a company that has wisely cut its dividends to conserve cash, as though this were an admirable position for a utility to be in. On page 30, lines 6 to 7 of his rebuttal testimony, he quotes a *Value Line* report about DQE, to which he added the boldface for emphasis, "It is considering a reduction in the quarterly distribution to $0.25 a share, starting in the upcoming December period. **This would save cash and lend DQE flexibility to improve its overall finances."** Mr. Murray failed to tell the Commission, however, that DQE lost $2.75 per share in 2001. In fact, on page 30, lines 7 to 8 of his rebuttal testimony, Mr. Murray made the following remarkable statement: "Clearly, some companies realize that in order to improve their financial situation, they have to reevaluate their dividend policy ..."

Q. WHAT IS "REMARKABLE" ABOUT MR. MURRAY'S STATEMENT?

A. DQE is a company that is reporting losses and shrinking in size. It is selling assets and totally restructuring in order to maintain solvency, in addition to considering a cut in dividends to conserve cash. It is remarkable that Mr. Murray, as a representative of the Staff, would hold up a company that is in such dire circumstances and struggling to maintain its solvency as a regulatory standard for a Missouri company to emulate.

Q. YOU SAID THAT DQE IS SHRINKING IN SIZE. WHAT DO YOU MEAN?

A. DQE's assets have declined rapidly since 1993. In 1993 DQE had assets of $3.1 billion. It ended 2001 with an asset value of $1.7 billion.

Q. HOW DOES DQE'S DECLINE IN ASSETS COMPARE TO EMPIRE'S SITUATION?

A. Empire's assets have increased rapidly because of investment in plant to provide utility service (see Schedule DAM-31). Of course, Empire's need to include these new investments in utility-plant-in-rate-base is one of the purposes of this rate case.

Q. YOU SAID THAT MR. MURRAY USED DQE AS A REGULATORY STANDARD. IS THERE OTHER EVIDENCE THAT MR. MURRAY USES DQE AS A STANDARD IN THIS PROCEEDING?

A. Yes. Not only did Mr. Murray hold out DQE's potential dividend cut to conserve cash and avoid insolvency as a regulatory standard, he selected DQE as one of only four companies, out of a group of 54 that he reviewed, as comparable to Empire. For example, he stated, on page 32 of his direct testimony, lines 22-24, "This final group of four publicly traded electric utility companies serves as a proxy group *to test the reasonableness of my DCF cost of common equity of Empire.*" [Emphasis added].

Q. IS THERE EVIDENCE THAT MR. MURRAY KNEW THAT HE WAS USING A COMPANY IN SERIOUS FINANCIAL DIFFICULTY AS A STANDARD FOR EMPIRE IN THIS PROCEEDING?

A. Surely he did know the condition of DQE. In Schedule 20 of his direct testimony, he shows that DQE's earnings per share of common stock declined from $1.67 in 1991 to $0.31 in 2001, and he provided the calculation to show that this represented a decline of 15.5 percent over the five-year period. As noted earlier, however, he did not correctly report that DQE lost $2.75 per share in 2001. He also showed in this schedule that the asset value of the company, as represented by the book value per share, was declining over the same period by 4.23 percent. Of course, the financial community is familiar with DQE's serious financial situation and restructuring efforts.

Q. WHAT KIND OF EVIDENCE EXISTS THAT DQE IS IN SERIOUS FINANCIAL CIRCUMSTANCES?

A. An example of the evidence appears in the most recent annual report in which Mr. Morgan O'Brien, President and CEO of DQE, Inc., described the need for restructuring and steps needed to improve its balance sheet because of investments in non-utility enterprises. He stated in his letter to investors:

> "We incurred some additional setbacks of our own during 2001. We wrote off approximately $200 million of investments. Our stock price, which began the year around $33 ended 2001 at $18.31."

Also, *Value Line*, September 6, 2002, in a very blunt statement, advised investors to avoid DQE common stock, "Investors would probably do better elsewhere." Moreover, DQE's cash difficulties are ongoing. On September 12, 2002, Zack's listed DQE as a #5 strong sell recommendation for investors to avoid further "misery." With this announcement, Zack's noted, as follows:

> "In its second quarter, earnings for the company missed the consensus view by four cents and revenue fell from the year-ago level. Over the past three months, earnings estimates have slumped by seven cents and eight cents for this year and next respectively.

Q. IS THERE ANY EVIDENCE THAT THE FINANCIAL EXIGENCY OF DQE FURTHER INFLUENCED MR. MURRAY'S RECOMMENDATION FOR EMPIRE IN THIS CASE?

A. Yes, there is. Mr. Murray averaged the poor financial statistics of DQE, including the negative numbers, with those of the other three companies to develop the numbers that he reported as an average for his "Four Comparable Electric Utility Companies." For example, he averaged the 15.5 percent decline in five-years earnings per share of DQE with the earnings per share growth of the other three companies, and he reported an "average" 0.31 percent earnings growth for his "Comparable Electric Utility Companies." To show how including DQE affected his analysis, averaging just the earnings of other three companies without the decline of DQE would have produced an average growth rate in earnings per share of 4.19 percent for the five-year period.

Q. IS THERE EVIDENCE THAT MR. MURRAY RECOGNIZED THE IMPLICATIONS OF HIS COST OF CAPITAL RECOMMENDATION FOR EMPIRE?

A. No. In fact, Staff Witness Murray further distanced himself and his recommendation for Empire's common stock earnings from any responsibility for maintaining a viable electric system in a Missouri company. In talking about Empire's inability to raise its common stock dividend, he made the following incredible statement, beginning on line 20 of his rebuttal testimony: "In recommending a fair and reasonable rate of return, *it is not the Staff witnesses' responsibility* to ensure that the company will have earnings sufficient to maintain a certain level of dividends." [Emphasis added].

Q. WHY DO YOU CALL THIS STATEMENT "INCREDIBLE?"

A. It shows a total and complete lack of understanding of the impact of the regulatory decision on the investor's perception about dividend payments, and ultimately the ability of the utility to provide reliable service.

Q. PLEASE EXPLAIN.

A. Empire has not increased its common stock dividend in the past nine years, and the dividend payout has steadily declined because of an earnings decline. This is not a case of management increasing dividends at a rate faster than earnings growth can support. This is not a case of a company having a single bad year in earnings and maintaining the same dividend to common stockholders so there is a temporary high payout ratio. <u>This is a case of Empire expanding its plant, incurring new investment and not having a growth in earnings to support any increase in dividends to common stockholders</u>. Mr. Murray's statement is "incredible" because he seems oblivious to the financial realities and the implications of these realities.

Q. HOW DO DIVIDEND POLICIES AFFECT INVESTOR'S PERCEPTIONS?

A. Investors invest in securities expecting a return. Investors relying on dividend income will not invest or will be forced to withdraw investment in companies that do not provide the anticipated dividends. Since Empire has not increased its nominal dividend for nine years, the investors have, in fact, experienced a *decline* in real dividend income. Note in Schedule DAM-32, which shows an inflation-adjusted dividend, that there has been a steady decline in real dividend income for investors in Empire's common stock over a period of nearly a decade. This, in turn, erodes investors' trust in the capability of the Company to finance its service expansion with common stock. This is the reality of prolonged inadequate earnings. Attributing dividend policy to management, as Mr. Murray attempts to do, does not diminish the regulatory responsibility for adverse financial consequences. In the case of Empire, the Company's revenues are primarily from Missouri electric utility customers, and one cannot disassociate the Company's financial circumstances from its regulatory treatment. The irony of Mr. Murray's position is that DQE, the company that he has described as "comparable" and a model, got into serious financial difficulty because of investments in non-utility and non-regulated enterprises. In contrast, Empire is a "pure" regulated utility. It has been unable to raise its dividend and is in a difficult financial position because allowed returns have not been sufficient to support the investments needed to provide utility service.

Q. DO YOU BELIEVE THAT THE FINANCIAL COMMUNITY IS AWARE OF THIS DISTINCTION?

A. Of course, the financial observers are aware of the circumstances of Empire. For example, *Value Line,* October 4, 2002, stated:

> "Although rate relief should help the bottom line recover from the depressed tally of 2001, the company might not earn the dividend this year. We believe the company will cover the dividend in 2003 assuming that it gets a *reasonable* rate order in Missouri. [Emphasis added].

Value Line continued:

> "Management has stated its intention to maintain the dividend at the current level, but *harsh regulatory treatment* could give the board little choice but to reduce the disbursement." [Emphasis added].

Q. IS THERE ANY RECENT EXPERIENCE OF THE MARKET'S REACTION WHEN A UTILITY ANNOUNCED A REDUCTION IN COMMON STOCK DIVIDENDS?

A. Yes. TXU Corporation announced, on October 14, 2002, that it was reducing its common stock dividend to preserve liquidity, and the price of common stock shares dropped immediately by approximately 40 percent.

Q. DO YOU HAVE ANY CONCERNS ABOUT THE INCLUSION OF SHORT-TERM DEBT IN EMPIRE'S CAPITAL STRUCTURE AS BOTH MR. MURRAY AND MR. BURDETTE PROPOSE IN THEIR REBUTTAL TESTIMONY?

A. Yes. Both Mr. Murray and Mr. Burdette use faulty reasoning to justify the inclusion of short-term debt in Empire's capital structure. I presume that they have followed the lead of other witnesses in other proceedings who have recommended including short-term debt. However, the basis for including short-term debt in a capital structure does not apply at all in the case of Empire in this proceeding, and the testimonies of Mr. Murray and Mr. Burdette clearly demonstrate this.

Q. DO ANALYSTS EVER INCLUDE SHORT-TERM DEBT IN CAPITAL STRUCTURE IN A RATE CASE?

A. Yes. There are justifications for including short-term debt in a capital structure for ratemaking, but those circumstances simply do not exist in Empire's case at this time.

Q. WHAT ARE THE CIRCUMSTANCES THAT YOU ARE REFERRING TO THAT JUSTIFY INCLUDING SHORT-TERM DEBT IN THE CAPITAL STRUCTURE OF A UTILITY FOR RATEMAKING PURPOSES?

A. The only basis for including short-term debt in a utility's capital structure for ratemaking purposes is the use of short-term debt as a component of capital that supports the rate base.

Q. COULD YOU EXPLAIN THIS RELATIONSHIP?

A. Broadly, a utility such as Empire, which is a relatively pure electric utility, will use short-term debt for three purposes. These are the use of short-term debt: (1) to balance the irregular cash flows of revenues with irregular operating expenses; (2) to bridge the time period between incurring the cost of plant investment and the issuance of permanent capital in the form of long-term debt or common stock; and (3) to support a continuous component in the permanent capital structure of the utility.

Q. WHEN WOULD A UTILITY USE SHORT-TERM BORROWING TO BALANCE ITS CASH FLOWS BETWEEN REVENUES AND EXPENSES?

A. Obviously, a utility needs to meet its payroll in the off-peak months such as in the spring and fall when revenues are low. Also, a utility must pay fuel bills in the off-peak periods when preparing for the peak demand periods. Of course, the peak demand months of summer, and to a lesser extent of winter, are when the utility receives most of its annual revenue. Because of the timing mismatch between revenues and expenses, there is likely to be an ebb and flow of short-term balances.

Q. SHOULD SHORT-TERM DEBT INCURRED TO BALANCE REVENUES AND OPERATING EXPENSES BE INCLUDED IN THE CAPITAL STRUCTURE OF A UTILITY FOR RATEMAKING PURPOSES?

A. Of course not. The operating expenses incurred in providing utility services are included in the revenue requirement and recovered directly in rates. The cost of capital in a rate proceeding is used to determine the cost of capital of the rate base. Since these short-term borrowings are not permanent, in the sense that they are incurred to support rate-base investment, they should not be reflected or recovered in the cost of capital of the rate base.

Q. WHEN WOULD A UTILITY USE SHORT-TERM BORROWINGS AS A BRIDGE BETWEEN INCURRING THE COSTS OF CAPITAL EXPANSION AND THE ISSUANCE OF LONG-TERM DEBT AND COMMON STOCK?

A. When a utility is building capital facilities, it pays for this construction, at least in part, with short-term borrowings. Then periodically during the construction process, the utility will issue securities in the form of long-term debt or common stock. Of course, the utility must accumulate a sufficient financing requirement so that the block of securities issued will be large enough to justify the issuance expenses, and the issuance expenses will be allocated over the entire block of securities. In addition, when the market is less receptive and security prices are temporarily depressed, a utility may delay issuance. In this way, there is an accumulation of short-term debt in support of plant expansion simply because of market timing. Consequently, because of the lumpiness of securities issuance and market timing strategies, there will be periods of increased short-term debt in support of ongoing construction programs to "bridge" to permanent financing.

Q. IS THIS USE OF BRIDGE SHORT-TERM FINANCING CONSISTENT WITH GOOD, PRUDENT FINANCIAL PLANNING?

A. Yes, of course, it is.

Q. SHOULD THE SHORT-TERM DEBT THAT IS USED FOR BRIDGE FINANCING OF CONSTRUCTION PROGRAMS BE USED TO DETERMINE THE COST OF CAPITAL OF A UTILITY FOR RATEMAKING PURPOSES?

A. No. Bridge financing of construction costs is temporary financing, and it is not used to support plant providing utility service to ratepayers. In other words, plant construction typically is not capital in the utility's rate base, and this short-term debt incurred to support plant expansion is not part of the cost of capital of plant used to provide utility service.

Q. WHEN WOULD A UTILITY USE SHORT-TERM DEBT AS A COMPONENT OF PERMANENT CAPITAL?

A. A utility might use short-term debt as a capital component to support its utility plant, provided it has the short-term borrowing capacity beyond the needs of short-term debt, and to balance the cash flow and to provide the bridge financing for construction, if short-term rates remain at a very low level for a period of time. A second reason that a utility may use short-term borrowing to support its utility plant in service is because it is in a financial situation, such as a violation of its bond indenture, that denies it low-cost access to the longer-term capital markets.

Q. DO YOU THINK THAT USING SHORT-TERM DEBT TO FINANCE PERMANENT CAPITAL SUCH AS A UTILITY RATE BASE IS GOOD FINANCIAL POLICY?

A. It is a risky financial policy, and I believe that it is, and should be, used judiciously. Short-term interest rates can rise sharply, and the utility can miss the opportunity to lock in long-term debt when long-term rates are relatively low. For this reason, many, perhaps most, utilities will not support the utility rate base with short-term borrowings even if they have the borrowing capacity.

Q. AS YOU UNDERSTAND THE COMPANY POLICY, HOW DOES EMPIRE USE SHORT-TERM DEBT?

A. It is my understanding that Empire uses short-term debt for the traditional purposes of balancing its irregular cash flow and as bridge financing. The latter is especially notable in this instance because of the recent construction program and Empire's having been denied the opportunity to issue common stock for a period of time because of the merger agreement with Utilicorp. From my review of the company's policies, there is no evidence that Empire has used short-term debt to provide permanent financing for the utility plant in service. In fact, I pointed out the transitory nature of the short-term debt at page 3, lines 9 to 17, of my rebuttal testimony.

Q. WHY DO YOU SAY THAT MR. BURDETTE AND MR. MURRAY USED FAULTY REASONING FOR JUSTIFYING THE INCLUSION OF SHORT-TERM DEBT IN EMPIRE'S CAPITAL STRUCTURE IN THEIR ANALYSES?

A. Both Mr. Burdette, at page 2, lines 22-33 of his rebuttal testimony, and Mr. Murray, correctly excluded the level of short-term debt equal to the construction work in progress ("CWIP") from the short-term debt that they included in the permanent capital structure. This is the second reason for short-term debt, which I mentioned previously. However, they both erred by not also excluding the level of short-term debt used for balancing the utility's cash flow.

Q. HOW COULD YOU TELL THAT MR. MURRAY AND MR. BURDETTE DID NOT EXCLUDE THE SHORT-TERM DEBT FOR BALANCING CASH FLOWS FROM THEIR CALCULATION OF SHORT-TERM DEBT TO INCLUDE IN THE CAPITAL STRUCTURE?

A. Empire's short-term borrowings fell below even the levels for CWIP. Consequently, there could be no short-term borrowing that would be in support of the utility rate base. For example, as recently as May 2002, the level of short-term borrowings was smaller than the level of CWIP (see Schedule DAM-33). This is also shown in Mr. Burdette's Schedule MB-13, which is attached to his rebuttal testimony.

Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?

A. Yes. It does.

AFFIDAVIT

STATE OF OKLAHOMA)
) SS
COUNTY OF OKLAHOMA)

Before me, the undersigned Notary Public, personally appeared DONALD A. MURRY, who being duly sworn on oath deposes and says that the foregoing prepared testimony and statement of facts contained therein are true and correct to the best of his knowledge, information and belief.

Donald A. Murry

Donald A. Murry

Subscribed and sworn to before me this 15th day of October, 2002.

Carolyn S. Hanes

Notary Public 01019787

My Commission Expires:
December 4, 2005

NOTARY SEAL PUBLIC
CAROLYN S. HANES
Oklahoma County
Notary Public in and for
State of Oklahoma
My commission expires Dec. 4, 2005.