# BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

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| In the Matter of the Application of The Empire District Electric Company for Authority to Issue and Sell under its Existing Indenture of Mortgage and Deed of Trust Dated as of September 1, 1944, as Amended and Supplemented, up to and Including $255,000,000 Principal Amount of its First Mortgage Bonds, in One or More Series, and to, Among Other Things, Execute and Deliver a Supplemental Indenture or Indentures to Provide for the Terms of Said Bonds. | ) ) ) ) ) ) ) ) ) ) ) | Case No. EF-2006-0263 |

## STAFF RECOMMENDATION

COMES NOW the Staff ("Staff") of the Missouri Public Service Commission ("Commission") and respectfully states as follows:

1. On December 19, 2005, The Empire District Electric Company ("Empire" or "Company") filed an Application requesting authority to issue and sell, from time to time, up to and including $255,000,000 aggregate principal amount of Empire's First Mortgage Bonds under its existing Indenture of Mortgage and Deed of Trust.

2. On February 1, 2006, the Commission issued an Order directing the Staff to file its Recommendation or a Status Report regarding the Recommendation by March 1, 2006.

3. The Staff filed a Status Report on March 1, 2006 and a Second Status Report on March 17, 2006, the latter revising the Staff's expected filing date to March 24, 2006. On March 24, 2006, citing good progress in ongoing discussions between the Staff and Empire regarding the conditions to be included in the Staff's Recommendation, and the need for more time to

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conclude those discussions, Empire filed a motion requesting that the Commission grant the Staff an additional week, until March 31, 2006, in which to file its Recommendation

4. Attached hereto as Appendix A is a Staff Memorandum recommending approval of Empire's Application, subject to nine conditions. Condition 1 recommends, among other things, that the Commission authorize Empire to issue and sell only up to and including $200,000,000 aggregate principal amount, rather than the $255,000,000 requested in the Application. As explained in the attached Memorandum, the Company had originally planned to use $55 million of the $255 million in secured debt for its proposed purchase of Aquila's Missouri gas properties[1], which transaction is anticipated to close in 2006. Empire has since decided to use unsecured debt to complete this transaction; hence, the Staff is recommending the $55 million reduction in secured debt issuance authority. It is the Staff's understanding that Empire is in agreement with the recommended reduction and indeed, that all eleven conditions are acceptable to the Company.

WHEREFORE, the Staff respectfully recommends that the Commission issue an Order authorizing Empire to issue and sell long-term debt up to $200,000,000 aggregate principal amount, subject to the conditions set forth in the attached Memorandum.

[1] Case No. GO-2006-0205

Respectfully submitted,

**/s/ Dennis L. Frey**
Dennis L. Frey
Senior Counsel
Missouri Bar No. 44697

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## Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, or transmitted by facsimile or electronic mail to all counsel of record this 31st day of March 2006.

**/s/ Dennis L. Frey**

MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. EF-2006-0263, The Empire District Electric Company

FROM: David Murray, Financial Analysis Department

| | |
|---|---|
| David Murray 03/31/06 | Denny Frey 03/31/06 |
| Project Coordinator / Date | General Counsel's Office / Date |

SUBJECT: Staff's Recommendation for approval with conditions of the Application of The Empire District Electric Company (Empire or Company) for Authority to issue Debt in the form of First Mortgage Bonds.

DATE: March 31, 2006

**The Empire District Electric Company**

1. (a) **Type of Issue:** First Mortgage Bonds (hereinafter referred to as 'Bonds').

   (b) **Amount:** Not to exceed the reduced amount of $200 million.

   (c) **Rate:** The interest cost of the Bonds, including any applicable discounts, will not exceed 9 percent unless Empire first obtains the Commission's approval.

   (d) **Other Provisions:** Empire will file a document setting forth the aggregate principal amount to be sold, price information, and estimated expenses of each issuance.

2. **Proposed Date of Transaction:** Any time over the period of the shelf registration, which expires on December 1, 2008.

3. (a) **Statement of Purpose of the Issue:** The net proceeds from the sale of each series of the Bonds will be added to Empire's general funds for use in connection with the acquisition of property, business or entities; the construction, completion or improvement of its plant or system; the improvement or maintenance of service; the discharge or lawful refunding of its obligations, or the reimbursement of moneys actually expended from income or any other moneys in the treasury not secured or obtained from the issuance of stocks, bonds, notes or other evidences of indebtedness.

   (b) From a financial perspective, does Staff deem this purpose reasonable?

   Yes _X_ No

4. **Type of Transaction:** Empire anticipates it will issue and sell each new series of Bonds in any of the following ways: (a) in a public offering through an underwriter or underwriters or dealer or dealers, (b) in a private placement directly to a limited number of purchasers or a single purchaser, or (c) in an offering through agents.

5. **Copies of executed instruments defining terms of the proposed securities:**

___ (a) If such instruments have been previously filed with the Commission, a reference to the Case Number in which the instruments were furnished.

_X_ (b) If such instruments have not been executed at the time of filing, a statement of the general terms and conditions to be contained in the instruments that are proposed to be executed.

___ (c) If no such instruments are either executed or to be executed, a statement of how the securities are to be sold.

6. **Certified copy of resolution of the directors of applicant, or other legal documents authorizing the issuance of the securities reviewed:**

Yes _X_ No

7. **Pro-forma Balance Sheet and Income Statement reviewed:**

Yes _X_ No

8. **Capital expenditure schedule reviewed:**

Yes _X_ No

9. **Journal entries are required to be filed by the Company to allow for the Fee Schedule to be applied:**

Yes No _X_

10. **Recommendation of the Financial Analysis Department:**

___ Grant by session order (see Comments)

_X_ Conditional Approval granted pending receipt of definite terms of issuance (see Comments)

___ Require additional and/or revised data before approval can be granted (see Comments)

___ Formal hearing required (see Comments)

___ Recommend dismissal (see Comments)

**COMMENTS:**

The Empire District Electric Company (Empire) is a public utility engaged in the business of generating, purchasing, transmitting, distributing and selling electric energy in Missouri, Kansas, Arkansas and Oklahoma. Missouri comprises 88.8% of Empire's retail electric utility customers. Empire will also soon be a distributor of natural gas if the proposed acquisition of Aquila Inc.'s (Aquila) Missouri gas properties is closed.

Empire filed a Registration Statement with the Securities and Exchange Commission (SEC) on October 17, 2005, for its $400 million universal shelf registration of common stock, preference stock, unsecured debt securities and first mortgage bonds. The Registration Statement was declared effective by the SEC on November 1, 2005.

On December 19, 2005, the Company filed an application requesting that the Missouri Public Service Commission (Commission) authorize Empire to issue and sell under its existing Indenture of Mortgage and Deed of Trust up to and including $255 million principal amount of its First Mortgage Bonds in one or more series.

The Company's Application respecting the purpose of the Bonds stated that the proceeds from the sale of each series of the Bonds may be used to provide financing for its construction program, including the Projected Infrastructure Investments as detailed in Appendix A (see Attachment A to this Memorandum) of the Experimental Regulatory Plan that was approved by the Commission in Case No. EO-2005-0263. The Application also stated that Empire plans to discharge long-term indebtedness by the payment of principal at maturity, to refinance outstanding indebtedness, including the payment of applicable redemption premiums, and for other corporate purposes.

Empire's Application had originally anticipated that $55 million of the $255 million in secured debt would be used to finance Empire's proposed purchase of Aquila's Missouri gas properties in Case No. GO-2006-0205, which is anticipated to close in 2006. The use of these funds for this purpose was identified in the corrected Appendix 5 attached to the Application. However, since the filing of the Application, Empire has decided to use unsecured debt to complete this transaction. Accordingly, the Staff and Empire agree that the amount of secured debt for which Commission authority is requested in this proceeding should be reduced to $200 million. Although Empire now anticipates issuing unsecured debt rather than secured debt for the gas acquisition, Empire represents that it still plans on issuing $255 million in total debt through 2008. Consequently, the pro forma financial statements that anticipated the issuance of $255 million in debt do not need to be revised.

According to the corrected Appendix 5 attached to the Application, $100 million of the proposed secured debt will be used to retire $50 million of Trust Preferred Securities and $50 million of 7.05% Series Senior Notes. The Application does not identify the specific projects that may be funded by the remaining $100 million in proposed secured debt, other than a reference to Projected Infrastructure Investments identified in the Experimental Regulatory Plan.

Empire's Application requests the financing be approved for use for a broad set of circumstances. If the financing is approved to be used for "other corporate purposes," as stated in the Application, then this could apply to virtually any use. Because the financing request proposes to use Empire's Missouri electric utility properties to secure the debt, it is prudent to require that the amount of funds from this financing authority only be used for purposes that benefit Empire's electric utility properties. Staff believes it is prudent to limit the use of the remaining $100 million of funds in this request to projects detailed in Appendix A of Empire's Experimental Regulatory Plan, to investments necessary for Empire's recently announced participation in the coal-fired Plum Point Power Plant (Plum Point) and for other incidental electric utility projects. Although Plum Point wasn't mentioned in the Application and is not part of the Experimental Regulatory Plan, Staff is aware that there will be construction expenditures required for this project during the period of the requested financing authority. In fact, these expenditures are embedded in the pro forma financial statements analyzed by Staff.

Further, Staff believes that if any of the proceeds intended to be used for refinancing of existing securities are not ultimately used for this purpose, these funds should also be limited to uses associated with Empire's construction plans described in the previous paragraph. If Empire encounters the need to use the funds for purposes other than refinancing and its current construction plans, then Empire should be required to file another Application seeking Commission authorization to do so.

In its Application, the Company seeks authority to issue long-term indebtedness at interest rates not to exceed 11%. The pro forma financial statements provided in response to Staff Data Request 0005 assume an interest rate of 6% through 2008 because of the current lower cost of capital. Staff believes that it is prudent to limit the interest rate to 9%, which is the same ceiling that was recommended by the Staff and established by the Commission in Empire's last finance case, Case No. EF-2004-0109.

Staff has reviewed the pro forma financial statements that were provided by Empire in response to Staff Data Request 0005. Staff relied on the representations made in those financial statements when analyzing the effect of the $255 million in proposed total financing. The pro forma financial statements anticipate the issuance of a maximum of $255 million in debt, whether secured or unsecured, over the next three years. Because Empire is a Kansas Corporation, it is required to request Commission approval to issue financing only when it seeks authority to pledge its Missouri utility properties to secure such financing. Consequently, to the extent that Empire also issues unsecured financing over the next three years, this debt would not reduce the $200 million capacity that may be granted under this Application.

Staff's recommendation for approval of this financing is based on the capital mix that is currently projected to be employed by Empire in its pro forma financial statements. Specifically, Empire anticipates issuing $155 million of debt and $75 million of common equity in 2006; $30 million of debt in 2007; and $70 million of debt and $70 million of common equity in 2008. If Empire were to deviate significantly from these projections, then the capital structures that Staff analyzed in the pro forma financial statements may be different. Staff discusses a proposed condition later in its recommendation that will provide some assurance on the maximum amount of debt leverage that Empire may employ over the term of the financing.

The Experimental Regulatory Plan in Case No. EO-2005-0263 specifically indicated that the Adjusted Total Debt to Total Capitalization ratio would be addressed in future Empire financing cases. Pursuant to this provision, Staff evaluated Empire's pro forma financial statements over the term of the proposed financing to determine how Empire's financing plan may affect its capital structure. Staff also analyzed the pro forma financial statements to determine how Empire's financing plan may affect its Adjusted Funds from Operations (FFO) Interest Coverage ratio and Adjusted FFO as a Percentage of Average Total Debt (Adjusted FFO to Average Total Debt) ratio. These two ratios were agreed to be used in Empire rate cases during the term of Experimental Regulatory Plan to determine if additional cash flow is necessary from Missouri electric jurisdictional operations. All three of the ratios were specifically defined in Appendix C (see Attachment B to this Memorandum) of the Experimental Regulatory Plan. The Experimental Regulatory Plan allows for Adjusted FFO Interest Coverage to be at least 3.2x for Missouri jurisdictional operations and Adjusted FFO to Average Total Debt to be at least 19.5% (see Attachment C to this Memorandum for all ratio targets and methodology). As stated in the Experimental Regulatory Plan, if any of the amounts used in calculating these ratios are considered to be imprudent, the ratios shall be adjusted as necessary at the time of future rate cases.

The pro forma financial statements were based on several assumptions made by Empire regarding the performance of its operations and certain rate relief expected over this period. While Staff inquired about some of the assumptions in the pro forma financial statements, Staff has not changed any of these assumptions for purposes of reviewing the ratios discussed below.

Staff compared Empire's December 31, 2005 actual capital structure to its pro forma capital structures from 2006 through 2008 (see Attachment D). These capital structures have not been adjusted for off-balance sheet debt such as operating leases and purchased power agreements. As can be seen on Attachment D, if Empire executes its financing plan as shown in its pro forma financial statements, then Empire's common equity ratio will be maintained at close to the 2005 year-end actual level of approximately 47%. Empire assumed a $23 per share price for its public offering of common stock for purposes of the pro forma financial statements. If Empire's share price should decline for any reason, Empire may feel pressure to issue less common equity at the time of issuance. If so, this may cause Empire's capital structure to be more leveraged.

A recent February 13, 2006 Standard & Poor's (S&P) research report on Empire provided the results of S&P's calculations of the three ratios that are used as benchmarks in the Experimental Regulatory Plan. Staff compared these results to the pro forma calculations of these ratios for 2006 through 2008 provided by Empire in response to Staff Data Request 0005 (see Attachment E). Staff reviewed these calculations and believes they are generally consistent with S&P's methodology. However, Staff notes that Empire's calculations included other items that were not specifically defined in the Experimental Regulatory Plan. Staff also notes that the items added by Empire show additional FFO, which would reduce any possible needed amortization in future rate cases. Staff will review these calculations in detail if amortization becomes an issue in future rate cases, but Staff believes they are reliable for purposes of reviewing the finance case.

Two of the three ratios are consistent with the benchmarks for Empire's current "BBB" credit rating. Adjusted FFO to Average Total Debt falls below the benchmarks. The calculation of these ratios was based on pro forma financial statements provided by Empire that anticipated Empire's requested rate relief in its current pending rate case. Empire's current request for rate relief does not anticipate the need for additional FFO through the amortization mechanism agreed to in its Experimental Regulatory Plan. Consequently, the lack of anticipated FFO to achieve a 19.5% FFO to Average Total Debt ratio does not appear to be caused by an expected lack of funds from Empire's Missouri electric utility operations, at least for 2007, which would be the year in which the new rates would be in effect.

Based on the pro forma financial statements provided by Empire, it appears that Empire's proposed acquisition of the Aquila gas properties will have a slightly negative impact on the Adjusted FFO to Average Total Debt ratio and the Adjusted FFO Interest Coverage ratio. However, the dilution of these ratios is offset by the lower business risk profile associated with natural gas distribution operations. Empire's plans to issue an appropriate mix of capital to complete the transaction (45% equity and 55% debt).

If Empire is to improve its consolidated FFO to Average Total Debt ratio, then it needs to improve its FFO from operations other than its Missouri jurisdictional electric utility operations and/or reduce the amount of debt leverage it uses. However, Attachment D indicates that the Adjusted Total Debt to Total Capitalization ratio for the years 2006 through 2008 is not expected to exceed the 56.5% benchmark identified in the Experimental Regulatory Plan (see Attachment C). Consequently, based on this benchmark, Staff believes that Empire does not plan to use excessive leverage. Although the pro forma ratios do not exceed the 56.5% benchmark, it is possible that as actual events occur, this benchmark may be breached. Staff believes that it is prudent, therefore, to condition the approval of this financing on Empire's commitment to ensure that this ratio is below the benchmark on the basis of a rolling twelve month average. Staff also believes that if this ratio should exceed the benchmark based on a rolling twelve month average during the period subject to review in a rate case, then the amount of debt exceeding 56.5% and its associated interest expense shall not be considered for purposes of determining additional amortizations. It is Staff's understanding that this condition is acceptable to Empire.

Although Empire's FFO to Average Total Debt ratio is projected to be below the benchmarks for a "BBB" credit rating, this expectation in and of itself does not appear to be justification for S&P to lower Empire's credit rating to below investment grade. In fact, on February 13, 2006, S&P issued a research report on Empire that removed Empire's credit rating from a negative CreditWatch, which was placed on Empire after it announced the proposed acquisition of the Aquila gas properties. A company is placed on CreditWatch when an event or a deviation from an expected trend has occurred. If this event is expected to negatively affect credit quality, then S&P places the company on a negative CreditWatch. However, after S&P met with Empire's management to discuss the acquisition of the Aquila natural gas properties and it analyzed updated financial forecasts that incorporated the gas operations, it removed Empire from negative CreditWatch. Based on comments in S&P's report, it appears that S&P also analyzed financial data through 2008. Consequently, the proposed financing in this case, based on current financial projections, should not negatively affect Empire's ability to attract debt capital at a reasonable cost.

**OTHER ISSUES:**

The Staff has verified that the Company has filed its annual report and is not delinquent on any assessment. The only case that Staff is aware of that may be affected by this filing is Empire's current rate case, Case No. ER-2006-0315.

**RECOMMENDED CONDITIONS:**

Staff recommends that the Commission approve the Application submitted by Empire in this case subject to the following conditions:

1. That the Company shall be authorized to issue up to the reduced amount of $200 million in First Mortgage Bonds under its existing Indenture of Mortgage and Deed of Trust. The Company shall not be authorized to use any portion of the debt securities for any purpose other than to discharge long term indebtedness by the payment of principal at maturity, to refinance outstanding indebtedness, including the payment of applicable redemption premiums, for construction identified as Projected Infrastructure Investments in Appendix A of the Experimental Regulatory Plan in Case No. EO-2005-0263, for construction associated with the Plum Point Power Plant and for other incidental electric utility construction projects.

2. That the Company shall submit to the Financial Analysis Department of the Commission the three key financial ratios (i.e. Adjusted Total Debt to Total Capitalization, Adjusted Funds From Operations Interest Coverage, and Adjusted Funds From Operations as a percentage of Average Total Debt) that were agreed to and defined in the Stipulation and Agreement in Case No. EO-2005-0263. The financial ratios shall be submitted on a quarterly calendar year basis and after each issuance of long-term debt and/or common stock identified in Appendix 5 of the Application. The requirement to submit the financial ratios on a quarterly calendar year basis shall begin after the first issuance of First Mortgage Bonds covered by this Application. The ratios shall be calculated for Empire on a consolidated basis and for Empire's Missouri jurisdictional electric utility operations.

3. That the Company's Adjusted Total Debt to Total Capitalization Ratio objective shall be 56.5% during the period of the Experimental Regulatory Plan approved by the Commission in Case No. EO-2005-0263. If the Adjusted Total Debt to Total Capitalization Ratio exceeds 56.5% based on a rolling twelve month average for the period subject to review in a rate case during the period of the Experimental Regulatory Plan, the amount of debt by which the

56.5% limit is exceeded and its associated interest expense shall not be considered in the calculation for determining additional amortization in any such rate case.

4. That Empire shall make available to the Staff sufficient documentation to ensure that the funds, and the amount of any and all other benefits that accrue to the funds, acquired through issuance of securities under this Application shall be used exclusively for the benefit of Empire's regulated electric utility operations, and not for the other operations of Empire or any of its affiliates or non-regulated activities.

5. That the Company shall be required to file with the Commission all final terms and conditions on this financing including, but not limited to, the aggregate principal amount to be sold or borrowed, price information, estimated expenses, and the loan or indenture agreement concerning each issuance.

6. That the interest rates for these debt issuances shall not exceed 9% including any applicable discounts unless Empire first obtains the Commission's approval.

7. That the Company shall submit to the Financial Analysis Department of the Commission any information concerning communications with credit rating agencies in connection with this issuance(s).

8. That nothing in the Commission's order shall be considered a finding by the Commission of the value of these transactions for rate making purposes, and that the Commission reserves the right to consider the rate making treatment to be afforded these financing transactions and their results in cost of capital, in any later proceeding.

9. That the Company shall file with the Financial Analysis Department of the Commission any information concerning use of the funds from the issuance(s) with regard to redemption of any outstanding long-term debt, including Net Present Value calculations indicating the amount of interest cost savings.

Attachments:
A Projected Infrastructure Investments
B Financial Ratio Definitions
C Process Illustration
D Changes in Capitalization for 2005-2008 for The Empire District Electric Company
E Comparison of Empire's Actual and Pro-Forma Financial Ratios to the Benchmark Financial Ratios from Empire's Experimental Regulatory Plan

# Attachment A

**Is Deemed**

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## Appendix C

## Financial Ratios

**Credit Ratio Ranges & Definitions – Standard & Poor's – Business Risk Level 6**

| | BBB | | |
|---|---|---|---|
| | Min | Middle 1/3 | Max |
| **Adjusted Total Debt to Total Capitalization** (1) | 48% | 51% - 55% | 58% |
| **Adjusted Funds From Operations Interest Coverage** (2) | 3.0x | 3.4x - 3.8x | 4.2x |
| **Adjusted Funds From Operations as % of Average Total Debt** (3) | 18% | 21% - 25% | 28% |

**Ratio Definitions * :**

(1) "Adjusted Total Debt to Total Capitalization" is calculated as Adjusted Total Debt ÷ Total Capitalization where Adjusted Total Debt and Total Capitalization are defined as below:

- Adjusted Total Debt is calculated as:
  - Notes Payable + Current Maturities of Long-Term Debt + Current Capitalized Lease Obligations + Long-Term Debt + Capitalized Lease Obligations + Total Off-Balance Sheet Debt
    - Total Off Balance Sheet Debt includes off-balance sheet financings such as:
      - Operating leases and purchase power debt-equivalent

- Total Capitalization is equal to:
  - Total Debt + Common Stock Equity

(2) "Adjusted Funds From Operations Interest Coverage" is calculated as (Funds From Operations + Cash Interest Paid + AFUDC Debt + Interest on OBS Debt) ÷ Interest Expense where Funds From Operations and Interest Expense are defined as below:

- Funds From Operations is calculated as:
  - Net Income + Depreciation and Amortization + Pension Expense – AFUDC + Deferred taxes

- Interest Expense is calculated as:
  - Interest Expense (net) + Allowance for Funds Used During Construction (debt) + Interest on OBS debt

(3) "Adjusted Funds From Operations as a % of Average Total Debt" is calculated as (Funds From Operations + Depreciation Adjustment for Operating Leases) ÷ Adjusted Average Total Debt where Funds From Operations and Adjusted Total Debt are defined as above.

- Adjusted Total debt is the average of two years

* Information based upon Standard & Poor's Ratings Services Utility Financial Ratio Definitions updated January 13, 2005.

## APPENDIX D

## PROCESS ILLUSTRATION

### Adjustment of Amortization Amounts

Explanation of the Method Used to Determine the Adjustment to Amortization Amounts Required for Empire to Meet the Financial Ratio Targets.

**Method:**

For this illustration, the adjusted rate base as used in ER-2004-0570 provides the base financial information used in these calculations. Empire made adjustments to this base financial information to include certain off balance sheet items. These adjustments were to conform with rating agency methods for balance sheet re-statement. Empire identified these accounting adjustments, such as the equivalent debt treatment of operating leases and capacity contracts. The equivalent debt treatment of these off balance sheet items was determined by calculating the net present value of the future stream of lease or contract payments, discounted at 10%,. The base financial information was then adjusted by the equivalent debt balances and the interest expense associated with the equivalent debt balances. From this adjusted information, Empire then calculated the three guideline ratios defined in Appendix C for total regulated company and as allocated to the Missouri jurisdiction. If either of the two financial ratios failed to meet the required criteria below, then Empire determined the amount of additional funds from operations that would be required for Empire to meet the financial metric target.

**Financial Ratio Targets for Additional Amortization Calculation:**
a. 3.2x Adjusted Funds from operations interest coverage (an operational guideline)
b. 19.5% Adjusted Funds from operations as a percentage of average total debt (an operational guideline)

The Signatory Parties acknowledge a 56.5% Adjusted Total Debt to Total Capital objective. This objective will not be addressed through this amortization but will be satisfied through future Empire financing requests before the Commission during the term of this Agreement.

**Explanation of Attachment to Appendix D:**

This illustration is based on EDE financial information consisting of information filed in case ER-2004-0570 and other EDE financial documents. This illustration assumes that the Commission has found all expenditures to be prudent and reasonable and has accepted the jurisdictional allocation factor. For this illustration, EDE statements were placed on a jurisdictional basis by applying an allocation factor to the EDE balances. The base jurisdictional information was used to calculate the three (3) financial ratios. In this illustration, the Missouri electric jurisdictional adjusted funds from operations (FFO) as a percent of average debt was found to be 17.59%, which is below the financial ratio target of 19.5%. In order for the target to be achieved, $6,399,213 of additional FFO would be needed from Missouri. The additional FFO was then studied to determine if there would be any additional tax impacts on cash flow resulting from the additional FFO. This illustration assumes that the entire additional FFO would have negative tax cash flow impacts, thereby resulting in an additional amortization of $3,987,265 needed in order to meet the target. The Signatory Parties have not agreed to a methodology to determine the tax impacts related to additional FFO. In this illustration, the revenue requirement amount equals the amortization amount. The overall impact on Missouri customers would be a 2.58% increase in revenue requirement. This example is an illustration only. The actual amount of amortization needed will be determined in Empire's next rate case.

**Explanation of Adjustments to balance sheet for rating agency methodology:**

- Operating Lease Debt Equivalent - Present value of future lease payments for the operating lease for the aluminum railcars using a 10% discount rate.
- Purchase Power Debt Equivalent - Present value of future capacity payments of purchased power capacity obligation using a 10% discount rate. A portion of this amount is then treated as debt-equivalent, based on the risk factor (10-20%, 30%, or 50%) assigned to each contract.

Transactions included in the amounts above are subject to review by the Commission for prudence. Amounts determined to be not prudent will not be included in the calculation of the financial ratios for purposes of adjusting the amortization amount. The prudence and reasonableness of these transactions will be determined in Empire's next general rate case.

The illustration does not include the effect of $SO_2$ sales on cash flow because currently these sales have not occurred. To the extent actual $SO_2$ sales occur, these sales will be included as cash flow for purposes of Appendix D and whether the resulting projected cash flow meets the targets.

**Attachments**

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**Are Deemed**

**Highly Confidential**

**In Their Entirety**

**BEFORE THE PUBLIC SERVICE COMMISSION**
**OF THE STATE OF MISSOURI**

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| In the Matter of the Application of The Empire District Electric Company for authority to issue and sell under its existing Indenture of Mortgage and Deed of Trust dated as of September 1, 1944, as amended and supplemental, up to and including $255,000,000 principal amount of its First Mortgage Bonds, in one or more series and to, among other things, execute and deliver a Supplemental Indenture or Indentures to provide for the terms of said Bonds. | ) ) ) ) ) ) ) ) ) ) | Case No. EF-2006-0263 |

AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI )
) ss.
COUNTY OF COLE )

David Murray, of lawful age, on his oath states: that he has participated in the preparation of the forgoing Written Memorandum; that the information is given by him; that he has knowledge of the matters set forth; and that such matters are true and correct to the best of his knowledge and belief.

David Murray

David Murray

Subscribed and sworn to before me this 31st day of March 2006.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

D Suzie Mankin

Notary Public