

Exhibit No.: \_\_\_\_\_  
Issue: Capital Structure  
Return on Common Equity  
Rate Design  
Accumulated Deferred Income Taxes  
Areas of Agreement  
Witness: David W. Gibson  
Type of Exhibit: Rebuttal Testimony  
Sponsoring Party: Empire District  
Case No.: ER-2001-299  
Date Prepared: May 2, 2001

**Before the Public Service Commission  
of the State of Missouri**

**Rebuttal Testimony**

**of**

**David W. Gibson**

Exhibit No. 14  
Date 5/29/01 Case No. ER-2001-299  
Reporter KEM

**May 2001**

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REBUTTAL TESTIMONY  
OF  
DAVID W. GIBSON  
THE EMPIRE DISTRICT ELECTRIC COMPANY  
BEFORE THE  
MISSOURI PUBLIC SERVICE COMMISSION  
CASE NO. ER-2001-299

1 Q. PLEASE STATE YOUR NAME.

2 A. David W. Gibson.

3 Q. ARE YOU THE SAME DAVID W. GIBSON WHO SUBMITTED DIRECT  
4 TESTIMONY IN MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")  
5 CASE NO. ER-2001-299 ON BEHALF OF THE EMPIRE DISTRICT ELECTRIC  
6 COMPANY ("EMPIRE")?

7 A. Yes, I am.

8 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

9 A. To respond to certain matters raised by the Missouri Public Service Commission Staff  
10 ("Staff") witness Roberta A. McKiddy and Office of Public Counsel ("OPC") witness  
11 Mark Burdette concerning capital structure and return on equity. In addition, I will  
12 address matters concerning rate design and accumulated deferred income taxes. I will  
13 also discuss some areas of agreement.

14 **CAPITAL STRUCTURE**

15 Q. DO YOU AGREE WITH THE CAPITAL STRUCTURE PROPOSALS PRESENTED  
16 BY MS. MCKIDDY AND MR. BURDETTE?

17 A. No, I do not. The capital structures as proposed by both witnesses consists mainly of  
18 actual December 31, 2000 data. This data results in a capital structure of approximately  
19 40% equity and 60% debt which is not a normal capital structure for Empire.

20 Q. WHY DO YOU SAY A 40% EQUITY AND 60% DEBT CAPITAL STRUCTURE IS  
21 NOT "NORMAL" FOR EMPIRE?

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A. In its initial filing in this case Empire proposed a capital structure of 47.5% equity and 52.5% debt. Historically, Empire has set a target capital structure of 45-50% debt, 45-50% equity and 5-10% preferred stock. Since 1992 and prior to the merger agreement with UtiliCorp United Inc. ("UtiliCorp"), we were within those ranges. The merger agreement with UtiliCorp provided that Empire could not issue additional common equity. As a consequence we issued additional long-term debt in order to finance the State Line Combined Cycle plant and redeem the outstanding preferred stock. This, in part, caused our capital structure to become "debt heavy" or more leveraged than in the past.

Q. WILL THE USE OF EMPIRE'S PROPOSED CAPITAL STRUCTURE FOR RATEMAKING PURPOSES IN THIS CASE MAKE THE CUSTOMERS PAY FOR THE FAILED MERGER WITH UTILICORP?

A. No, quite to the contrary. With respect to this issue ratepayers are receiving a benefit from the failed merger.

Q. PLEASE EXPLAIN.

A. Empire's common equity is comprised of the original cost of its stock and those earnings that are retained by Empire. The merger costs reduced the amount of retained earnings. Since the total amount of equity is reduced, the weighted cost of debt and equity is therefore reduced which results in a lower overall cost of capital to ratepayers. The following table is a simple illustration of this point:

	<u>Without Merger</u>			<u>With Merger</u>		
	<u>Amount</u>	<u>Rate</u>	<u>Weighted</u>	<u>Amount</u>	<u>Rate</u>	<u>Weighted</u>
Common equity	\$100,000	.115	.0575	\$90,000	.115	.0545
Debt	100,000	.080	.0400	100,000	.080	.0421
Total	200,000		.0975	190,000		.0966

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1 As can be seen in this illustration, the return on rate base would have dropped from  
2 9.75% to 9.66%. So, as the Staff and OPC propose it, the ratepayers are receiving a  
3 benefit from the fact that the merger failed.

4 Q. PLEASE CONTINUE.

5 A. In addition to receiving the benefit from deducting merger costs from the common equity  
6 balance, the ratepayers are receiving the benefit from a capital structure that is more  
7 highly leveraged than is normal for Empire. Since we were precluded from issuing more  
8 equity during the time that the merger was pending, we issued \$100,000,000 in unsecured  
9 long-term notes at the end of 1999. This resulted in Empire's equity percentage dropping  
10 from 48% to 40%. Had it not been for the pending merger, we would not have issued all  
11 of that amount in debt.

12 Q. HAS EMPIRE ADDRESSED ITS "ABNORMAL" CAPITAL STRUCTURE SINCE  
13 THE MERGER WITH UTILICORP FAILED?

14 A. Yes. After the merger failed, we needed to pay down the amount of short-term debt that  
15 was outstanding from costs associated with our construction program. At the time, we  
16 looked at issuing common stock, long-term debt or preferred stock. It was believed that  
17 the issuance of common would not be prudent at that time since it would dilute earnings  
18 for the current year. The issuance of additional debt was really not an option since that  
19 would have put us at over 60% debt. The preferred was an option, but it also would result  
20 in lower earnings available to pay shareholders in relation to a debt issuance. As a  
21 consequence, we decided to issue trust preferred securities since it would not result in a  
22 dilution of earnings and we were able to receive a tax deduction for the interest payments.  
23 The trust preferred securities were issued in March 2001. We anticipate issuing common  
24 stock during the fourth quarter of this year in order to pay down our outstanding short-  
25 term debt, which was about \$40,000,000 at the end of March 2001.

1 Q. GIVEN THE ISSUANCE OF THE TRUST PREFERRED SECURITIES, WHAT  
2 CAPITAL STRUCTURE ARE YOU PROPOSING THAT THE COMMISSION  
3 ADOPT FOR THIS CASE?

4 A. Empire proposes that the Commission adopt a capital structure of 45% common equity,  
5 7.9% trust preferred and 48% long-term debt. This would meet the need of Empire to  
6 maintain a balanced capital structure and yet reflect the lower end of the historical capital  
7 structure in order to pass savings on to ratepayers which resulted from the failed merger.  
8 This proposed capital structure compares to the actual ratios of 37.31% common equity,  
9 7.92% trust preferred and 54.77% long-term debt at the end of March 2001.

10 **RETURN ON COMMON EQUITY**

11 Q. WHAT RATE OF RETURN ON COMMON EQUITY IS PROPOSED BY STAFF  
12 WITNESS MCKIDDY FOR PURPOSES OF THIS CASE?

13 A. The rate of return on common recommended by Ms. McKiddy is in the range of 8.5% to  
14 9.5%.

15 Q. HOW DO YOU CHARACTERIZE THIS RECOMMENDATION?

16 A. It is unreasonable.

17 Q. WHY?

18 A. This is clearly not reflective of the market for Empire since we issued \$50,000,000 in  
19 trust preferred stock during March 2001 at a rate of 8.5% and unsecured long-term debt in  
20 the amount of \$100,000,000 in November of 1999 at a rate of 7.7%. In addition, she cites  
21 a return of 7.79% for an average yield on Mergents Public Utility Bonds (Schedule 5-1).  
22 That would mean that the spread between what she is recommending and the yield on  
23 bonds is only .71% to 1.71%. I also find it curious that the rate for customer deposits is  
24 9% which is higher than the low end of her recommended range. In her flawed analysis,  
25 Ms. McKiddy has missed several very fundamental factors that would lead to a higher  
26 rate of return recommendation for Empire.

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1 Q. PLEASE EXPLAIN.

2 A. First of all, in her so-called DCF analysis, Ms. McKiddy used the average stock prices for  
3 October 2000 through December 2000 as seen in her Schedule 14. During this time  
4 period, Empire's proposed merger with UtiliCorp was still in progress and our stock price  
5 was reflective of the anticipated premium that would have been paid for Empire's stock if  
6 the merger were completed. She made a similar mistake by her choice of a high stock  
7 price for the month of January 2001.

8 Q. PLEASE EXPLAIN THIS LAST STATEMENT.

9 A. On December 29, 2000, Empire stock had a high of \$26.3125 and on January 2, 2001, it  
10 had a high of \$25.5625. On January 3, after it was announced that the merger was  
11 terminated, the stock high was only \$20.50. For the remainder of January 2001, the highs  
12 ranged from \$20.25 to \$19.50. Since Ms. McKiddy is using an average of the monthly  
13 high prices to determine the dividend yield, the weight given to the January 2, 2001  
14 opening high does not accurately represent the prices for remainder of the month. By  
15 excluding the stock price data which reflects the anticipated merger premium, the  
16 dividend yield would have been approximately 6.3%, not 5.5%.

17 Q. WHAT IS YOUR RECOMMENDATION CONCERNING THE USE OF EMPIRE  
18 STOCK PRICES AS IT RELATES TO A DIVIDEND YIELD?

19 A. Based on the Staff's improper use of merger related stock prices, I would recommend that  
20 the Commission true-up the stock prices to June 30, 2001. This would provide five  
21 months of data, which data would exclude the anticipated merger premium, to use for  
22 purposes of calculating a dividend yield.

23 Q. PLEASE DESCRIBE THE REMAINING COMPONENT OF MS. MCKIDDY'S  
24 RECOMMENDED RETURN ON EQUITY.

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1 A. The other half of the recommended range is represented by the expected growth rate of  
2 3.0% to 4.0% (Schedule 13). Although it appears that the range is the result of  
3 reasonable data, the rationale for her growth rate is flawed.

4 Q. WHY IS THE RATIONALE FOR HER GROWTH RATE FLAWED?

5 A. First of all, the data that is used appears to be the result of a pick and choose criteria. By  
6 this I mean that there does not appear to be a consistency in using data used to determine  
7 the growth rates. For example, she cites the use of a projected earnings per share growth  
8 rate of 6% by Value Line and then averages it with a lower growth rate of 2% that is  
9 projected by Standard and Poor's. In determining the reasonableness of the DCF results,  
10 she cites the beta of .50 that is used by Value Line and accepts it as presented. (Schedule  
11 18). If the data obtained from Value Line is acceptable to be used as is in the CAPM  
12 process then why is it diluted in the DCF process by using a lower estimate from  
13 Standard and Poor's? The answer appears to be that it was only used because the Value  
14 Line rate was too high. The same conclusion can be reached by reviewing the historical  
15 data for EPS and the growth rates of 1.53% to 5.22% (Schedule 13). The remaining  
16 historical data was either constant (BVPS 1.5%) or abnormally low (DPS .7% or 0%).  
17 The reason for the low rates was not explored. For example, the reason for the DPS  
18 growth rate of only .7% from 1990 to 2000 was due to the fact that dividends have not  
19 been increased since 1992. That is the reason that the growth rate from 1995 to 2000 was  
20 0%. When any data is used in any analysis, it must be viewed for reasonableness. It does  
21 not appear that this was done in her analysis.

22 Q. YOU STATE THAT THE RESULTS OF THE ANALYSIS PERFORMED BY MS.  
23 MCKIDDY WAS NOT REASONABLE. HOW DID YOU REACH THAT  
24 CONCLUSION?

25 A. In addition to the use of data that included the failed merger with UtiliCorp, the data, if  
26 analyzed to determine the underlying causes, would have resulted in different



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1 conclusions. This can be clearly seen when considering the dividend payment of Empire.  
2 As stated above, the dividend has not changed since 1992. During that time, Empire's  
3 plant has increased from approximately \$547 million to \$1,049 million. During the same  
4 period, earnings per share went from \$1.26 to \$1.35. Clearly, the growth in earnings has  
5 not kept pace with the growth in plant. During that time, the payout ratio was a little over  
6 100%. Add to this the fact that Empire's stock price is actually lower than it was at the  
7 end of 1992 and it only adds to the conclusion that earnings have clearly not kept pace  
8 with our needs to serve our customers. In addition to this, the analysis that she performed  
9 by using comparative companies does not support an 8.5 to 9.5% return on common  
10 equity.

11 Q. PLEASE CONTINUE.

12 A. Using CAPM, the nine comparable companies results in a return of 9.69% to 10.03%  
13 (Schedule 26). Using the same companies, the average estimated cost of common equity  
14 is 11.64% (Schedule 25). On the same schedule, the proposed growth range is 5.00 to  
15 6.50% which compares to a value of 3.00 to 4.00% as recommended by Ms. McKiddy  
16 (Schedule 15). In these instances, she is using data that is below the comparable  
17 companies and yet uses this same data to justify her conclusions. This is simply wrong.  
18 In addition, she shows the projected return on equity for Empire for 2001 at 12.00% as  
19 compared to the comparable companies with an average of 15.50% and a low of 11.50%  
20 for the same period. If her recommendation for return on equity is accepted by the  
21 Commission, it is hard to understand how Empire could possibly achieve the projected  
22 return of 12.00%. I would urge the Commission to reject her recommended return on  
23 equity range because it is not supported by facts as indicated and further because it does  
24 not reflect the risk that is faced by Empire.

25 Q. YOU MENTION THAT EMPIRE IS SUBJECT TO RISK THAT IS NOT REFLECTED  
26 IN THE STAFF'S PROPOSED RETURN ON EQUITY. PLEASE EXPLAIN.

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1 A. On page 34 lines 9 through 12 of her testimony, Ms. McKiddy cites the fact that Value  
2 Line predicts that the industry average for return on equity would be 13.0% for 2000 and  
3 2001 through 2003. She then concludes that the market views Empire as less risky than  
4 the industry. This conclusion is in fact contradicted by others on the Staff.

5 Q. PLEASE EXPLAIN.

6 A. Staff witness Choe on page 3, lines 9 and 10 of his direct testimony, refers to the fact that  
7 we cannot predict "without much uncertainty what the future of natural gas market will  
8 bring...". This fact coupled with the increased use of natural gas would lead to increased  
9 risk, not less.

10 Q. STAFF WITNESS MCKIDDY HAS CONCLUDED THAT THE LOW END OF HER  
11 RECOMMENDED RETURN ON EQUITY ALLOWS EMPIRE TO MEET ITS NET  
12 EARNINGS REQUIREMENT UNDER ITS INDENTURE. DOES THIS MEAN THAT  
13 HER RECOMMENDED RETURN IS REASONABLE?

14 A. No. The net earnings requirement is a legal requirement based on an indenture that was  
15 created in 1944. The indenture is meant as a protection measure for bondholders only.  
16 Moreover, the environment that utilities operate in today is vastly different than that  
17 which existed in 1944. Based on her data at the low end of her recommendation included  
18 on Schedule 19, Empire would have to incur only \$2,072,350 in interest costs to be at the  
19 2 times coverage limitation. This would equate to less than \$30 million in new bonds at  
20 7.5%.

21 Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THE STAFF'S  
22 RECOMMENDED RETURN ON EQUITY?

23 A. Yes. On page 27 of her testimony, Ms. McKiddy cites the pre-tax interest coverage ratio  
24 and concludes that although it does not support an "A" rated utility, it does support the  
25 "negative" outlook that was placed on Empire by Standard & Poor's. I would have to  
26 conclude that what she is saying is that a downgrade by Standard & Poor's to a "BBB"

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1 rating is acceptable. The result will be higher costs to Empire customers through the  
2 form of higher debt costs and an adverse impact on our shareholders through a dilution of  
3 earnings. This is because the number of shares needed to raise the same amount of equity  
4 funds will be higher since the share price will be lower.

5 Q. HOW DOES THAT HAPPEN?

6 A. If the return is lowered in relation to other utility companies, Empire will be viewed as  
7 riskier and therefore the price of the stock will drop relative to those less riskier stocks.  
8 As a simple example, if we were to raise \$30,000,000 and the stock price were \$20 per  
9 share, we would issue 1,500,000 shares. If the price of stock were \$15 per share, then the  
10 number of shares that would be issued would be 2,000,000.

11 Q. THE STAFF HAS DETERMINED THAT AT THE LOW END OF ITS  
12 RECOMMENDED RETURN ON EQUITY RANGE THAT EMPIRE RECEIVE A  
13 RATE REDUCTION OF OVER \$19 MILLION IF THE STATE LINE COMBINED  
14 CYCLE PLANT IS IGNORED. WHAT IS YOUR REACTION TO THIS?

15 A. As I mentioned previously, any result must be viewed as to its reasonableness. If Empire  
16 was forced to reduce its rates by over \$19 million, it would have the following effect:

1

Net income applicable to common stock at 12/31/2000	\$23,617,154
Staff gross revenue requirement	-19,520,407
Tax effect of Staff gross revenue requirement	+7,591,563
Adjusted net income applicable to common stock	\$11,688,310
Weighted average number of common shares outstanding	17,503,665
Earnings per weighted average share of common stock	\$0.67

2 This result is clearly not even close to being reasonable.

3 **RATE DESIGN**

4 Q. HOW DO YOU RESPOND TO THE RATE DESIGN PROPOSALS OF THE STAFF,  
5 OPC AND PRAXAIR?

6 A. Empire cannot agree with the proposals of these parties. As indicated in its initial filing,  
7 due to the size of the proposed rate increase and the fact that fuel and purchased power is  
8 such a large component of Empire's cost structure, an equal percentage rate increase  
9 should be given to all customers.

10 Q. IN PRIOR RATE CASES HAS EMPIRE BEEN MOVING TOWARDS RATES THAT  
11 ARE NOT SUBJECT TO CROSS SUBSIDIES?

12 A. Yes. This is yet another reason why an equal percentage increase should be approved.  
13 Without this, the proposed shifts would result in the return to more inequities among the  
14 different rates, not less.

15 Q. DO YOU HAVE ANY OTHER COMMENTS CONCERNING RATE DESIGN?

16 A. Yes. Any rate design that is approved should not force rate shifting. By that I mean that  
17 a rate approved for a class of customers must be for those customers and not make them  
18 shift to a lower cost rate. This has happened in the past to Large Power and Large  
19 General Service customers and noted as something to be taken into consideration at page  
20 11, lines 18-23 of the direct testimony of Staff witness Janice Pyatte.

**ACCUMULATED DEFERRED INCOME TAXES**

Q. WHAT IS THIS ISSUE?

A. The Staff has deducted accumulated deferred income taxes from rate base for loss on reacquired debt, contributions in aid of construction ("CIAC") and liberalized depreciation. The Staff excluded deferred income taxes for interest capitalized.

Q. HOW DO YOU RESPOND?

A. If the Staff wants to deduct other accumulated deferred income taxes from rate base, then the Staff must be consistent and deduct other deferred income taxes such as the one for interest capitalized. The Staff has indicated to Empire that it would review the reasons for the deferral with a view toward possibly resolving this issue.

**AREAS OF AGREEMENT**

Q. AS A RESULT OF THE PREHEARING CONFERENCE, ARE THERE ANY AREAS OF AGREEMENT BETWEEN THE STAFF AND EMPIRE?

A. Yes, we reached an agreement with the Staff on the following items:

- Increased postage costs will reflect customer growth. Other nominal costs associated with the customer growth, such as envelopes, will also be added to the revenue requirement.
- The property tax expense adjustment proposed by the Staff was originally calculated by using plant in service times a property tax rate and then reduced to reflect capitalized property taxes. The Staff has agreed that since there was no CWIP in plant in service that there should not have been a deduction for capitalized taxes.
- Accumulated deferred income taxes – CIAC was mistakenly added to the Staff's total for accumulated deferred income taxes. The amount was a debit whereas the other components were credits and should have therefore been subtracted from the total. This has been pointed out to Staff and the Staff has agreed to make the correction.


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- 1     •     The weather normalization adjustment as proposed by the Staff appears to be reasonable.  
2             The Staff has indicated that it will explain its method and model to Empire personnel.
- 3     •     The Staff made a simple math error when figuring the adjustment for injuries and  
4             damages. This was to be corrected by Staff.
- 5     Q.     DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?
- 6     A.     Yes, it does.

# AFFIDAVIT

STATE OF MISSOURI )  
 ) ss  
COUNTY OF JASPER )

On the 2nd day of May, 2001, before me appeared David W. Gibson, to me personally known, who, being by me first duly sworn, states that he is the Vice President - Finance of The Empire District Electric Company and acknowledged 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.

  
David W. Gibson

Subscribed and sworn to before me this 2nd day of May, 2001

Patricia A. Settle  
Patricia A. Settle, Notary Public

**My commission expires: August 16, 2002**

