Exhibit No.:	_______________
Issue(s):	Rate of Return (ROR)/ Capital Structure/Affiliate Transactions
Witness/Type of Exhibit:	Murray/Reply to Answers to Commission Questions
Sponsoring Party:	Public Counsel
Case No.:	ER-2019-0374

REPLY TO TESTIMONY RESPONDING TO COMMISSION QUESTIONS

OF

DAVID MURRAY

Submitted on Behalf of the Office of the Public Counsel

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2019-0374

May 12, 2020

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric Company's Request for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in its Missouri Service Area	)))))	Case No. ER-2019-0374

VERIFICATION OF DAVID MURRAY

David Murray, under penalty of perjury, states:

1. Attached hereto and made a part hereof for all purposes is my responsive testimony to answers to Commission questions in the above-captioned case.

3. My answer to each question in the attached responsive testimony to answers to Commission questions is true and correct to the best of my knowledge, information, and belief.

David Murray

David Murray
Utility Regulatory Manager
Office of the Public Counsel

REPLY TO TESTIMONY RESPONDING TO COMMISSIONER QUESTIONS

OF

DAVID MURRAY

THE EMPIRE DISTRICT ELECTRIC COMPANY

FILE NO. ER-2019-0374

Q. What is your name?

A. My name is David Murray; the same David Murray who pre-filed direct, rebuttal, surrebuttal, supplemental surrebuttal, and testimony in response to commission questions, and which are marked as exhibit nos. 210C, 211C, 212C, 213, and 299-9 respectively.

Q. Do you have a response to any of the witnesses' answers to the Commission's questions issued on April 28, 2020?

A. Yes. I would like to respond to Empire witnesses Robert B. Hevert and Mark T. Timpe.

Q. What Commission question did Mr. Hevert address in his testimony?

A. Mr. Hevert addressed question five under **Issue 18. Affiliate Transactions.** The Commission's question was as follows:

> 5. Empire - In Robert Hevert's testimony on Page 62, he states that it "is the utility's operating risk that defines the capital structure and cost of capital, not investors' sources of funds." Given this statement, it could be inferred that pricing of Empire's $90 million financing from LUCo was not solely based on historical long-term debt but also the estimated operating risk of Empire within the group. However, on Page 8 of Mark Timpe's rebuttal testimony he stated that the terms of Empire financing was "based on the weighted average life of LUCo's March 2017 financing and was equivalent to the term of Liberty-Empire's last pre-acquisition financing in August 2015, thereby making the term consistent with past practice at "old Empire."" Please explain if additional factors beyond those mentioned by Mark Timpe when into determining the pricing for Empire's financing.

Q. What is Public Counsel's response?

A. I agree with Mr. Hevert's statement that it is the utility's operating risk (referred to as "business risk" by rating agencies) that defines the capital structure and the cost of capital. LUCo's low-risk regulated utility assets, including those of Empire, have defined the amount and terms of the debt (referred to as "financial risk" by rating agencies) its assets can support and still maintain a 'BBB' credit rating. The amount and cost of debt LUCo's operating utilities support is accurately and reliably captured in my recommended capital structure, which consists of 46% common equity and 54% long-term debt. The costs of the debt in LUCo's capital structure are a result of arms-length transactions, with terms and conditions required by third-party debt investors. The terms and conditions assigned to the Empire affiliate note were based on an internal methodology, not a market transaction. As testified by Mr. Timpe, the internal methodology was based on terms related to $750 million of debt Liberty Utilities Finance GP1 ("LUF") issued in March 2017.[1,2] The cost of these funds were based on LUCo's credit profile, not Empire's. Mr. Timpe only partially describes the internal procedure LUCo and Empire used to assign a term and interest rate to the affiliate note. I will provide some additional details Mr. Timpe didn't provide that will illustrate the problems with relying on an internal methodology, regardless of whether this methodology is intended to mimic a market transaction, to imply that the cost assignment is market-driven and economically efficient for the affiliate debtor.

First, Mr. Timpe notes that a 15-year tenor was assigned to the affiliate note because this was the tenor of Empire's most recent 3rd party debt issuance. Apparently, the logic for this tenor was that if Empire were still a stand-alone company, it would choose to issue debt with the same tenor as its last debt issuance. This is not sound financial policy and is not consistent with Empire's past practice. The tenor of the last debt issuance would only have relevance to the extent that this term either lengthened or shortened the weighted average maturity of all of the company's debt outstanding. As of June 1, 2018, the date when LUCo advanced Empire $90 million in proceeds to retire its first mortgage bonds, Empire had a weighted-average maturity of 16.12 years on its long-term debt. As of the same date, LUCo had a weighted-average maturity of 13.45 years on its long-term debt. Because LUCo's capital structure is actively managed for purposes of raising debt capital at economical costs, this weighted-average maturity provides direct insight into APUC's

[1] Timpe Rebuttal Testimony, p. 8.
[2] Mr. Timpe indicated the $750 million was received from an unsecured financing issued in March 2017. LUF issued the $750 million of long-term debt directly to debt investors. LUF loaned $650 million of this debt to LUCo and $100 million to LUCo's intermediate holding company, Liberty Utilities (America) Holdco Inc., which then used this $100 million loan to buy equity in LUCo.

financial policies as it relates to financing its regulated utility investments. Using LUCo's weighted-average maturity as a guide to APUC's management of its regulated utility debt profile, Empire could have been assigned debt with a much shorter-term tenor than 15 years and still had a weighted-average maturity that was longer than LUCo's as of the same date.

Second, as Mr. Timpe admits in his rebuttal testimony, the cost assigned to the Empire affiliate note was based on LUCo's third-party debt transactions through LUF on March 24, 2017.[3] However, what Mr. Timpe doesn't admit is that the cost applied to the affiliate note was based on a selection of only two tranches from the $750 million of LUF debt issued on March 24, 2017. On March 24, 2017, LUF (LUCo's debt financing platform) issued $750 million of Series E debt which consisted of the following tranches: Tranche 1 - $100 million (3-year maturity, 2.78% coupon), Tranche 2 - $80 million (5-year maturity, 3.30% coupon), Tranche 3 - $70 million (7-year maturity, 3.69% coupon), Tranche 4 - $250 million (10-year maturity, 3.94% coupon), Tranche 5 - $21 million (20-year maturity, 4.54% coupon), and Tranche 6 - $229 million (30-year maturity, 4.89% coupon). The weighted-average cost of all six tranches was 4.00%. If Empire had been assigned an implied 15-year tenor on March 24, 2017, pursuant to the methodology described by Mr. Timpe, the cost of this debt would be based on applying 50% weight to Tranche 4 and 50% weight to Tranche 5, which would result in a 4.24% cost assigned to Empire. Considering the fact that the weighted-average maturity of all six tranches of debt is 14.75 years, assigning Empire a share of all of the tranches would have the same effect on Empire's weighted-average maturity and also result in a lower cost of debt being charged to Empire. However, as I indicated before, considering that LUCo had a weighted-average maturity of 13.45 years, in order to lower Empire's weighted average maturity to a level consistent with LUCo, Empire's affiliate note could have been assigned costs consistent with the 3-year debt, which had a coupon of 2.78%. Perhaps not surprisingly, LUF used the lowest cost debt from its 2017 debt offering (2.78%, 3-year tranche) to loan funds to LUCo's holding company for purposes of buying equity in LUCo ($100 million of the $395 million of off-balance sheet debt).

[3] Ex. 8, Timpe Rebuttal Testimony, p. 8.

Finally, Mr. Timpe's assignment of LUCo's debt costs ignore the financial risk (i.e. use of debt) differences between LUCo's capital structure and Empire's capital structure. As I previously indicated in my other pre-filed testimony in this case, Empire's FFO/debt ratios are in the 21% to 23% range, which indicates a much lower amount of financial risk in Empire's capital structure. LUCo's FFO/debt ratios in the 15% to 16% range indicate a higher amount of financial risk.[4] The differences in the FFO/debt ratios corroborate the accuracy and reliability of my determination of LUCo's adjusted capital structure, which shows much more debt in LUCo's capital structure as compared to Empire's. The debt cost assignment methodology described by Mr. Timpe makes no adjustment for Empire's equity-rich capital structure.

Q. Has Mr. Hevert misstated or mischaracterized any facts in his testimony answering this Commission's question?

A. Yes. Mr. Hevert indicates that it is my position that LUCo issued $395 million of long-term debt to fund equity investments in its regulated utilities. I never indicated LUCo issued the $395 million of off-balance-sheet debt to fund equity investments in LUCo's subsidiaries. In fact, technically, LUCo hasn't directly issued any long-term debt at all. Liberty Utilities Finance GP1 ("LUF") issues the long-term debt directly to third-party debt investors.[5] However, debt investors' required returns on this debt are based on LUCo's credit profile because it unconditionally guarantees all of the debt issued by LUF. In order to inflate LUCo's per books common equity ratio, LUF loaned $260 million to LUCo's immediate parent company, Liberty Utilities (America) Holdco Inc., for the sole purposes of buying equity in LUCo. As Empire's affiliate, Liberty Utilities (Midstates Natural Gas) Corp. (Liberty Midstates), affirmed during Case No. GR-2018-0013, Liberty Utilities (America) Holdco Inc. exists for the sole purpose of providing financing to LUCo (i.e. it has no other asset other than the equity ownership in LUCo).[6]

[4] Murray Direct, p. 16.
[5] Murray Direct, p. 7, p. 6, ll. 6-11.
[6] Murray Direct, Schedule DM-D-3.

The testimony I filed in this case indicates that the $395 million was used to buy equity in LUCo in order to show a higher per books equity balance. However, although I know that the $395 million was eventually used to make investment in LUCo's subsidiaries, I do not know if this was in the form of loans, equity investments or another type of capital transfer.

Q. Does Mr. Hevert's answer to the Commission's question continue to emphasize the concept of "maturity matching" that he, Mr. Timpe and Mr. Cochrane have claimed are important characteristics of good financial policy?

A. Yes. Mr. Hevert continues to espouse the virtues of assigning Empire a longer tenor affiliate note. Mr. Hevert claims that the principle of "maturity matching" is important to consider when financing assets. He claims that the longer the life of the assets, the more important it is to issue longer-term tenors for debt issuances. He also emphasizes, that the issuance of longer-term debt minimizes the amount of financing risk, which is a common concern for capital-intensive enterprises such as utilities.

Q. Is this concept theoretical as it relates to Empire's capital structure?

A. Yes. Empire's capital structure no longer has any practical meaning for purposes of raising capital in third-party debt markets. However, Empire's capital structure still has a significant impact on the rates Empire's ratepayers are charged.

Q. Which capital structure has the most meaning as it relates to the "maturity matching" concept espoused by Empire's witnesses?

A. LUCo's capital structure. The virtues espoused by Empire's witnesses regarding "maturity matching" are contradicted by the management of LUCo's capital structure, as I discussed in my previous answers in this testimony. The principle of "maturity matching" sounds good on paper, but it rings hollow when the company responsible for raising debt capital for Empire and its other regulated utility investments does not abide by these virtues.

Q. What Commission questions did Mr. Timpe address in his testimony?

A. Mr. Timpe addressed questions three and four under **Issue 18. Affiliate Transactions**. The Commission's questions were as follows:

3. Empire - In Mark Timpe's testimony, he indicated that LUCo aggregates financing through short-term credit facility until it gets to a scale where they can take it to the debt capital markets to replace it with short-term debt. When is LUCo's short-term credit facility due to be repaid? Has this debt been taken to the capital markets to be replace with long-term debt? If so, what are the terms of the new debt?

4. Empire - What were the terms of the last debt Empire pre-acquisition in August 2015?

Q. What is Public Counsel's response?

A. First, Mr. Timpe notes that Empire's $90 million first mortgage bonds were replaced with a like amount promissory note having "competitively bid market terms which resulted in a 15-year term and a 4.53% interest rate." A key clarification to Mr. Timpe's response is that the "competitively bid market terms" were based on terms required of LUCo's (or more specifically LUF's) competitively bid debt, not Empire's. The terms fixed-income investors required were based on LUCo's consolidated business risk (i.e. operating risk) and financial risk (i.e. use of debt in the capital structure), which includes LUCo's use and guarantee of the $395 million of off-balance sheet debt. LUCo's capital structure is actively managed and rated for purposes of accessing debt markets. Empire's is not. Additionally, as Mr. Timpe indicates in his response, LUCo monitors future debt maturity schedules, short-term debt balances and projected cash flows in determining when it will again access capital markets. LUCo's monitoring of these issues are a function of an actively managed capital structure that is objective, market-tested and consequential for raising capital. Mr. Timpe's decision to simply assign a 15-year maturity to an affiliate note because this was the term of Empire's last third-party debt issuance, does not reflect an active, objective and independently managed capital structure.

It is also noteworthy that Mr. Timpe emphasizes the importance of managing LUCo's capital market needs in light of the impact of the COVID-19 pandemic. Public Counsel also inquired about LUCo's capital structure management during the economic and financial disruptions that occurred subsequent to the start of the COVID-19 pandemic. Empire was not forthcoming with answers to these data requests because Empire claimed such financial issues fell outside the ordered true-up period, January 31, 2020, for this case.

Q. Does this conclude your response to the other parties' answers to the Commission's questions?

A. Yes.