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Issue:	*Cost of Capital*
Witness:	*ROBERTA A. McKIDDY*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No.:	*ER-2001-299*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

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SURREBUTTAL TESTIMONY

OF

ROBERTA A. McKIDDY

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2001-299

Jefferson City, Missouri
May 2001

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Q. Please state your name.

A. My name is Roberta A. McKiddy.

Q. Are you the same Roberta A. McKiddy who filed direct and rebuttal testimony in this proceeding on behalf of the Staff of the Missouri Public Service Commission (Staff)?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Company witnesses Myron McKinney, David Gibson, Don Murry and Office of Public Counsel (OPC) witness Mark Burdette. Mr. McKinney sponsors rate of return testimony, Mr. Gibson sponsors capital structure and return on equity testimony, while Mr. Murry sponsors cost of capital testimony on behalf of The Empire District Electric Company (EDE). Mr. Burdette sponsors rate of return testimony on behalf of the OPC. I will address the issues of appropriate capital structure, return on common equity (ROE), and overall rate of return to be applied to EDE for ratemaking purposes in this proceeding.

Capital Structure

Q. Do you believe the capital structure proposed by EDE is appropriate?

A. No, I do not. Mr. Gibson suggests EDE should be allowed to employ a hypothetical capital structure of 47.5 percent equity and 52.5 percent debt because using actual December 31, 2000 data "results in a capital structure of approximately 40 percent equity and 60 percent debt which is not a normal capital structure for Empire." The determination to modify the capital structure of EDE was solely the decision of EDE management. Although the capital structure of EDE is different from its historical levels, Staff does not consider it to be an unusual capital structure for an electric utility. Staff was recently made aware of information published in C.A. Turner Reports, March 2001, which stated the average equity ratio for an electric utility (defined as having primarily electric operations) was approximately 38 percent. The average equity ratio for a combination gas and electric utility was approximately 37 percent.

Q. What capital structure did Staff employ in developing a weighted cost of capital for EDE?

A. Staff employed an "actual" capital structure at the twelve-month period ending date of December 31, 2000 of 39.80 percent common equity and 60.20 percent long-term debt.

Q. Do you believe Staff employed a more appropriate capital structure for EDE than that proposed by Company witnesses?

A. Yes, I do. When EDE entered into an agreement with UtiliCorp United, Inc. (UtiliCorp) to merge operations (Case No. EM-2000-369), EDE's management made a conscious decision to change its capital structure by buying back its preferred stock outstanding. In spite of this decision, EDE's stock price continued to rise in anticipation of completion of the aforementioned merger. However, UtiliCorp terminated the merger transaction. It appears that EDE would like Staff to assist in minimizing the impact of the merger termination by using a hypothetical capital structure for purposes of setting rate of return, in essence, assisting EDE in obtaining recovery through rates of costs associated with the failed merger. However, Staff does not believe this would be appropriate and cites the following as a basis for its belief:

> In cases where the balancing of consumer interests against the interest of investors causes rates to be set at a "just and reasonable" level which is insufficient to ensure the continued financial integrity of the utility, it may simply be said that the utility has encountered one of the risks that imperil any business enterprise, namely the risk of financial failure...In addition, the *Hope* decision observed, "regulation does not insure that the business shall produce net revenues." [quoting *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590, 62 S.Ct. 736 [745], 86 L.Ed. 1037, 1052 (1942)]." 320 U.S. at 602, 64 S.Ct. at 288, 88 L.Ed. at 345. The risks, which utilities are to bear, were further noted in *Natural Gas Pipeline*, 315 U.S. at 590, 62 S.Ct. at 745, 86 L.Ed. at 1052, where it was stated that "the hazard that the property shall not earn a profit remains on the company in the case of a regulated, as well as an unregulated business." Since the risk of non-profitability remains upon regulated utility companies, it follows that the consequence of that lack of profitability, to wit diminished financial integrity, also rests upon utility companies.
>
> If the impact of diminished financial integrity were shifted from utility companies to the consumers, as would be the case if the utilities were regarded as having a constitutionally guaranteed right to rates which would preserve their financial integrity, elevating their rates above those levels that would otherwise be regarded as providing a "just and reasonable" return on assets utilized in the public service, the result would effectively circumvent the longstanding principle... [Source: Pennsylvania Electric Company v. Pennsylvania Public Utility Commission, 502 A.2d 130, pp. 134-135 (Pa. 1985), cert. denied, 476 U.S. 1137 (1986).]

It should be noted that Staff has agreed to true-up EDE's capital structure through June 30, 2001. However, Staff continues to believe it will be more appropriate to use EDE's "actual" capital structure. The true-up of EDE's capital structure will include EDE's recent issuance in February 2001 of trust preferred stock (TOPrS).

Q. Will the use of a hypothetical capital structure for EDE result in an increase in cost of capital?

A. Yes, it will. The increased cost is illustrated below:

Weighted Cost of Capital as of December 31, 2000 for EDE
Using EDE's Proposed Hypothetical Capital Structure

		Using ROE of		
Capital Component	% of Capital	8.50%	9.00%	9.50%
Common Equity	47.50%	4.04%	4.28%	4.51%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Long-Term Debt	52.50%	4.14%	4.14%	4.14%
Total	100.00%	**8.18%**	**8.42%**	**8.65%**

Vs.

Weighted Cost of Capital as of December 31, 2000 for EDE
Using EDE's Actual Capital Structure

		Using ROE of		
Capital Component	% of Capital	8.50%	9.00%	9.50%
Common Equity	39.80%	3.38%	3.58%	3.78%
Preferred Stock	0.00%	0.00%	0.00%	0.00%
Long-Term Debt	60.20%	4.74%	4.74%	4.74%
Total	100.00%	8.13%	8.33%	8.52%

Return on Common Equity for EDE

Q. Mssrs. McKinney, Gibson, Murry and Burdette all criticize the range of stock prices used by Staff in its DCF calculation. How do you respond to such criticism?

A. In my opinion, the range of stock prices employed by Staff are more appropriate than those used by either the Company witness or OPC. First, Mr. Murry uses a single stock price as quoted by Value Line, which reflects a single price representing the entire year of 2000 through October 2000. I find it curious that Mr. Murry and other Company witnesses criticize my use of stock prices that reflect the rise in stock price caused by the now terminated merger transaction when, in fact, the stock price used by Mr. Murry also reflects the same rise in stock price. As stated in my rebuttal testimony on page 6, lines 11 through 15, "Mr. Murry utilizes a single high and low share price for EDE quoted from Value Line that represents the entire calendar year 2000, which are very similar to those stock prices reported in Standard and Poor's Stock Guide for the reporting period ending October 2000. Staff believes that in doing so, Mr. Murry has over-stated the dividend yields of EDE and his comparable electric utility group."

On the other hand, Mr. Burdette criticizes Staff's use of stock prices and suggests Staff should use a range of stock prices from a more current period. Mr. Burdette chose to use the recent five weeks prior to the filing of his direct testimony. I disagree with the time period chosen by Mr. Burdette since these stock prices clearly reflect the full impact of the terminated merger transaction, which serves to inappropriately over-state the dividend yields used in his analysis.

Staff believes its approach of averaging stock prices over a period both before and after the merger termination minimizes the impact of the merger termination, strives to normalize EDE's stock price and produces a stock price that is more representative of the price investors are currently willing to pay for the stock of EDE. As stated in my direct testimony at page 23, lines 19 through 11, "this averaging technique is an attempt to minimize the effects on the dividend yield, which can occur due to daily volatility in the stock market." For these reasons, Staff believes its approach is more appropriate than those used by other witnesses.

Q. Mr. Murry criticizes at some length Schedule 19 attached to Staff witness McKiddy's direct testimony. How do you respond to this criticism?

A. Mr. Murry is misguided in his criticism. Mr. Murry is correct that on Schedule 19, attached to my direct testimony, the pre-tax interest coverages shown for EDE range from 2.16 times to 2.29 times, based on Staff's estimated range for return on equity of 8.50 percent to 9.50 percent. However, Mr. Murry is incorrect in believing that these pre-tax interest coverages are based on the full amount of revenues that would result from EDE's operations. The Income Available for Coverage shown on Line 8, includes only revenues generated from return on equity plus any preferred dividends, annual interest costs and income taxes paid by EDE. It does not include any portion of revenue requirement related to prudent operating costs, including depreciation and other taxes (See Schedule 28 of Staff witness McKiddy's direct testimony).

Q. Mr. Murry also criticizes the growth rates derived by Staff witness McKiddy. How do you respond to this criticism?

A. Mr. Murry is correct that there is no 2.00 percent five-year projected EPS Growth Rate for Empire District Electric in Standard & Poor's Corporation Earnings Guide, February 2001. This correction will be noted on Schedule 13 of Staff witness McKiddy's direct testimony and corrected on-the-record at the upcoming Evidentiary Hearing. Mr. Murry is also correct that the 2.00 percent five-year EPS Growth Rate for Empire District Electric in the Standard and Poor's Stock Guide is for an historical period. However, Staff believes that investors will use historical growth as a reliable predictor of projected growth. This belief can be confirmed by statements made in Staff's source document entitled, "The Cost of Capital – A Practitioner's Guide" on page 8-18, written by David C. Parcell, prepared and published by the Society of Utility and Regulatory Financial Analysts, 1997 Edition. Due to a lack of published projected growth rate information for EDE, Staff chose to use S&P's historical five-year growth rate as a substitute based on the methodology prescribed in the aforementioned publication.

Q. Mr. Murry criticizes Staff's use of growth rates at some length. In doing so, does Mr. Murry provide any plausible alternatives for which Staff to consider?

A. No. In fact, Staff submitted Data Request No. 3811 to Mr. Murry on April 18, 2001 requesting information related to stock prices and growth rates used within his analyses. Staff made several attempts to get a response to this data request and finally received such response on May 16, 2001. However, in reviewing the response provided by Mr. Murry, Staff found the response to be incomplete.

Q. Please explain.

A. Staff Data Request No. 3811 specifically asked Mr. Murry to "provide an explanation of how the estimated growth rates in Column 8 were derived. Mr. Murry should also provide specific dates and citations of his resource materials, specifically, from which Share Price, Earnings per Share and Growth Rate was obtained. In addition, Mr. Murry should provide specific citations that support the methodology employed in the determination of his Estimated Cost of Capital as shown on DAM-9." In response to Staff's request, Mr. Murry chose simply to provide an electronic copy of the data sheets used in his analyses, which were not included as part of his original workpapers submitted to Staff in response to Staff Data Request No. 1, along with a very brief characterization of his worksheets.

Mr. Murry did not provide an explanation of how the estimated growth rates in Column 8 of his Schedule DAM-9 were derived. Nor did Mr. Murry provide specific dates and citations of his resource materials from which Share Price were obtained. Finally, Mr. Murry failed to provide specific citations that support the methodology employed in the determination of his estimated cost of capital as shown on his Schedule DAM-9.

Q. In reviewing Mr. Murry's data response, did Staff form an opinion regarding Mr. Murry's analyses?

A. Yes. In reviewing Mr. Murry's electronic data sheets, Staff formed the opinion that Mr. Murry employed a "compound growth rate" methodology for purposes of determining a growth rate for use in his cost of capital analyses. However, it appears Mr.Murry chose to use a hybrid form of this methodology.

Q. Please explain.

A. Compound growth rate measures the period of annual growth rate between two sets of data, a beginning and ending value. In this case, Mr. Murry chose to use the average EPS for the period 1994-1996 as his beginning value and chose to use the projected EPS for the period 2003-2005 as his ending value. In essence, Mr. Murry is mixing actual historical growth with hypothetical projected growth to derive fundamentally flawed results.

Q. Do you believe Mr. Murry appropriately employed the compound growth rate methodology?

A. No. Traditionally, the compound growth rate methodology is used for determining an annual historical growth over a historical period with known values. In this instance, Mr. Murry chose to use a historical and projected value, respectively, as his beginning and ending values. Staff believes this is a mix of apples with oranges and produces results that are fundamentally flawed. In addition, it produces a growth rate of 5.42 percent for EDE, which is highly unlikely to be achieved in an environment of declining growth in the regulated electric utility industry. To further prove my point, Value Line Investment Survey reported on April 6, 2001 that EDE's growth in earnings per share for the past ten years was a negative 0.5 percent and for the past five years a positive 2.5 percent. In addition, it appears Mr. Murry attempted to develop a growth rate reflecting a ten-year period. However, Mr. Murry chose to use an average EPS value for the period 1994-1996 instead of using the EPS value for 1995, again substantiating Staff's belief that Mr. Murry's analysis produces results that are fundamentally flawed.

Staff believes it is appropriate to use the compound growth rate methodology for determining a company's historical growth rate. However, Staff believes the proper use of the methodology is to use a beginning and ending historical value. Furthermore, Staff believes historical growth rates should be used in combination with projected forecasts to arrive at an appropriate range of growth for purposes of determining an estimated range for return on equity. Staff also believes an analyst should avoid the use of a single projected forecast. Instead, Staff believes an analyst should use multiple sources and use an averaging technique to minimize any potential inaccuracies of those projections. Staff believes an analyst should also consider growth in dividends per share (DPS), earnings per share (EPS) and book value per share (BVPS) when determining an appropriate range of growth for purposes of calculating an estimated cost of common equity. A detailed explanation of Staff's approach can be found on page 22, lines 16 through 23 and page 23, lines 1 through 11 of Staff witness McKiddy's direct testimony (Also see Schedules 12 and 13 attached to Staff witness McKiddy's direct testimony).

Q. Do you have any other concerns regarding Mr. Murry's use of growth rates in the determination of his estimated cost of capital?

B. A. Yes. On pages 17, lines 1 through 21, of Staff witness McKiddy's rebuttal testimony, Staff discusses its perceptions regarding the derivation and application of the growth rates employed by Mr. Murry in determining his estimated return on equity. As stated on page 7, lines 19 through 21 of my rebuttal testimony, "it appears Mr. Murry chose to apply the projected growth rate that results in the highest cost of capital for each respective company rather than averaging the source data, thus overstating his estimated range for cost of capital." It should be noted that Mr. Murry refers to the results in Columns 9 and 10 of his Schedule Nos. DAM-8 and DAM-9 as "cost of capital." The results in these columns actually reflect his estimate of "return on equity." Cost of capital and return on equity are not the same. Cost of capital would include weighted costs of common equity, short- and long-term debt, as well as preferred stock.

Q. Mr. Murry also discusses bond ratings at some length. His rebuttal testimony relating to return on equity implies that the Commission should authorize an ROE sufficient for EDE to maintain an "A-" bond rating. Do you agree with Mr. Murry's recommendation?

A. No, I do not. It may be helpful to define how Standard and Poor's (S&P) assesses a credit rating Outlook. A Standard & Poor's Rating Outlook assesses the potential direction of a long-term credit rating over the intermediate to longer term. In determining a rating Outlook, S&P considers any changes in the economic and/or fundamental business conditions. A rating is not necessarily a precursor of a rating change or future CreditWatch action. CreditWatch highlights the potential direction of a short- or long-term rating. It focuses on identifiable events and short-term trends that cause the rating to be placed under special surveillance by Standard & Poor's analytical staff. These may include mergers, recapitalizations, voter referendums, regulatory action, or anticipated operating developments. Ratings appear on CreditWatch when such an event or a deviation from an expected trend occurs and additional information is necessary to evaluate the current rating. The "positive" designation indicates that a rating may be raised; "negative" indicates a rating may be lowered; and "developing" indicates that a rating may be raised, lowered or affirmed. It may also be helpful to define the true role of a credit rating as defined by S&P:

> A Standard & Poor's issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations or a specific financial program (including ratings on medium-term note programs and commercial paper programs.) It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated.
>
> The credit rating is not a recommendation to purchase, sell or hold a particular security. The rating performs the isolated function of credit risk evaluation, which is only one element of the investment decision-making process. A rating cannot constitute a recommendation inasmuch as it does not take into consideration other factors, such as market price and risk preference of the investor.
>
> Ratings do not create a fiduciary relationship between S&P and users of the ratings since there is no legal basis for the existence of such a relationship.
>
> It is commonplace for companies to structure financing transactions to reflect S&P's credit criteria so they qualify for higher ratings...Many companies go one step further and incorporate specific rating objectives as corporate goals...S&P does not encourage companies to manage themselves with an eye toward a specific rating. The more appropriate approach is to operate for the good of the business as management sees it, and to let the rating follow.
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> [Source: Standard and Poor's Ratings Direct, May 2000]

Q. Mr. Murry also implies that a downgrade in EDE's bond rating will be a direct reflection of any return on equity authorized in this proceeding. Can one issue alone cause a downgrade in a particular Company's credit rating?

A. It may, but in my opinion that is highly unlikely. Please let me explain further. According to the Corporate Ratings Criteria 2000 published by Standard and Poor's Ratings Direct (http://www.standardandpoors/ratingsdirect), S&P considers a number of factors when assigning a corporate credit rating. Such factors include the following:

Business Risk

Industry Characteristics
Competitive Position (e.g., Marketing, Technology, Efficiency, Regulation)
Management

Financial Risk

Financial Characteristics
Financial Policy
Profitability
Capital Structure
Cash Flow Protection
Financial Flexibility

S&P goes on to explain how this corporate rating criterion is employed. S&P states:

> Standard and Poor's uses a format that divides the analytical task into several categories, providing a framework that ensures all salient issues are considered. For corporates, the first several categories are oriented to fundamental business analysis; the remainder relate to financial analysis. As further analytical discipline, each is scored in the course of the ratings process, and there are also scores for the overall business risk profile and the overall financial risk profile.
>
> There are no formulae for combining scores to arrive at a rating conclusion. Bear in mind that ratings represent an art as much as a science. A rating is, in the end, an opinion. Indeed, it is critical to understand that the rating process is not limited to the examination of various financial measures. Proper assessment of debt protection levels requires a broader framework, involving a

> thorough review of business fundamentals, including judgments about the company's competitive position and evaluation of management and its strategies. Clearly, such judgments are highly subjective; indeed, subjectivity is at the heart of every rating.
>
> At times, a rating decision may be influenced strongly by financial measures. At other times, business risk factors may dominate. If a firm is strong in one respect and weak in another, the rating will balance the different factors. Viewed differently, the degree of a firm's business risk sets the expectations for the financial risk it can afford at any rating level. The analysis of industry characteristics and how a firm is positioned to succeed in that environment establish the financial benchmarks used in the quantitative part of the analysis.
>
> [Source: S&P's Corporate Ratings Criteria, 2000, pg. 17.]

Q. On page 12, lines 17 through 22 and on page 13, lines 1 through 3 of Mr. Murry's rebuttal testimony, he discusses "fuel pass-through provisions." Do you agree with Mr. Murry when he implies that return on equity should be upwardly adjusted to account for Empire's inability to recover fuel costs?

A. No, I do not. When determining a rate of return for a regulated utility within the Missouri jurisdiction, an analyst does not "directly" consider any particular risk on its own individual merit. Rather, an analyst accepts that the risk associated with a specific Company in "totality" is reflected in the stock price that investors are willing to pay for a particular stock based on the Efficient Market Hypothesis. An analyst also accepts that such risk is reflected in any analyses put forth by credible credit rating agencies such as Standard and Poor's and Moody's Investor Service, which are available to investors for review and consideration when making their investment decisions.

As stated in my rebuttal testimony, "One of the underlying assumptions of the DCF and CAPM models is acceptance of the Efficient Market Hypothesis. This hypothesis holds that securities are typically in equilibrium, meaning they are fairly priced in the sense that the price reflects all publicly available information on each security. Therefore, one could conclude that the public is fully aware of all publicly available information related to EDE and its operations. One could also conclude that the public is fully aware that EDE is a regulated entity and, therefore, shielded to a certain degree from the volatility of the market and subject to less risk."

Q. Finally, Mssrs. McKinney, Gibson and Murry criticize Staff's analysis and imply the estimated return on equity proposed by Staff is too low for EDE. Do you agree with their perception?

A. No, I do not. Staff believes it has provided a thorough analysis of EDE's cost of capital and performed sufficient "tests of reasonableness" to support its DCF analysis. Furthermore, Value Line Investment Survey published a revised estimate of EDE's Projected Return on Equity on April 6, 2001. In that publication, Value Line estimates EDE's Projected Return on Equity to be 9.00 percent in 2001. Value Line also makes a downward adjustment to EDE's projected growth in Earnings Per Share from 6.00 percent to 4.00 percent. I believe both of these revisions go further to support my estimated return on equity for EDE of 8.50 percent to 9.00 percent.

Q. Does this conclude your prepared surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric Company's Tariff Sheets Designed To Implement a General Rate Increase for Retail Electric Service Provided to Customers in the Missouri Service Area of the Company	)))))	Case No. ER-2001-299

AFFIDAVIT OF ROBERTA A. McKIDDY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Roberta A. McKiddy, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 14 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Roberta A. McKiddy

Roberta A. McKiddy

Subscribed and sworn to before me this 17th day of May 2001.

Rosemarie Riedl