Exhibit No.:	
Issue:	*Regulatory Plan Amortizations; Return on Equity*
Witness:	*Mark L. Oligschlaeger*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Rebuttal Testimony*
Case No.:	*ER-2006-0315*
Date Testimony Prepared:	*July 28, 2006*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

MARK L. OLIGSCHLAEGER

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2006-0315

Jefferson City, Missouri
July 2006

STAFF Exhibit No. 56
Case No(s). ER-2006-0315
Date 9-05-06 Rptr DF

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of The Empire District Company of Joplin, Missouri for authority to file tariffs increasing rates for electric service provided to customers in Missouri service area of the Company.	))))	Case No. ER-2006-0315

AFFIDAVIT OF MARK L. OLIGSCHLAEGER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Mark L. Oligschlaeger, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 13 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Mark L. Oligschlaeger

Mark L. Oligschlaeger

Subscribed and sworn to before me this 27th day of July 2006.

Toni M Charlton

TONI M. CHARLTON NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

TONI M. CHARLTON
Notary Public - State of Missouri
My Commission Expires December 28, 2008
Cole County
Commission #04474301

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MARK L. OLIGSCHLAEGER

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2006-0315

Q. Please state your name and business address.

A. Mark L. Oligschlaeger, P. O. Box 360, Jefferson City, MO 65102.

Q. Are you the same Mark L. Oligschlaeger who has previously filed direct testimony and supplemental direct testimony in this proceeding for the Staff?

A. Yes, I am.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of this testimony is to address assertions in the direct and supplemental direct testimony of The Empire District Electric Company (Empire or Company) in this proceeding regarding its potential need to include regulatory plan amortizations in its revenue requirement, and also to address certain issues concerning the Company's return on equity recommendations in this case found in the direct testimony of Dr. James H. Vander Weide.

EXECUTIVE SUMMARY

Q. Please briefly summarize your rebuttal testimony.

A. The Staff's current analysis demonstrates that regulatory plan amortizations should be included in the rates ordered for Empire in this proceeding, under both the Staff's revenue requirement recommendations for the IEC Continuation scenario or the IEC Termination scenario.

The Company's reliance on market-based valuations of equity in justifying its proposed adjustment to increase its allowed return on equity is inappropriate and inconsistent with traditional rate practices in this jurisdiction.

REGULATORY PLAN AMORTIZATIONS

Q. What are "regulatory plan amortizations?"

A. These amortizations are regulatory mechanisms approved by the Commission last year in the August 2, 2005, Order Approving Stipulation And Agreement for Case No. EO-2005-0263. The provisions in the regulatory plan approved for Empire allow for possible reflection of "amortizations" in rates if the Company fails to meet certain financial ratios in any general rate case filed prior to and including the rate case that reflects Empire's planned investment in the Iatan 2 generating station.

I discuss regulatory plan amortizations, and the Staff's position in this proceeding regarding them, in more detail in my supplemental direct testimony in this case.

Q. Did the Company address the matter of regulatory plan amortizations in its direct testimony in this case?

A. Yes. Company witness William L. Gipson discusses these amortizations on page 10, of his direct testimony. In his testimony, Mr. Gipson stated that Empire was not requesting inclusion of an amortization in the rates at the time of the filing of testimony. However, Mr. Gipson left open the possibility that the Company may seek an amortization at a later point in this proceeding, particularly if it chose to enter into new purchased power agreement contracts.

Q. Does the Staff agree with the Company's initial conclusion that it will not need a regulatory plan amortization in this case?

A. No. The Staff's analysis of Empire's need for regulatory plan amortizations in this proceeding, as set out in my supplemental direct testimony filed in this case, indicates that inclusion of amortizations in rates in this case is necessary under both of the revenue requirement scenarios before the Commission in this proceeding, the IEC Continuation scenario and the IEC Termination scenario.

Q. Why has the Staff come to a different conclusion on the need for amortizations than the Company?

A. The primary reason for this difference is that the Staff's analysis is based upon the financial results for a calendar year 2005 test year, with an update through March 2006, while Mr. Gipson's discussion of this matter in his direct testimony was based upon Empire's filed test year of the 12 months ended September 2005. Among other changes that took place between September 2005 and March 2006, the Company began obtaining wind energy under a 20-year operating lease arrangement with the Elk River Windfarm. This arrangement is being treated as an off-balance sheet obligation in the Staff's amortization analysis, and this inclusion appears to have had a material impact on the results of the amortization calculation formula.

Q. Does Mr. Gipson further address the subject of regulatory plan amortizations in his supplemental direct testimony in this proceeding, filed July 14, 2006?

A. Yes, he does. In this testimony at page 4, Mr. Gipson appears to reject the idea of using the mechanism of regulatory plan amortizations to potentially offset the limitations on Empire's recovery of fuel/purchased power expense that will result if the

Commission adopts the IEC Continuation scenario to set rates in this case. Mr. Gipson's stated reason for this position is his belief that the amortization provisions in the regulatory plan adopted in Case No. EO-2006-0263 were intended to address potential cash flow problems associated with its projected construction expenditures over the next few years, and were not intended to substitute for timely recovery of fuel/purchased power expense by the Company, or as a substitute for an upward adjustment to the allowed return on equity in the event timely recovery of Empire's fuel/purchased power expense is not allowed in this case.

Q. Does the Staff agree with Mr. Gipson on this point?

A. No, it does not. The amortization provisions in Empire's regulatory plan are intended to provide the Company with additional cash flow in the event its cash flow ratios fall to a range where credit rating agency downgrades become likely. The Staff doubts that credit rating agencies will care whether the reason for cash flow deterioration, if it occurs, relate directly to Empire's construction program or are instead caused by other events, such as the rate consequences of MPSC decisions involving fuel/purchased power or other matters; under both sets of circumstances, a downgrade will become more likely. Credit rating downgrades, and their resulting higher costs to utilities and their customers, is what the regulatory plan amortizations are designed to prevent. In the Staff's view, with certain specific exceptions spelled out in the Stipulation And Agreement in Case No. EO-2005-0263, it is irrelevant to focus on the cause of the Company's cash flow difficulties when considering whether amortizations are appropriate to include in rates.

Q. Is adoption of the IEC Continuation scenario by the Commission the only reason why a rate amortization might be necessary in this proceeding?

A. No. As previously mentioned, the Staff believes that rate amortizations are triggered under its revenue requirement recommendations for both the IEC Continuation and the IEC Termination scenarios. This illustrates that there are many other factors besides recovery of fuel/purchased power expenses that will affect Empire's cash flow, and hence its need for regulatory plan amortizations.

Q. Do the Staff's revenue requirement recommendations in this proceeding for the IEC Termination and IEC Continuation scenarios violate any of the criteria set out in the Stipulation And Agreement for Case No. EO-2005-0263 which govern whether Empire will be allowed regulatory plan amortizations in rates?

A. No. There are six listed causes of cash flow deficiencies spelled out on page 14, of the Stipulation And Agreement, in Case No. EO-2005-0263, for which rate amortizations will not be allowed. These causes include the impact of Empire's non-jurisdictional and non-regulated costs and risks on its cash flow, and and the impact of imprudent or disallowed Missouri costs on Empire's cash flow. In the Staff's opinion, the cash flow impacts of the Staff's revenue requirement recommendations under both scenarios in this case do not fall into any of these six categories of causes for cash flow deficiency for which use of rate amortizations is prohibited.

Q. Does the Staff support inclusion of amortizations in rates in this case that would be related, all or in part, to a Commission decision to adopt either the IEC Continuation scenario or the IEC Termination scenario for ratemaking purposes?

a. Yes, if such amortizations are justified under the calculation formulas approved in the Stipulation And Agreement, in Case No. EO-2005-0263. The Staff believes that inclusion of regulatory plan amortizations in rates triggered in whole or in part by adoption of either the IEC Continuation scenario or IEC Termination scenario would be consistent with the provisions of the Stipulation And Agreement, in Case No. EO-2005-0263, and would support such an amortization in those circumstances.

RETURN ON EQUITY

Q. What issue are you addressing in regards to return on equity (ROE)?

A. Company witness Dr. James H. Vander Weide, on page 49, of his direct testimony, calculates a preliminary 11.3% return on equity (ROE) for Empire based upon his analysis of the ROE requirements of a group of "proxy companies." Dr. Vander Weide then calculates an additional ROE allowance for Empire of 40 basis points (i.e., an 11.7% ROE) on account of Empire's higher leverage (debt) levels in its capital structure compared to the proxy companies. On page 50, of his direct testimony, Dr. Vander Weide further explains that his leverage adjustment is based upon a comparison of his proxy group's market value capital structures to Empire's book value capital structure.

In this testimony, I will explain why use of market valuations of a utility's capital structure components for this purpose is inappropriate and inconsistent with how this Commission has traditionally set rates. Staff witness David Murray of the Financial Analysis Department will be addressing in his rebuttal testimony other weaknesses with Dr. Vander Weide's attempt to reconcile his proxy group market value capital structure cost-of-capital estimate to Empire's book value capital structure cost-of-capital estimate.

Q. At page 50, of his direct testimony, Dr. Vander Weide indicates he examined the market values of Empire's and the proxy companies' capital structure, which would include both debt and equity sources of capital. Is this true?

A. No. After examining Dr. Vander Weide's analysis, Staff witness Murray concluded that Dr. Vander Weide only made a market-based valuation of the proxy companies' equity capital, not their debt capital. For this reason, my testimony will focus on the issue of book vs. market valuation of equity, and not address similar issues related to valuation of debt.

Q. Please summarize why it is improper to value a utility's equity capital at market values for ratemaking purposes.

A. Traditional ratemaking in Missouri has been based upon the original cost of the assets placed in utility service and upon the actual amount of capital investment made by utility equity investors to finance those assets. Equity investors should bear all of the risk of market fluctuations in the value of their owned stock, because they will receive all of the benefit if they sell the stock at a higher price than they originally paid for it.

Q. Please explain how a utility's equity is normally valued in the regulatory process for the purpose of setting rates.

A. A utility's equity is carried on the utility's books based upon the amount of funds raised when the new equity was issued. This equity balance can change based upon the amount of earnings the company retains, or because of asset impairments and/or write-downs when assets are sold. Subsequent changes in the market value of equity over time, however, have not been incorporated into a utility's revenue requirement by the Missouri Commission or any other regulatory commission, to my knowledge.

Q. Is market valuation of utility assets used to provide service to customers reflected in the rate process in Missouri?

A. No. The assets used to provide service by utilities, which are financed by a combination of debt and equity sources, are also carried on the utility's financial statements at net book cost, based upon the cost actually incurred by the utility to construct or purchase the asset. Subsequent market fluctuations in the values of those assets are ignored for ratemaking purposes.

Q. Can you provide an example that compares a book valuation of equity to a market valuation of equity?

A. Yes. Assume a utility issues a share of common stock and an investor purchases it for $25.00. That investor now is the owner of one share of utility stock and the utility has received $25.00 of capital in return for the stock to invest in its operations as it sees fit. The utility books the proceeds from the equity sale in the Equity section of its balance sheet, carried at its $25.00 "book value."

Assume again that, some time later, the utility's stock has increased in market value to $30.00 a share. That means that the original purchaser of the one share of stock referenced above can now find a willing buyer to purchase that share at $30.00 and reap a $5.00 profit on the sale of the one share if he or she chooses. However, the original buyer of the utility's equity may not choose to sell the share to another investor at $30.00, perhaps because he or she believes the market price of the equity may go higher still, or because the original purchaser places a high value on the regular receipt of dividends from the stock, or for some other reason.

To the extent the original purchaser of the stock in the example above chooses to keep the share of stock even as its market value increases, the increase in the stock's value from \$25.00 to \$30.00 is an *unrealized gain*. If that purchaser chooses instead to sell the share for a \$5.00 profit, that transaction results in a *realized gain* to the original purchaser.

Q. What effect do market fluctuations in the value of utility stock, and realized and unrealized gains and losses based upon those market fluctuations, have on the amount of capital available to the utility to invest?

A. These fluctuations have no direct effect on the amount of a utility's capital. In the assumptions mentioned above, if the market price of one share of stock increased from \$25.00 to \$30.00, the utility still only has the original \$25.00 paid by the original purchaser of the stock as an investment source. If that purchaser of a share of stock chooses to sell that share to someone else for a \$5.00 gain, that transaction is entirely between the two individual investors. The utility gains or loses nothing by that transaction and still retains only the \$25.00 of capital from the initial offering of the stock.

Stated another way, if a utility sells a share of stock for \$25.00, and invests the money in utility assets, \$25.00 would be placed in the utility's rate base on which to earn a return, and \$25.00 would be placed in the utility's capital structure as equity financing. Subsequent market valuations in the value of that share of stock would not affect the utility's valuation of its assets and related equity financing for ratemaking purposes or for purposes of recording the asset and equity values on the utility's balance sheet.

Q. Why do regulatory commissions base capital structure valuations on the book value of equity, not its market value?

A. Regulatory commissions, such as the MoPSC, have traditionally measured the equity components of utility capital structures based upon their book value because this valuation is an accurate measurement of the actual capital provided to the utility from equity sources. In contrast, market valuations of equity capital would include the realized and unrealized gains and losses of individual utility investors, which have no impact on the amount of capital available to the company to invest in utility operations.

Q. When individual utility investors buy or sell stock, do ratepayers share in the resulting gains or losses in any way?

A. No. The individual equity investors receive the benefit or detriment of the gain or loss on the stock transaction in entirety.

Q. When utilities sell assets at a gain or loss compared to their book value, how are these gains and losses treated by this Commission?

A. To my knowledge, the Commission has consistently allowed utility shareholders to bear the benefit or detriment of gains and losses associated with the sale of utility assets. This Commission's ratemaking policies have not put utility customers at risk for market fluctuations in the value of utility assets, or in the market value of the capital sources used to finance the assets.

Q. When utilities sell their assets or stock as a whole in the context of merger/sale transactions, how are these gains and losses treated by this Commission?

A. The treatment is consistent. Differences between the sale (market) prices of assets or stock and the book value of the assets or stock in the context of merger/sale transactions are generally called "acquisition adjustments" or "merger premiums." It has been the consistent and long-standing practice of this Commission, and many other regulatory commissions, to ignore acquisition adjustments/merger premiums in setting rates, and continues to base ratemaking under the new utility ownership on the original cost (book value) of the utility's assets or stocks.

Q. In this context, what is the essence of Dr. Vander Weide's proposal to adjust Empire's ROE by comparing his proxy group's market value capital structure to Empire's book value capital structure?

A. It is a proposal to deviate from original cost ratemaking, and instead to base rates in part dependent on market fluctuations in the value of the Dr. Vander Weide's proxy companies' equity.

It is my understanding that proposals to adjust a utility's ROE to take into account the relative percentage of debt in the utility's capital structure are not uncommon or inherently controversial in this jurisdiction. However, those proposed adjustments to ROE have typically relied upon book valuations of capital structure components, not market valuations.

Empire's proposed ROE adjustment in this case is different. Dr. Vander Weide has measured the proxy companies' relative percentage of capital structure debt by valuing these companies' equity on a market basis. The higher the market valuation of a company's equity, the lower the percentage of capital structure debt this type of analysis will show for a utility. When you compare the market-based valuation of the proxy companies' capital structures to the book value capital structure of Empire, the lower debt percentage in the proxy companies' capital structure compared to the book value percentage of debt in Empire's capital structure purportedly "justifies" an upward ROE adjustment because of Empire's alleged higher debt levels, and greater financial risk.

Q. Please provide a simple example of how Dr. Vander Weide's methodology for determining his market-value capital structures works.

A. Assume Utility A (which has filed a rate case) has a book value capital structure of 50/50 debt and equity, and a proxy group of companies has the same book value capital structure percentages. Clearly there is no risk difference between the two groups of companies on account of leverage levels, and no adjustment to ROE for Utility A would be justified on that basis.

However, then assume that the cost-of-capital analyst chooses to measure the equity component of the proxy companies' capital structure at market value, and that market value of equity is higher than the book value. Further assume that after the equity component is measured by its market value, the results of the analysis shows that the proxy companies' capital structure now has an equity percentage of 60%, and a debt percentage of 40%. When you compare that debt percentage to Utility A's book valuation debt percentage of 50%, it appears that Utility A has a higher percentage of debt in its capital structure, and hence more financial risk than the proxy companies. Therefore, the cost-of-capital analyst concludes that an upward adjustment to Utility A's ROE is warranted, due to Utility A's "greater" financial risk.

This is the type of analysis Dr. Vander Weide performed to justify his proposed 40-basis point upward ROE adjustment for Empire.

Q. Why would the upward adjustment to Empire's ROE advocated by Dr. Vander Weide under his market-based equity valuation approach be inappropriate?

A. It is inappropriate because the result of this analysis would be to force ratepayers to provide higher revenue streams to utilities based simply on higher valuation levels of utility share prices. This would make ratepayers effectively responsible for shareholders having an opportunity to achieve a certain level of realized and unrealized market gains on their equity investments.

Q. Why shouldn't ratepayers have this responsibility?

A. Under traditional rate practices, ratepayers have been responsible for providing equity investors the opportunity for a reasonable return on the actual equity capital contributed by investors. Shareholders have entirely borne the risk of subsequent gains and losses on their equity investments based upon fluctuations in the market value of their equity investment. And shareholders should bear this risk in its entirety, since they and not the ratepayers will be the beneficiaries of any realized gains associated with increasing market values of utility equities.

Q. Based upon the general principle followed by this Commission that gains or losses associated with utility assets and equity should be assigned to shareholders, is it a fair proposition to adopt Empire's position to calculate ROE in part on a market valuation of utility equity?

A. No, not at all. If customers have an explicit or implicit responsibility to provide additional revenue streams to a utility because other utility companies' stocks are trading at some market premium above book value, then customers should fairly and consistently share in any realized gains that utility equity investors ultimately reap, at least in part due to customers' rate support. As it has never been the Commission's policy to somehow require utilities and their investors to "share" market-based equity gains with customers, Empire's use of market-based valuations of equity to determine its ROE recommendation in this case should be rejected.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.