Exhibit No.
Issue: Depreciation
Witness: Gregory A. Knapp
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Empire District
Case No. ER-2004-0570
Date Testimony Filed: Nov 4, 2004

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Missouri Public Service Commission

Before the Public Service Commission Of the State of Missouri

Rebuttal Testimony

Of

Gregory A. Knapp

November 2004

Exhibit No. 28
Case No(s). ER-2004-0570
Date 12-06-04 Rptr KF

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November 2004

AFFIDAVIT

STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the 2nd day of November, 2004, before me appeared Gregory A Knapp, to me personally known, who, being by me first duly sworn, states that he is the Vice President – Finance and Chief Financial Officer 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.

Gregory A Knapp

Gregory A. Knapp

Subscribed and sworn to before me this 2nd day of November, 2004

Patricia A Settle

Pat Settle, Notary Public

My commission expires:

Patricia A. Settle
Notary Public - Notary Seal
State of Missouri
County of Jasper
Expires February 09, 2008

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THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION

REBUTTAL TESTIMONY
OF
GREGORY A. KNAPP
THE EMPIRE DISTRICT ELECTRIC COMPANY
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I Introduction

Q. Please state your name, position and business address.

A. Gregory A. Knapp. I am Vice President – Finance and Chief Financial Officer of The Empire District Electric Company ("Empire" or "Company"). My business address is 602 Joplin Street, Joplin, Missouri.

Q. What are your responsibilities in your position with Empire?

A. I am responsible for the accounting, tax, budgeting, financing and treasury activities of the Company.

Q. Please state your educational background and professional experience?

A. I hold a Bachelor's degree in Business Administration from Missouri Southern State University and an MBA from Southwest Missouri State University. I am a licensed Certified Public Accountant in the State of Missouri and a member of the Missouri Society of Certified Public Accountants and the American Institute of Certified Public Accountants.

In March, 2002, I was appointed to my current position. From July 2000 until rejoining Empire in January 2002 I served as Controller for the Missouri Department of Transportation. For 22 years prior to that I was employed at

Empire first as Director of Auditing and then as Controller and Assistant Treasurer. Prior to joining Empire in 1978 I worked first for an international public accounting firm and then a regional electric utility.

<u>II Purpose and Summary of Testimony</u>

Q. Please state the purpose of your rebuttal testimony?

A. In this testimony, I will discuss the financial impact on the Company of the low depreciation allowance recommended by Staff and OPC as well as discuss certain related energy policy issues.

Q. Please explain the purpose of depreciation in utility ratemaking.

A. Depreciation distributes long-lived asset costs by the assignment of depreciation rates to the individual accounting periods during the property's life, resulting in an allocation of costs to individual accounting periods. Included in this cost, in accordance with standard accounting / ratemaking principles, is a calculation of net salvage. Positive or negative net salvage is the value of the asset at the end of its life less the cost to remove and dispose of the asset. This allows for all of the costs associated with the asset, including net salvage, to be recognized by the customers that actually benefit from the use of the property.

Q. Does the Company support the depreciation rates that are reflected in the original filing?

A. Yes, The testimony of Company witness Donald Roff will support these calculations. Mr. Roff will also discuss the technical concepts of depreciation and why Empire can not support the rates proposed by Staff and OPC.

Q. Is the Company recommending the full impact of the depreciation rates to

be implemented from the original filing?

A. No. Empire filed schedules supporting the need for a $52.4 million revenue increase. However, the Company believes the magnitude of this increase would be too drastic for our customers. The Company determined to lessen the impact by approximately $14.1 million resulting in a $38.3 million revenue increase. The reduction was attributed to deprecation as explained by Company witness Roff in his rebuttal testimony.

Q. Why was there such a significant impact on deprecation expense?

A. The primary reason for the substantial increase is the fact that existing depreciation rates, as established in rate case ER-2001-299, are simply too low. Also having an effect are the retirement dates used to calculate the depreciation rates for production plant coupled with new investment and the effect of negative net salvage value.

<u>III Financial Impact</u>

Q. What are the financial impacts of a low depreciation allowance?

A. Technical and theoretical arguments aside, depreciation is a source of cash to partially fund the construction of new utility infrastructure. Our business model is straight forward; cash to run the business is either provided by the customers through rates or the cash is obtained in the capital markets. When this model is working properly, customers pay for the cost of providing utility service, including an appropriate depreciation allowance, plus the opportunity for the owners of the business to earn a fair return on their investment. When out of balance and customers are not fully paying the cost of service, the company is required to borrow more money to finance infrastructure requirements.

This is the situation in which Empire finds itself. Annual capital expenditures, excluding new generation additions, have been in the $40 to $45 million range in the last several years. This is a level of capital expenditures commonly referred to by the rating agencies as a "maintenance level" of expenditures, meaning this is the year in – year out level to fund the usual utility needs of providing safe and reliable service to customers. Contrast that to the annual depreciation allowance of around $28 million and it is easy to see that we are not even close to funding normal wear and tear replacements and new services without repeatedly going to the financial markets.

This unhealthy cycle ultimately results in increased costs because borrowing money is more expensive than using funds generated internally.

Q. What factors cause borrowed funds to be more expensive than internally generated funds?

A. First and most obvious there is a transaction cost to access the financial markets. Second, a utility suffering from a less than full recovery of cost will be assessed a higher cost of borrowing in the financial markets.

Q. Does the depreciation allowance ordered by the Commission impact the view of Empire by the financial markets?

A. Yes. This was very directly shown by Standard & Poor's in July 2002 when it lowered its credit rating on Empire to BBB from A-. S&P specifically cited Missouri's "low plant depreciations allowances" as one of three factors in the downgrade. (See Exhibit 1).

And on September, 28, 2004, S&P again took action as a result of concerns over Missouri regulation by placing Empire on "Creditwatch with negative implications". S&P again referred to the "low depreciation allowances" (along with low allowed Return on Equity and a lack of a fuel adjustment clause) as a primary factor in the action. (See Exhibit 2).

Q. Are you aware of any other rating action taken against a Missouri utility where depreciation was cited?

A. Yes. I understand Moody's downgraded Laclede Gas Co. in 2002 related, in part, to concerns over reduced cash flows related to low depreciation accruals. It is obvious the credit rating agencies hold a negative view of Staff's depreciation methodologies. Staff's and OPC's approach leads to depreciation rates that are significantly lower than levels allowed in other states. Composite depreciation rates of 3.00% are more the norm and, as discussed by Empire witness Mr. Roff on pages 6 and 7 of his direct testimony in this case, the rates proposed by Staff and OPC are significantly below that. The unfortunate result is that infrastructure additions now and in the future will cost more to finance than might have been the case. These costs will ultimately be passed on to future customers.

IV Other Energy Policy Issues

Q. Are there other Empire specific concerns with Staff's approach to depreciation?

A. Yes. Staff's approach imposes additional risks on both Empire and our customers. Depreciation expense and thereby customers rates are certainly lower under Staff's approach, at least in the near term. However, our business and responsibility, as well as, the State's business and responsibility go beyond the near term and extend far into the future to assure adequate utility infrastructure in the years to come. Unreasonable deferral to some future period of net salvage on assets being consumed today increases the risk of recovery for the utility and certainly increases the cost to future customers. And to the extent credit ratings are damaged, costs will be even higher. Additionally, I do not believe it is appropriate to saddle future generations of customers with the cost of removing and disposing of assets (net salvage) that are being used today. Inter-generational equity is the ratemaking concept whereby the customers receiving benefit from service pay for that service. Standard depreciation practices and Empire's proposal both reflect net salvage in a manner that charges customers with their fair share of this cost. The approach advocated by Staff and OPC is counter to this basic principle.

Q. Are there other concerns with Staff's approach to depreciation?

A. Yes. Staff's approach imposes additional risks on the economy of the State of Missouri. Regulatory policy that does not support necessary and prudent utility infrastructure investments places Missouri at a disadvantage to most other states when businesses consider expansion in or relocation to Missouri. Today's business and industry demand strong, dependable and expandable utility service. Artificially low rates today will not be much of a comfort if timely investments are not made or if rate shock is the future product of today's short sighted decisions. Missouri's economic viability and energy security are linked to a sound utility infrastructure.

V Concluding Remarks

Q. Do you have any final remarks?

A. Yes. I believe the Commission should not adopt a depreciation policy that is as far out of the mainstream as Staff's and OPC's approach to net salvage. Empire is in a growing area of the state and requires significant cash to fund infrastructure additions. Squeezing a sound source of funding at this time imposes additional risks on both Empire and our customers. These risks are manifested in the form of lower credit ratings. Future costs will rise as a result or infrastructure will not get built in a timely fashion. I can see this in Empire's future and it is very easy to see this in the future of all Missouri utilities if Staff's and OPC's unreasonable position is adopted.

Q. Does this conclude your testimony?

A. Yes.

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Return to Regular Format

Research:

Summary: Empire District Electric Co.

Publication date: 02-Jul-2002

Credit Analyst: Todd A. Shipman, CFA, New York (1) 212-438-7676; Craig Hauret, New York (1) 212-438-7938

Credit Rating: BBB/Stable/A-2

Rationale

On July 2, Standard & Poor's lowered its corporate credit rating on Joplin, Mo.-based Empire District Electric Co. (EDE) to 'BBB' from 'A-'. The rating on the company's commercial paper program remains at A-2. The outlook was revised to stable from negative.

The rating action on energy provider EDE reflects a downward trend in the company's financial profile that was not adequately stemmed in recent regulatory actions. Roughly 80% of EDE's revenues are derived in Missouri, where the regulatory environment is marked by relatively low allowed ROEs, low plant depreciation allowances, and the lack of a permanent fuel adjustment clause to help shield the company from its markedly increased dependence on natural gas. While the temporary fuel and purchased-power mechanism now in place in Missouri helps to mitigate potential volatility in energy prices through 2003, Standard & Poor's is concerned about future regulatory policy regarding the timely recovery of prudently incurred fuel and purchased-power expenses.

EDE has an average business profile, and a financial position (adjusted for purchased power obligations) that is marginally adequate for the new rating. The business profile is supported by a healthy service area with limited industrial concentration, negligible unregulated activities, and a credit-quality conscious management. In addition to the aforementioned regulatory environment, concerns include EDE's reliance on the Asbury coal plant, illustrated by the company's poor financial performance in 2001 during which the plant experienced extended maintenance. This dependence will diminish as more capacity comes on line through 2004, but Asbury will still provide a significant amount of generation. Furthermore, Nox compliance issues at the plant will affect the company's operating and financial risks going forward.

Continued reductions in capital spending (outside of expansion) and cost controls are leading to improved earnings protection. Rates are higher, but EDE will remain competitive in the region. In addition, the other principal financial measures are expected to fall in line with levels suitable for the established risk profile at the 'BBB' level: funds from operations (FFO) to debt at 20%, FFO coverage at 3.5 times, and debt to capital at 53%.

Outlook

The stable outlook assumes reasonable regulatory response in future rate proceedings, manageable environmental compliance costs that are recoverable through rates, and the continued improvement in risk management of the company's generation fleet, fuel procurement, and purchased-power needs.

Ratings List

Empire District Electric Co.

Corporate credit rating BBB/Stable/A-2

A complete list of the ratings is available to RatingsDirect subscribers at www.ratingsdirect.com, as well as on Standard & Poor's public Web site at www.standardandpoors.com under Ratings Actions/Newly Released Ratings.

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Empire District Electric Rating Placed on CreditWatch Negative

Publication date: 28-Sep-2004

Analyst(s): Barbara A Eiseman, New York (1) 212-438-7666;
Gerrit Jepsen, New York (1) 212-438-7916

Credit Rating: BBB/Watch Neg/A-2

Rationale

On Sept. 28, 2004, Standard & Poor's Ratings Services placed its 'BBB/A-2' corporate credit rating on Empire District Electric Co. on CreditWatch with negative implications. The CreditWatch listing reflects prospects for erosion of Empire's pressured financial condition if recent testimony by the Missouri Public Service Commission (MPSC) staff in Empire's pending general rate case is ultimately endorsed by the MPSC. Hearings begin in early December with a final order due by March 27, 2005.

Joplin, Mo.-based Empire has about $400 million in long-term debt outstanding.

Empire is seeking a $38.3 million (14.8%) rate increase that is predicated on a return on common equity (ROE) of 11.65%. The utility is also requesting a five-year interim energy charge (IEC) to help manage risk and recover fuel costs. The MPSC staff has recommended an ROE range of 8.29% to 9.29% with 8.79% as the midpoint which would result in a revenue increase of only $9.5 million at 8.29%, $12 million 8.79%, and $14.4 million at 9.29%, inclusive of the IEC period. Furthermore, the staff has proposed that the IEC be adopted for a period of only 24 months, owing to the extreme volatility of natural gas prices. Because there is no fuel djustment clause in Missouri, reinstatement of the IEC for a longer period would provide for more predictable and stable earnings.

Although the staff's recommendation is not binding on the commission, an MPSC order that mirrors the staff's recommendation would harm Empire's creditworthiness. The requested rate hike is needed to recover capital additions, including two peaking units that were installed in 2003, higher operating and maintenance expense, escalating pension and health care costs, and rising fuel and purchased power costs.

Empire's credit quality reflects an average business profile and a financial position (adjusted for off-balance-sheet, purchased-power obligations) that remains somewhat weak, albeit improving, for the current ratings. Empire benefits from a service territory with a well-diversified business mix, below-average rates due to the low embedded cost of its coal plants, and adequate liquidity. However, the company remains challenged by its regulatory environment. Empire is a public utility involved in the generation, purchase, transmission, distribution, and sale of electricity primarily in Missouri (89% of electric operating revenues), Kansas (6%), Oklahoma (3%), and Arkansas (3%).

Empire's business profile is supported by a healthy service area with little industrial concentration. The territory consists primarily of small, rural customers that benefit from Empire's below-average rates, which the company derives from low-cost coal plants. The company does conduct some higher-risk, nonregulated activities, but they are extremely limited and Empire has demonstrated its willingness to exit ventures if financial performance does not materialize.

A challenging regulatory environment tempers the strengths of Empire's business profile. Under the jurisdiction of the MPSC, Empire suffers from relatively low allowed ROEs, receives low depreciation allowances, and lacks a fuel-adjustment clause to help shield the company from its markedly increased natural gas dependence. The absence of a fuel-adjustment clause exposes Empire to potential fuel and purchased-power price volatility, which concerns Standard & Poor's. Timely recovery of prudently incurred fuel and purchased-power expenses is important for Empire's credit quality.

Regarding its financial profile, Empire is focused on improving its earnings and cash flow protection measures by hedging fuel expenses and controlling other costs. As long as the company continues to aggressively hedge its forecast natural gas needs (as of April 2004, Empire had hedged about 65% of its remaining expected gas burn for 2004 with rates at or below those budgeted in its rate structure) and receives timely and adequate rate relief, key financial measures should fall be marginally suitable for the established risk profile at the 'BBB' level.

Empire's credit facility is rated one notch below the corporate credit rating to reflect its subordination to Empire's secured debt. Because the loan is unsecured, Standard & Poor's expects that lenders will fare the same as senior unsecured creditors in the event of a default.

Short-term credit factors.

The short-term rating on Empire is 'A-2'. For the short term, Standard & Poor's expects cash flow from operations to fully fund maintenance capital expenditures and dividends, assuming continued, timely recovery of regulatory-related costs. Future actions by the MPSC will weigh heavily on Empire's credit profile because of the lack of conventional regulatory support (no fuel-adjustment clause and no construction-work-in-progress recovery). The current short-term rating incorporates additional rate

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relief over the near term, given currently strong natural gas and coal prices. Empire's primary coal supply contract expires in December 2004, and current coal prices exceed those in its existing fixed-price contract. The lack of adequate rate relief would adversely affect the company's profitability.

Empire's adequate liquidity is supported by access to a $100 million unsecured revolving credit facility that matures in April 2005 and limited, long-term debt maturities in the next five years. As of June 30, 2004, the facility was fully available and adequate for working-capital needs, assuming Empire continues to prudently hedge its expected natural gas burn. The facility includes no rating triggers, but requires total debt (excluding trust-preferred securities) to be less than 62.5% of total capital, and EBITDA to be at least 2x interest charges (including distributions from trust-preferred securities). Empire safely met the debt-to-capital requirement (46.5%) and the EBITDA-to-interest covenant (3.34x) as of June 30, 2004.

Other points of note include:

- The company annually distributes about $30 million in common dividends, which would provide flexibility in a liquidity crunch.
- Restrictions in Empire's mortgage bond charter, particularly an interest coverage requirement, would limit the issuance of new first mortgage bonds to roughly $213 million as of June 30, 2004. However, no such restrictions exist on unsecured debt issuances.
- Empire has limited room for capital expenditure reductions, as projected generation outlays are required to maintain reserve margins. Projected growth expenditures will require external funding.
- Although the company operates various diversified businesses, Standard & Poor's believes that their sale would generate few proceeds.

Ratings List

	To	From
Empire District Electric Co.		
Corporate credit rating	BBB/Watch Neg/A-2	BBB/Stable/A-2
Senior secured debt	A-/Watch Neg	A-
Senior unsecured debt	BBB-/Watch Neg	BBB-
Preferred stock	BB+/Watch Neg	BB+
Commercial paper	A-2/Watch Neg	A-2

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