Exhibit No.
Issue: Reason for Rate Case
Witness: W. L. Gipson
Type of Exhibit: Direct Testimony
Sponsoring Party: Empire District
Case No.

Before the Public Service Commission
of the State of Missouri

Direct Testimony

of

W. L. Gipson

April 2004

DIRECT TESTIMONY
OF
W. L. GIPSON
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO.

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. William L. Gipson, 602 Joplin Street, Joplin, Missouri 64801.

Q. WHO IS YOUR EMPLOYER AND WHAT POSITION DO YOU HOLD?

A. The Empire District Electric Company ("Empire" or "Company") is my employer. I hold the position of President and Chief Executive Officer.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

A. I hold a Bachelor of Science Degree in Business Management Technology and an Associate Degree in Computer Science from Missouri Southern State University in Joplin, Missouri.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE.

A. Prior to joining Empire I worked for an international furniture manufacturing company and a regional bank. I joined Empire as a Computer Programmer in 1981. I have held positions in Information Services, Economic Development and Operations. My employment with Empire has been continuous since 1981.

Q. HAVE YOU PREVIOUSLY PRESENTED TESTIMONY BEFORE THIS OR ANY OTHER REGULATORY BODY?

A. Yes, I have presented testimony before the Missouri Public Service Commission (“Commission”), the Kansas Corporation Commission, the Oklahoma Corporation Commission, and the Arkansas Public Service Commission.

Q. MR. GIPSON, WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?

A. The purpose of my testimony is to provide the background for Empire's decision to request rate relief.

Q. PLEASE DESCRIBE EMPIRE.

A. Empire is a Kansas corporation with its principal office and place of business at 602 Joplin Street, Joplin, Missouri 64801. Empire is engaged in the business of providing electrical utility services in Missouri, Kansas, Arkansas and Oklahoma; water utility services in Missouri; and has a certificate of service authority issued by the Commission to provide certain telecommunications services.

Q. WILL YOU PLEASE DESCRIBE THE AREA SERVED BY EMPIRE AND GIVE A BRIEF DESCRIPTION OF THE CUSTOMERS SERVED?

A. Empire provides electric service in an area of approximately 10,000 square miles in southwest Missouri and the adjacent corners of the states of Kansas, Oklahoma, and Arkansas. Empire's operations are regulated by the utility regulatory commissions of these four states as well as the Federal Energy Regulatory Commission ("FERC"). The area embraces 120 incorporated communities in 21 counties in the four-state area.

The area economy is diversified. The service territory features small to medium manufacturing operations, medical, agricultural, entertainment, tourism, and retail interests all contributing to average or above-average customer growth over the last several years.

At the end of 2003, Empire served 131,400 residential customers, 23,154 commercial customers, 362 industrial customers, 1,735 public authority customers, and four wholesale customers throughout our system. Most of the communities in the service area are small, with only 29 being in excess of 1,500 population. Only 10 communities have a population in excess of 5,000, and the largest city is Joplin, Missouri, with a population of approximately 45,500.

In Missouri, at the end of 2003, Empire served 114,893 residential customers, 20,346 commercial customers, 291 industrial customers, 1,404 public authority customers, and three wholesale customers. In addition to electric service, Empire also provides regulated water service to approximately 4,500 customers in the Missouri communities of Aurora, Marionville, and Verona.

Q. EXPLAIN, GENERALLY, EMPIRE'S NEED FOR A RATE INCREASE AT THIS TIME.

A. This filing for a rate increase is important for Empire because we need to (1) recover additional operating expenses and the return of and on existing and new investment that constitutes the used and useful rate base costs of serving the local community; and (2) re-gain financial flexibility to reliably serve our customers in the most effective manner.

Empire's request is due to over $100 million in infrastructure investments, higher fuel costs, and the need to earn adequate rates of return and to properly reflect the economic cost of assets through the depreciation allowance.

Furthermore, Empire is operating in an increasingly complex and volatile industry while responding to increased customer demands. Empire faces the need to make significant capital investments over the next several years in order to continue to support our customers' power demand and provide reliable, high-quality service.

Empire, with the help of the Commission, seeks to create a forward-looking regulatory framework that benefits the customers, employees and stockholders.

Q. THE SCHEDULES IN THIS FILING SUPPORT THE NEED FOR A $52.4 MILLION REVENUE INCREASE. PLEASE EXPLAIN WHY THE TARIFFS FILED IN THIS CASE LIMIT THE INCREASE TO $38.3 MILLION, OR AN APPROXIMATE 14.8% INCREASE IN REVENUE.

A. A $52.4 million increase in revenue is justified and fully supported in this filing. However, the impact on our customers of a 20.2% increase in rates, however justified, would be significant. After much consideration, we determined to lessen the impact in this case by approximately $14.1 million. Specifically, the portion of our proposed increase attributable to depreciation rates, sponsored by Empire witness Mr. Donald Roff, has been pared down to reflect only a portion of the changes recommended by Mr. Roff.

Q. WHAT SIGNIFICANT INVESTMENTS HAS EMPIRE MADE TO ITS INFRASTRUCTURE?

A. In 2001, Empire entered into an agreement to purchase two FT8 peaking units to be installed at the Empire Energy Center with generating capacity of 50 megawatts each. These units began commercial operation in April 2003 and added a total of 100 megawatts of capacity. The testimony of Mr. Brad Beecher, Vice President of Energy Supply, will elaborate further on these rate base additions.

Empire also continues to make substantial improvements in its distribution and transmission system in order to meet growing customer demand. In addition, last May, the Empire service territory received catastrophic damage after a tornadic supercell moved through the area. Our employees worked diligently throughout the week to rebuild lines, repair substations and return power to customers. Further details are provided in the testimony of Mr. Mike Palmer, Vice President of Commercial Operations.

Q. PLEASE ELABORATE ON EMPIRE'S HIGHER FUEL COSTS.

A. Thirty percent of the energy during the test year was generated from Empire's natural gas-fired units or purchased on the spot market. In recent years, the wholesale natural gas market has seen a substantial increase in prices. Empire actively worked to mitigate these rising prices by implementing a hedging program in 2001.

While less an issue during the last couple of years due to Empire's success in locking in low prices, the current long-term trend in gas prices would create substantial credit pressure if left unaddressed. Mr. Brad Beecher will describe the fuel price increases in detail and explain the elements of the hedging program in his testimony.

Q. WHAT IS EMPIRE RECOMMENDING TO REGULATE THE CURRENT LONG-TERM INCREASES IN GAS PRICES?

A. Empire has put forth three separate methodologies. Those include a Fuel and Purchased Power Adjustment Clause ("FAC"), an Interim Energy Charge ("IEC") and the twelve-month ending forecast that uses production cost modeling. Implementation of one of the alternatives is needed to provide a timely recovery of fuel and purchased-power expenses. This will also allow for fewer rate cases, improved credit risk and financial flexibility and continued customer protection against fuel price volatility through Empire's hedging activities. Testimony by Mr. Brad Beecher discusses these methodologies in detail.

Q. WHAT IS THE COMPANY'S PROPOSED RETURN ON COMMON EQUITY ("ROE") IN THIS CASE?

A. The Company is proposing an ROE of 11.65 percent. This was derived from a range of 11.3 percent proposed by Empire witness Dr. James H. Vander Weide to 12.0 percent proposed by Empire witness Dr. Donald A. Murry. Empire has chosen the midpoint of 11.65 percent. In their direct testimonies, Dr. Murry and Dr. Vander Weide will support their proposals.

The Company must meet its obligations to its customers for reliable electric power service. To meet this ongoing obligation the Company must also be able to finance significant capital projects. The Company must also have the financial performance necessary to maintain or improve its bond ratings. Despite our best efforts, the Company cannot find a way to accomplish this without earning an adequate return on common equity. It is important to note that to secure adequate financing in this more complex economic environment, investors and rating agencies increasingly look at performance as measured by the returns actually achieved. Therefore, it is also important that the Company be afforded an opportunity to actually earn its authorized return. The average return earned on common equity for the last five years has been 7.66 percent. Compared to an embedded debt cost of 7.25 percent and a preferred cost of 8.93 percent, this level of earnings restricts the financial flexibility of the Company and does not fairly compensate equity investors.

Q. ARE YOU RECOMMENDING ANY CHANGES TO DEPRECIATION?

A. Yes. Empire contracted Deloitte & Touche LLP ("Deloitte") to conduct a depreciation study. The study resulted in a recommendation by Deloitte to change the depreciation rates. The study recommended an annual rate increase in Missouri depreciation expense of approximately $24 million. The primary reason for the substantial increase is the effect on annual depreciation expense of the relatively low existing depreciation rates. 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. This is further discussed by Empire witness Mr. Donald S. Roff in his testimony.

However, Empire realizes the magnitude of this increase would be too drastic for our customers. Therefore we are recommending the depreciation rates be phased in over a period of time.

Q. HOW DO YOU PROPOSE THE COMMISSION PROVIDE THE SUPPORT YOU HAVE REQUESTED?

A. I would ask that the Commission provide such regulatory support in the form of:

(1) An interim energy charge (or fuel adjustment clause) that helps Empire manage risk and recover fuel costs;

(2) A rate of return and depreciation allowance that are more comparable to what other state regulators have allowed for Empire and other utilities;

(3) Full cost recovery for other prudent operating expenses; and

(4) Rates designed to provide a reasonable opportunity to earn the allowed return.

It is important the Commission support these four requests to allow Empire to regain the financial and operating flexibility needed to serve our customers both in the immediate and long-term. It will also allow Empire to bestow a fair and reasonable balance between the interest of our customers and our shareholders, a large proportion of which are Missouri residents and part of the local community.

Q. WHAT AFFECT DOES MISSOURI REGULATION HAVE ON EMPIRE?

A. Regulatory policies for depreciation rates, recovery of fuel cost, and allowed return all directly influence revenues and earnings. The inability for Empire to earn sufficient return impacts the Company's ability to compete for capital, and therefore, stifles cash flow.

In the testimony of Dr. Murry, the results of the Regulatory Research Associates study of US regulatory commissions will be presented. Missouri was described as "restrictive" with equity returns "modestly below industry averages."

Q. WHAT IMPACT COULD EMPIRE'S REQUEST HAVE ON THE CREDIT RATING AND FUTURE FINANCIAL OUTLOOK?

A. In order to understand where we are going, it is necessary to understand where we have been. Prior to the failed merger with UtiliCorp United, Inc., Empire was rated as A2 by Moody's and A- by Standard & Poor's ("S&P"). Since the failed merger in 2001, both rating agencies downgraded our debt to a level just above "junk" status. Empire has been able to restore its capital structure and has worked diligently to restore our financial performance.

Q. PLEASE CONTINUE.

A. On July 2, 2002, S&P issued the following comment: "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."

In addition, on September 25, 2003 they stated that "Standard & Poor's views Empire as a well-managed, credit-conscious, and cost-effective company that tries to compensate for its sometimes difficult regulatory environment."

We are requesting additional regulatory support from the Commission that will allow us the opportunity to re-gain needed financial flexibility and operate more safely within the investment-grade credit rating categories.

Q. ARE THERE ANY OTHER COMMENTS YOU WOULD LIKE TO MAKE?

A. Yes, I would like to reiterate the importance of receiving Commission support. It is important to our customers, shareholders and employees. Implementation of the requested rates will allow us to continue to provide exceptional service to our customers, provide an equitable rate of return to our shareholders permitting our stock to remain competitive, and provide stable employment to our employees. This will allow Empire to remain a financially sound company with a strong presence in the local economy.

Q. DOES THIS CONCLUDE YOUR PREPARED DIRECT TESTIMONY AT THIS TIME?

A. Yes, it does.