

**Exhibit No.** \_\_\_\_\_

**Issue:** Capital Structure

**Rate of Return**

**Witness:** David W. Gibson

**Type of Exhibit:** Surrebuttal Testimony

**Sponsoring Party:** Empire District

**Case No.:**

**Date Prepared:** May 17, 2001

**Before the Public Service Commission  
of the State of Missouri**

**FILED<sup>3</sup>**

**MAY 17 2001**

**Missouri Public  
Service Commission**

**Surrebuttal Testimony**

**of**

**David W. Gibson**

**May 2001**

## **INDEX**

	<b><u>Page</u></b>
Capital structure	2
Return on common equity	3

SURREBUTTAL TESTIMONY  
OF  
DAVID W. GIBSON  
THE EMPIRE DISTRICT ELECTRIC COMPANY  
BEFORE THE  
MISSOURI PUBLIC SERVICE COMMISSION  
CASE NO. ER-2001-299

1 Q. PLEASE STATE YOUR NAME.

2 A. David W. Gibson.

3 Q. ARE YOU THE SAME DAVID W. GIBSON WHO SUBMITTED DIRECT AND  
4 REBUTTAL TESTIMONY IN MISSOURI PUBLIC SERVICE COMMISSION  
5 ("COMMISSION") CASE NO. ER-2001-299 ON BEHALF OF THE EMPIRE  
6 DISTRICT ELECTRIC COMPANY ("EMPIRE")?

7 A. Yes, I am.

8 Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

9 A. To respond to certain matters in rebuttal testimony by the Missouri Public Service  
10 Commission Staff ("Staff") witness Roberta A. McKiddy and Office of Public  
11 Counsel ("OPC") witness Mark Burdette concerning capital structure and return on  
12 equity.

13

14 **CAPITAL STRUCTURE**

15

16 Q. DO YOU AGREE WITH THE PROPOSALS TO USE THE CAPITAL  
17 STRUCTURE OF EMPIRE AS OF THE END OF JUNE 2001 AS SUGGESTED BY  
18 MS. MCKIDDY AND MR. BURDETTE IN THEIR REBUTTAL TESTIMONY?

19 A. No.

20 Q. WHY NOT?

21 A. Empire's earnings for the first quarter of 2001 were \$2,207,201 while our dividend  
22 was \$5,634,710 or a \$3,427,509 decrease in common equity from the balance at the

1 end of 2000. Without any rate relief in the second quarter, we will see another  
2 decrease in common equity for that quarter as well. The result will be that common  
3 equity will have decreased just because earnings are not adequate to cover expenses  
4 and dividends. If the Commission permits this decrease in equity, it will result in a  
5 smaller revenue requirement than what is justified. This is just another reason why the  
6 Commission should "normalize" Empire's capital structure in order to take away those  
7 seasonal and operating abnormalities. Empire proposes that the Commission adopt a  
8 capital structure of 45% common equity, 7.9% trust preferred and 48% long-term  
9 debt. This would meet the need of Empire to maintain a balanced capital structure and  
10 yet reflect the lower end of the historical capital structure in order to pass savings on  
11 to ratepayers which resulted from the failed merger. This proposed capital structure  
12 compares to the actual ratios of 37.31% common equity, 7.92% trust preferred and  
13 54.77% long-term debt at the end of March 2001.

#### 14 15 RETURN ON COMMON EQUITY

16  
17 Q. HOW DO YOU CHARACTERIZE THE CONTINUED RECOMMENDATION BY  
18 MS. MCKIDDY FOR A 8.5% TO 9.5% RETURN ON EQUITY AS SET OUT IN  
19 HER REBUTTAL TESTIMONY?

20 A. It is unreasonable.

21 Q. WHAT EVIDENCE DO YOU HAVE THAT HER RECOMMENDATION IS  
22 UNREASONABLE?

23 A. A review of the results for rate case decisions published by Regulatory Research  
24 Associates, Inc., ("RRA").

25 Q. WHAT IS REGULATORY RESEARCH ASSOCIATES, INC.?

1 A. RRA is an independent research organization that was started in 1982 and provides  
2 comprehensive and timely research to the investment, corporate and regulatory  
3 communities regarding public utility regulation.

4 Q. HOW DID YOU OBTAIN THIS REPORT?

5 A. The report is commercially available from RRA.

6 Q. WHAT DID YOU CONCLUDE FROM THIS REVIEW?

7 A. From a review of the rate cases that were concluded during the last decade, the high  
8 average return on equity was 12.70% in 1990 while the low was 10.77% in 1999. In  
9 2000, the return averaged 11.43%. The average return for the first quarter of 2001  
10 was 11.38%. The recommendation by Ms. McKiddy is so low that it would not even  
11 show up on this chart. The high end of the recommendation by Mr. Burdette would  
12 barely make the chart and is still approximately 1¼% below the average. Once again,  
13 this is not reasonable. I have attached a chart from the RRA publication, which  
14 depicts the average return on equity that was given for electric utilities.

15 Q. ARE YOU SUGGESTING THAT THE COMMISSION SET EMPIRE'S RETURN  
16 ON COMMON EQUITY RATE BASED ON THE PERIOD FROM 1990 TO 2000?

17 A. No, I am merely trying to show the trend over the last decade for authorized rates of  
18 return on common equity. The results for 2000 and the first quarter of 2001 are more  
19 indicative of what the current rate should reflect.

20 Q. HOW DID THE CAPITAL STRUCTURE FOR THESE RATE CASE DECISIONS  
21 COMPARE TO WHAT HAS BEEN RECOMMENDED IN THIS CASE?

22 A. For the period from 1990 to 2000, the average equity portion of the capital structure  
23 ranged low of 42.42% in 1990 to 48.85% in 2000. For the first quarter of 2001, it was  
24 49.69%. Once again, these are well above what has been recommended in this case  
25 and does not pass the reasonableness test.

1 Q. DO YOU HAVE ANY OTHER COMMENTS CONCERNING THE  
2 REASONABLENESS OF THE RATE OF RETURN THAT HAS BEEN  
3 RECOMMENDED BY MS. MCKIDDY?

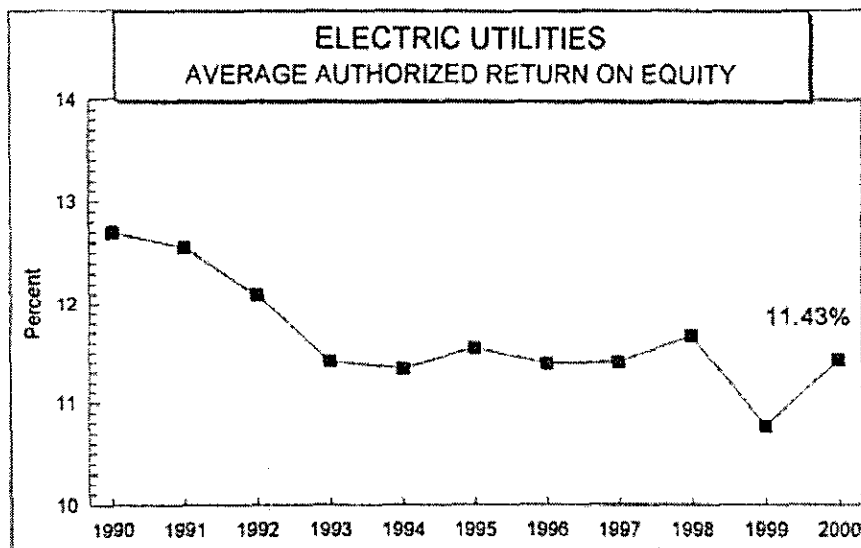
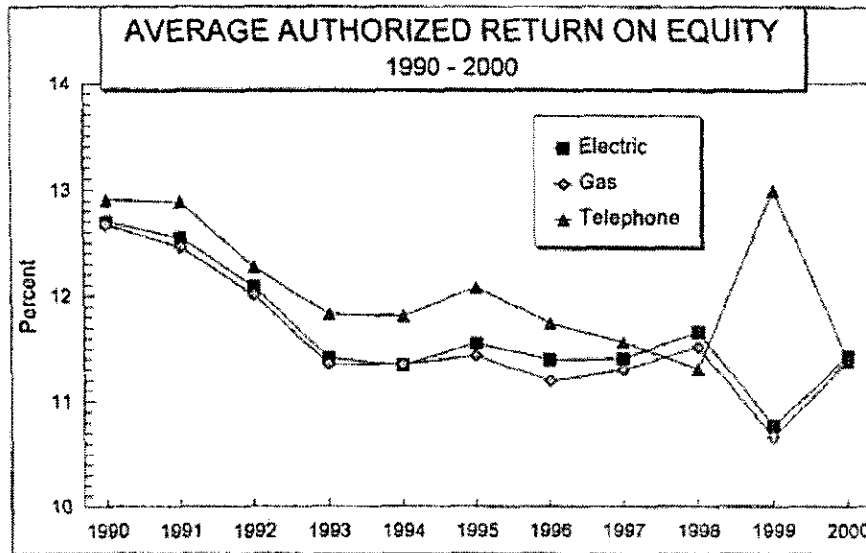
4 A. Yes, since my rebuttal testimony was written, we have received notification that  
5 Moody's has downgraded the senior secured debt of Empire from "A2" to "Baa1". In  
6 addition to the downgrade, the negative outlook was maintained due to the uncertainty  
7 surrounding the current rate case. This follows in the recent downgrade from Fitch  
8 from A+ to BBB+. A copy of these downgrades is attached. In addition, I have  
9 recently had several telephone calls from representatives of Moody's and Fitch  
10 regarding their concern that earnings will not support their ratings even after the  
11 downgrades. Moody's has recently questioned the rate for commercial paper and is  
12 also considering a downgrade in this area.

13 Q. WHAT WOULD BE THE RESULT OF FURTHER DOWNGRADES?

14 A. When Rating Agencies downgrade a company for whatever reason, the one who pays  
15 is ultimately the customer. This may be directly from a higher rate of capital or from  
16 the inability of Empire to provide the kind of service that our customers have come to  
17 know and deserve.

18 Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

19 A. Yes, it does.



Electric Utilities--Summary Table\*

	Period	ROR %	ROE %	Eq. as % Cap. Struc.	Amt. \$ Mil.
1990	Full Year	10.39 (42)	12.70 (44)	42.42 (40)	1,579.4 (48)
1991	Full Year	10.45 (44)	12.55 (45)	43.80 (44)	3,071.8 (53)
1992	Full Year	10.01 (46)	12.09 (48)	44.69 (44)	1,998.2 (51)
1993	Full Year	9.48 (30)	11.41 (32)	47.40 (30)	1,164.1 (42)
1994	Full Year	9.29 (30)	11.34 (31)	45.15 (30)	1,116.9 (40)
1995	Full Year	9.44 (30)	11.55 (33)	45.90 (30)	455.7 (43)
1996	Full Year	9.21 (20)	11.39 (22)	44.34 (20)	-5.8 (38)
1997	Full Year	9.16 (12)	11.40 (11)	48.79 (11)	-553.3 (33)
1998	Full Year	9.44 (9)	11.66 (10)	46.14 (8)	-429.3 (31)
1999	1st Quarter	8.55 (3)	10.58 (4)	43.18 (3)	-607.6 (5)
	2nd Quarter	9.10 (5)	10.94 (4)	48.48 (4)	-875.3 (10)
	3rd Quarter	8.57 (8)	10.63 (8)	43.99 (8)	-161.3 (8)
	4th Quarter	9.47 (2)	11.08 (4)	45.55 (2)	-39.8 (7)
1999	Full Year	8.81 (18)	10.77 (20)	45.08 (17)	-1,683.8 (30)
2000	1st Quarter	8.96 (5)	11.06 (5)	49.80 (5)	47.5 (10)
	2nd Quarter	9.07 (2)	11.11 (2)	48.40 (2)	-162.5 (8)
	3rd Quarter	9.17 (3)	11.68 (2)	47.73 (2)	-22.2 (12)
	4th Quarter	9.94 (2)	12.08 (3)	48.32 (3)	-169.2 (5)
2000	Full Year	9.20 (12)	11.43 (12)	48.85 (12)	-306.4 (36)

Gas Utilities--Summary Table\*

1990	Full Year	10.67 (30)	12.67 (31)	47.21 (29)	355.5 (41)
1991	Full Year	10.52 (35)	12.48 (35)	47.19 (33)	391.0 (43)
1992	Full Year	10.10 (29)	12.01 (29)	46.64 (27)	420.9 (34)
1993	Full Year	9.44 (41)	11.35 (45)	46.15 (41)	217.8 (49)
1994	Full Year	9.51 (32)	11.35 (28)	48.12 (27)	422.9 (42)
1995	Full Year	9.64 (16)	11.43 (16)	49.98 (15)	-61.5 (31)
1996	Full Year	9.25 (23)	11.19 (20)	47.69 (19)	193.4 (34)
1997	Full Year	9.13 (13)	11.29 (13)	47.78 (11)	-82.5 (21)
1998	Full Year	9.46 (10)	11.51 (10)	49.50 (10)	93.9 (20)
1999	1st Quarter	8.82 (3)	10.82 (3)	48.88 (3)	14.1 (3)
	2nd Quarter	8.98 (3)	10.82 (3)	48.63 (4)	9.4 (4)
	3rd Quarter	-- (0)	-- (0)	-- (0)	3.0 (1)
	4th Quarter	8.78 (3)	10.33 (3)	50.19 (2)	24.5 (6)
1999	Full Year	8.68 (9)	10.68 (8)	49.06 (9)	-51.0 (14)
2000	1st Quarter	9.87 (1)	10.71 (1)	53.95 (1)	103.9 (3)
	2nd Quarter	9.15 (4)	11.08 (4)	45.73 (4)	-27.6 (6)
	3rd Quarter	9.19 (5)	11.33 (5)	48.26 (5)	45.8 (5)
	4th Quarter	9.61 (3)	12.50 (2)	52.49 (2)	14.0 (6)
2000	Full Year	9.33 (13)	11.39 (12)	48.59 (12)	135.9 (20)

Telephone Utilities--Summary Table\*

1990	Full Year	10.30 (8)	12.91 (9)	53.60 (8)	42.4 (13)
1991	Full Year	10.85 (17)	12.69 (16)	55.87 (15)	17.8 (20)
1992	Full Year	10.04 (6)	12.27 (7)	51.39 (6)	-252.0 (13)
1993	Full Year	10.26 (12)	11.83 (12)	56.45 (12)	-198.1 (12)
1994	Full Year	9.91 (12)	11.81 (11)	57.46 (11)	-236.6 (16)
1995	Full Year	9.81 (8)	12.08 (8)	55.02 (7)	-264.0 (14)
1996	Full Year	9.65 (2)	11.74 (4)	56.00 (2)	-348.2 (11)
1997	Full Year	9.57 (5)	11.58 (5)	55.84 (5)	-154.4 (7)
1998	Full Year	9.37 (1)	11.30 (1)	52.00 (1)	-323.3 (13)
1999	1st Quarter	11.34 (1)	13.00 (1)	68.90 (1)	-347.7 (5)
	2nd Quarter	-- (0)	-- (0)	-- (0)	-9.2 (2)
	3rd Quarter	-- (0)	-- (0)	-- (0)	-119.1 (6)
	4th Quarter	-- (0)	-- (0)	-- (0)	-94.1 (6)
1999	Full Year	11.34 (1)	13.00 (1)	66.90 (1)	-570.1 (19)
2000	1st Quarter	9.39 (1)	11.50 (1)	54.00 (1)	-165.4 (8)
	2nd Quarter	-- (0)	-- (0)	-- (0)	-63.0 (1)
	3rd Quarter	9.64 (1)	11.25 (1)	59.18 (1)	-50.5 (2)
	4th Quarter	-- (0)	-- (0)	-- (0)	-111.5 (3)
2000	Full Year	9.52 (2)	11.38 (2)	56.59 (2)	-390.4 (14)

\* Number of observations each period indicated in parentheses.





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## Fitch Downgrades Empire District Electric Co. To 'BBB+'

26 Apr 2001 1:54 PM

Fitch-Chicago-April 26, 2001: Fitch has downgraded and removed from Rating Watch Negative the debt ratings of Empire District Electric Co. (EDE) as follows: senior secured debt downgraded from 'A+' to 'BBB+', preferred stock from 'A' to 'BBB-', and commercial paper from 'F1' to 'F2'. Approximately \$415 million of debt is affected. The downgrade reflects the significant erosion of the company's credit protection measures in the past two years and a regulatory environment in Missouri that exposes EDE to margin erosion from increased fuel costs. The Rating Outlook for the company is now Stable.

On March 8, the Missouri Public Service Commission denied EDE's application for an emergency tariff adjustment to recover higher natural gas costs. An order from the Missouri Commission is expected in October of this year responding to the company's November 2000 rate case filing. Fitch expects that EDE will continue to suffer erosion in its credit protection measures through the balance of 2001, depending upon natural gas prices and customer demand through the utility's peak season.

Due to high natural gas costs in 2000, increased interest expense relating to the construction of the State Line facility, and the lack of new common equity financing within the past two years, EDE's credit fundamentals are now more consistent with the 'BBB+' rating category. For year-end 2000, EDE's pretax interest coverage was 2.3 times (x) and the ratio of EBITDA to interest was 3.5x. The company's debt leverage, currently 59% of capital, is in line with 'BBB+' medians.

In November 2000, EDE filed an application with the Missouri Public Service Commission (MPSC) for a base tariff increase of nearly 20% (\$41.4 million). The requested tariff increase would recoup prospective gas acquisition costs and incorporate EDE's 60% share of the costs of a new 500 mw combined-cycle gas-fired power plant, the State Line unit, scheduled to enter commercial operation in June 2001. Recently, the staff of the Commission filed testimony regarding EDE's filing and recommended that the Commission increase electric rate base rates by \$15.5-\$18.2 million (7.2-8.5%). The staff's recommendation is \$23-26 million below the utility's request, relating to the following disallowances or adjustments: cost of capital (\$8-11 million); asset base (\$12 million); and other adjustments (\$2 million).

Owing to the January termination of EDE's merger agreement with Utilicorp United, EDE has been left without gas supply contracts or price hedging mechanisms to cover the majority of the natural gas fuel that will be used when the State Line unit begins operation. Under Missouri law, electric utilities in the state are not permitted to recover fuel or purchased power costs in any manner other than through their base tariffs, and there is no permissible mechanism for deferring and subsequently recovering variations in fuel or purchased power expense. For the coming summer, EDE's financial results and liquidity will be exposed to risk from two factors outside of the company's control: high summer electricity demand and natural gas prices.

EDE provides electric service to approximately 145,000 customers in parts of Missouri,

Fitch Corporate

Page 2 of 2

Kansas, Oklahoma, and Arkansas.

Contact: Karen Anderson 1-312-368-3165, Chicago or Ellen Lapson 1-212-908-0504, New York.

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**Global Credit Research**  
**Rating Action**  
 7 MAY 2001

**Rating Action: Empire District Electric Company (The)**

**MOODY'S DOWNGRADES EMPIRE DISTRICT ELECTRIC COMPANY, SR SECURED TO Baa1 OUTLOOK NEGATIVE**

New York, May 07, 2001 -- Moody's Investors Service has lowered the debt ratings of The Empire District Electric Company's (EDE) to reflect the company's deterioration in credit measures. In addition, to the company's heightened regulatory risk associated with its efforts to obtain necessary levels of rate increases from the Missouri Public Service Commission (MPSC) to recover the company's ongoing capital expenditures and increased operating expenses. The following debt ratings are lowered: senior secured to Baa1 from A2, senior unsecured to Baa2 from A3, junior subordinated to Baa3 from Baa1, preferred stock rating to "baa2" from "a3", and the commercial paper rating to Prime-2 from Prime-1. However, the uncertainty surrounding the final amount of rate relief the MPSC will authorize warrants a negative outlook.

EDE has increased its use of leverage to finance the construction of its State Line facility without issuing equity, which has contributed to a weaker credit profile. The company also faces rising operating expenses related to higher natural gas prices, and it will soon increase the volume of gas fuel used to fire its gas facilities as its State Line combined-cycle unit becomes operational this summer. The company's increased debt burden and higher operating expenses have resulted in a sustained weakening of the company cash flow coverage levels. Funds from operations (FFO) covered interest expense by 2.47 times for 2000, while earnings before interest and taxes (EBIT) interest coverage was 1.82 times. Although, Moody's expects coverage levels to improve over the intermediate term as the company receives some rate relief and its external financing needs will decline, the company's credit measures over the rating horizon are now more consistent with its Baa1 (senior secured) peer group.

On March 9, 2001, the Missouri Public Service Commission denied EDE's request for a \$16.8 million interim rate increase for the period from March 2001 through September 2001, to recover the expected higher natural gas fuel costs when the State Line Unit comes on line. The commission indicated EDE did not substantiate its claim that it was facing an "emergency" or "near emergency". EDE intends to pursue its \$41.5 million rate increase it filed November 3, 2000. However, on April 3, 2001, the staff of the MPSC recommended an increase to EDE's base rates between \$15.5-\$18.2 million, substantially below the company's request. The negative outlook encompasses the challenges the company will face if it does not obtain rate relief materially closer to the amount it requested in its rate case initiated on November 3, 2000.

The Empire District Electric Company is an investor owned utility headquartered in Joplin, Missouri.

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AFFIDAVIT

STATE OF MISSOURI     )  
                                      ) ss  
COUNTY OF JASPER     )

On the 16<sup>th</sup> day of May, 2001, before me appeared David W. Gibson, to me personally known, who, being by me first duly sworn, states that he is the Vice President - Finance 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.

  
\_\_\_\_\_  
David W. Gibson

Subscribed and sworn to before me this 16<sup>th</sup> day of May, 2001.

  
\_\_\_\_\_  
Patricia A. Settle, Notary Public

My Commission expires: August 16, 2002.

