Exhibit No.:
Issue: *Cost of Capital*
Witness: *Roberta A. McKiddy*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *True-Up Surrebuttal Testimony*
Case No.: *ER-2001-299*
Date Testimony Prepared: *August 17, 2001*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

TRUE-UP SURREBUTTAL TESTIMONY

OF

ROBERTA A. MCKIDDY

FILED
AUG 1 7 2001
Missouri Public Service Commission

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2001-299

Jefferson City, Missouri
August 2001

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THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2001-299

Q. Please state your name.

A. My name is Roberta A. McKiddy.

Q. Are you the same Roberta A. McKiddy who filed direct, rebuttal, surrebuttal and true-up direct 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 true-up surrebuttal testimony?

A. The purpose of this true-up testimony is to address comments made by Mr. David W. Gibson in his true-up rebuttal testimony regarding capital structure.

<u>Capital Structure</u>

Q. Do you agree with Mr. Gibson that The Empire District Electric Company's (EDE) actual capital structure at June 30, 2001 "does not represent a 'normal' capital structure for Empire?"

A. No, I do not. I do agree that EDE's capital structure at June 30, 2001 is not representative of historical capital structures employed by EDE prior to the announcement of its proposed merger with UtiliCorp. However, I do not believe EDE's capital structure is anomalous with the electric utility industry.

Q. Do you agree with Mr. Gibson's comments regarding your use of common equity ratio information obtained from C.A. Turner Reports?

A. No, I do not. Mr. Gibson has taken my use of the referenced C.A. Turner Reports information out of context. In my surrebuttal testimony, I simply stated, "Staff was recently made aware of information published by C.A. Turner Utility Reports, March 2001, which stated the average equity ratio for an electric utility (defined as having primarily electric operations) was approximately 38 percent." I make no further assertions regarding this information primarily because I refer to it only for the purpose of determining whether or not EDE's "actual" capital structure is anomalous to the electric utility industry.

Q. Do you believe EDE's capital structure is anomalous to the electric utility industry?

A. No, I do not. Although the capital structures reported for EDE at both December 31, 2000 and June 30, 2001 are different from its historical levels, Staff does not consider EDE's "actual" capital structure to be an unusual capital structure for an electric utility.

Q. Did Staff make any attempt to compare the returns on equity reported by C.A. Turner Utility Reports with the results of Staff's analysis?

A. No, Staff does not believe it is either necessary or appropriate to do so. It is the regulatory agency's duty to determine a fair rate of return and the appropriate revenue requirement for the utility, while maintaining reasonable prices for the public consumer. It is Staff's opinion that the determination of such fair rate of return should be based on company-specific data whenever possible. A company employs different forms of capital to support or fund the assets of the company. These funds are invested proportionately to support each dollar of the company's assets. Each different form of capital has a cost and these costs are weighted proportionately to fund each dollar invested in the assets. Assuming that the various forms of capital are within a reasonable balance and are costed correctly, the resulting total weighted cost of capital, when applied to rate base, will provide the funds necessary to service the various forms of capital. Thus, the total weighted cost of capital corresponds with a fair rate of return for the utility company. For Mr. Gibson to imply that companies with similar capital structures should be afforded similar costs of capital is simply wrong and inappropriate.

Q. Do you believe Staff employed a more appropriate capital structure for EDE than that proposed by Company witness Gibson in his true-up rebuttal testimony?

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. 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).]

Staff continues to believe it is more appropriate to use EDE's "actual" capital structure. The Office of Public Counsel also supports this contention. Therefore, Staff used EDE's "actual" capital structure at June 30, 2001 for purposes of its true-up analysis, which included EDE's February 2001 issuance 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 June 30, 2001 for EDE
Using EDE's Proposed Hypothetical Capital Structure

		Using ROE of		
Capital Component	% of Capital	8.50%	9.00%	9.50%
Common Equity	45.00%	3.83%	4.05%	4.28%
Preferred Stock	7.90%	.70%	0.70%	0.70%
Long-Term Debt	47.10%	3.71%	3.71%	3.71%
Total	100.00%	**8.24%**	**8.46%**	**8.69%**

Vs.

Weighted Cost of Capital as of June 30, 2001 for EDE
Using EDE's Actual Capital Structure

		Using ROE of		
Capital Component	% of Capital	8.50%	9.00%	9.50%
Common Equity	37.76%	3.21%	3.40%	3.59%
Preferred Stock	7.88%	0.70%	0.70%	0.70%
Long-Term Debt	54.36%	4.28%	4.28%	4.28%
Total	100.00%	8.19%	8.38%	8.57%

Conclusion

Q. Please summarize your position regarding the appropriate capital structure to be employed for purposes of determining an appropriate rate of return to be applied to EDE's rate base in setting rates in this proceeding.

A. Staff believes the appropriate capital structure to be used for setting rates should consist of 37.76 percent common equity, 7.88 percent trust preferred stock and 54.36 percent long-term debt.

Q. Please summarize the appropriate costs that should be employed for purposes of determining an appropriate rate of return to be applied to EDE's rate base in setting rates in this proceeding.

A. As stated in its true-up direct testimony, Staff believes the embedded cost of long-term debt should be 7.87 percent and the embedded cost of trust preferred stock should be 8.88 percent.

Q. Does this conclude your prepared true-up surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Application of The Empire District Electric Company for a General Rate Increase.	)))	Case No. ER-2001-299

AFFIDAVIT OF ROBERTA A. MCKIDDY

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Roberta A. McKiddy, being of lawful age, on her oath states: that she has participated in the preparation of the foregoing True-Up Surrebuttal Testimony in question and answer form, consisting of 6 pages to be presented in the above case; that the answers in the foregoing True-Up 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 16th day of August 2001.

Toni M Charlton

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004