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Missouri Public Service Commission

Exhibit No.:	
Issue:	*Regulatory Plan Amortizations*
Witness:	*Mark L. Oligschlaeger*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Supplemental Direct Testimony*
Case No.:	*ER-2006-0315*
Date Testimony Prepared:	*July 18, 2006*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SUPPLEMENTAL DIRECT TESTIMONY

OF

MARK L. OLIGSCHLAEGER

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2006-0315

Jefferson City, Missouri
July 2006

STAFF Exhibit No. 55
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 Direct Testimony in question and answer form, consisting of 12 pages to be presented in the above case; that the answers in the foregoing Direct 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 18th day of July 2006.

Toni 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 in this proceeding for the Staff?

A. Yes, I am.

Q. What is the purpose of your supplemental direct testimony?

A. The purpose of this testimony is to present the Staff's analyses of The Empire District Electric Company's (Empire or Company) need for rate relief as measured by certain financial ratios specified in the regulatory plan approved for the Company last year by the Commission.

EXECUTIVE SUMMARY

Q. Please briefly summarize your supplemental direct testimony.

A. The Staff has performed certain analyses in this rate proceeding in order to determine whether the regulatory plan "amortizations to maintain financial ratios", mechanism prescribed in the Case No. EO-2005-0263 Stipulation And Agreement approved by the Commission, would be triggered under either of the Interim Energy Charge (IEC) revenue requirement scenarios presented for Empire in this proceeding. These analyses are attached as Schedules 1 and 2 to this testimony, and show that regulatory plan amortizations are triggered under both of the revenue requirement scenarios presented by the Staff in this rate case.

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. The Iatan 2 rate case is now planned for 2010.

Q. Please describe the provisions in the Company's regulatory plan concerning possible "additional" amortizations to reflect in its rate proceedings.

A. The regulatory plan, as approved by the Commission, calls for special rate measures to be taken if Empire fails to meet the benchmarks set out in Appendix C "Financial Ratios" of the regulatory plan for any one of three standards set out by credit rating agencies as indicative of an investment grade rated company. These three standards are: 1) Adjusted Total Debt to Total Capitalization; 2) Adjusted Funds from Operations Interest Coverage; and 3) Adjusted Funds from Operations as a Percentage of Average Total Debt. The first ratio listed above will be monitored in Empire's applications for financing (and, in fact, was monitored in Empire's recent financing case, Case No. EF-2006-0263). However, the latter two ratios were to be examined in the context of general rate proceedings. If these two ratios are not met, the regulatory plan allows for incorporation of an "additional" amortization in the rate process under certain circumstances.

Q. Was it the Staff's expectation that regulatory plan amortizations might be applicable even before the construction of Iatan 2 commenced?

A. Yes. Although the Staff did not anticipate that Empire would file a rate increase case as early as it did, following Case No. EO-2006-0263, the Staff has viewed the regulatory plan amortizations as applying even before the construction of Iatan 2 literally commences. The Staff views the regulatory plan as a good faith effort to assist Empire in maintaining an investment grade credit rating commencing with the Commission's approval of the regulatory plan through the commercial operation date of Iatan 2 in 2010.

Q. What is the relevance of the amortization provisions in the Company's 2005 regulatory plan to this rate proceeding?

A. While Empire, the Staff and other parties have presented revenue requirement recommendations in this case based upon traditional cost-based ratemaking approaches, Empire's regulatory plan also requires calculation of an "alternative" revenue requirement, based upon Empire's financial ratios during this rate proceeding as well. If the regulatory plan amortization calculations produce an overall higher revenue requirement for Empire than traditional approaches do, the Stipulation And Agreement in Case No. EO-2005-0263 requires that the higher revenue requirement amount derived from the amortization calculations be adopted for Empire.

Q. Has the Staff performed analyses of whether Empire meets the benchmarks for the two credit ratings ratios under the revenue requirement scenarios presented by it to the Commission in this proceeding?

A. Yes. The Staff requested information from Empire to allow it to run calculations concerning the impact of the two revenue requirement scenarios outlined in this testimony on the Company's financial ratios set out in the regulatory plan approved in Case No. EO-2005-0263. Using that information, Schedule 1 and Schedule 2 of this testimony present the results of the Staff's regulatory plan amortization analysis for the IEC Termination and the IEC Continuation scenarios, respectively.

Q. What do these schedules show?

A. The calculated amortization amounts for each scenario are shown on line 87 of Schedule 1 and Schedule 2.

Schedule 1 shows that, under the Staff's traditional revenue requirement calculation for the IEC Termination scenario, Empire will not be able to maintain the required ratio of 19.5% Adjusted Funds from Operations as a Percentage of Total Debt, or the required ratio of 3.2 times Adjusted Funds from Operations Interest Coverage. Line 87 of Schedule 1 shows that an amortization amount of $9.275 million (before possible income tax impact) should be added to the Company's traditional revenue requirement under the IEC Termination scenario.

On Schedule 2, the Staff's calculations show that, under the IEC Continuation scenario, Empire will also fail to meet either of the same two financial indices set out in the regulatory plan discussed above. Line 87 of Schedule 2 shows that an amortization amount of $20.5 million (before possible income tax impact) should be added to the Company's traditional revenue requirement under the IEC Continuation scenario.

These schedules show that amortizations are required under the Staff's revenue requirement recommendations for either scenario to allow Empire the opportunity to maintain its current investment grade credit ratings as provided for in the regulatory plan approved by the Commission.

Q. What is another way of summarizing the results shown in Schedule 1 and Schedule 2?

A. The calculations show that, under either of the Staff's revenue requirement scenarios, Empire will not have sufficient funds from operations (cash flow) in order to meet the financial ratio benchmarks set out in the Company's regulatory plan approved by the Commission.

Q. How do the amortization amounts cited above relate to the Staff's revenue requirement recommendations in this case calculated in the traditional manner?

A. The calculated amortization amounts and the traditional revenue requirement recommendation amounts should be added together to determine the total amount of rate relief to be granted to Empire in this case under the approach called for in the Stipulation And Agreement in Case No. EO-2005-0263.

For example, the Staff's filed Preliminary Reconciliation dated July 7, 2006, indicates that, under the IEC Termination scenario, Empire should receive a rate increase of approximately \$2.1 million (after taking into account the reduction in IEC revenues of approximately \$8.7 million), when its revenue requirement is calculated in the traditional manner. The amortization amount for the IEC Termination scenario of approximately \$9.3 million from Schedule 1 should be added to the \$2.1 million traditional revenue requirement to derive a total rate increase for Empire in this case under this scenario of approximately \$11.4 million. Accordingly, \$11.4 million is the total increase required by

Empire in this rate proceeding in order to have an opportunity to maintain its current investment grade credit ratings under the IEC Termination scenario.

The same calculations apply to the IEC Continuation scenario. The Staff's traditional revenue requirement calculation of a negative $16 million under this scenario should be netted against the positive amortization amount of $20.5 million shown on Schedule 2 to derive a net revenue requirement of a positive $4.5 million for Empire in this case under the IEC Continuation scenario.

Q. Is there an agreed upon process and format for performing the amortization calculations in Case No. EO-2005-0263?

A. Yes. This process and format is set forth in Appendix D "Process Illustration–Adjustment of Amortization Amount" to the Stipulation And Agreement in Case No. EO-2005-0263.

Q. Has the Staff followed the prescribed process and format set out in Appendix D to the Stipulation And Agreement in Case No. EO-2005-0263?

A. Yes, with two modifications. The Company, in its response to Staff Data Request No. 301, indicated it had made two changes to the calculation set forth in the 2005 regulatory plan docket in its amortization calculations performed for purposes of its internal analysis of the impacts of this rate proceeding. First, the Company incorporated the impact of its requested rate relief in its revenues and income tax amounts used in the calculations. Second, Empire incorporated its balance of trust preferred stock (TOPRs) as part of its debt balance, and TOPRs dividends as part of its interest payments, in these calculations.

Q. Does the Staff agree with Empire's first proposed modification, concerning rate relief?

A. Yes. The intended purpose of the regulatory plan amortization provisions is to determine whether rate relief determined under traditional methods needs to be supplemented in order to allow Empire to remain rated at investment grade levels as considered and provided for in the regulatory plan. This can best be determined by incorporating the proposed results of the traditional ratemaking approaches into the amortization calculations. This has been done by adding the amount of the Staff's recommended rate relief under both scenarios to line 16, Electric Sales Revenues, of Schedule 1 and Schedule 2, respectively; and adding the amount of grossed-up income taxes associated with the Staff's recommended rate relief under both scenarios to line 26, Federal and State Income Taxes, of Schedule 1 and Schedule 2, respectively.

Q. Does the Staff agree with Empire's second proposed modification, concerning treatment of TOPRs?

A. Yes. The Staff understands that credit rating agencies treat TOPRs as debt equivalents, and TOPRs dividends as interest equivalents, for financial ratio analysis purposes. It is appropriate to analyze Empire's current TOPRs financing in the same fashion for purposes of performing the amortization calculations. The Staff has done this by including TOPRs dividends in line 14, Interest Expense, in Schedule 1 and Schedule 2; and by including the amount of net TOPRs financing in lines 65 and 66, Adjusted Total Debt 3/31/06 and Adjusted Total Debt 3/31/05, respectively, in Schedule 1 and Schedule 2.

Q. Please generally describe the sources of the information you are using in the amortization calculations that appear on Schedules 1 and 2.

A. The capital structure and debt cost information in these schedules is taken from the Staff's rate of return/capital structure recommendations in this proceeding, found in Schedules 9 and 20 to the direct testimony of Staff witness David Murray of the Financial Analysis Department.

The revenues, expenses and funds from operations information used in the amortization calculations was taken from the Staff's accounting schedules for the IEC Termination and Continuation Scenarios, and is consistent with the revenue requirement information reflected in the "Preliminary Reconciliation" filed July 7, 2006, by the Staff. As previously mentioned, the Staff's current rate relief recommendations under each scenario have been reflected in the amounts for revenues and income taxes from the Staff's accounting schedules for purposes of performing the amortization calculations.

The remaining information on Schedule 1 and 2, including amounts for the Company's cash interest payments, has either been obtained from its accounting system, its filed reports with the Securities and Exchange Commission, or directly from the Company through data request responses and informal information requests. An exception to this relates to off-balance sheet obligations, for which the Staff has relied upon certain information from a Standard & Poors' (S&P) document in order to value this item. This approach will be discussed in more detail later in this testimony.

Q. Please describe the Company's Elk River Windfarm transaction, and its relevance to the amortization calculations presented in Schedule 1 and Schedule 2.

A. In late 2005, Empire entered into an operating lease agreement to obtain wind energy from the Elk River Windfarm located in Kansas over a 20-year period. Operating leases, like purchased power agreements (PPAs), are considered to be "off-balance sheet" obligations by credit rating agencies. Off-balance sheet obligations are items that are considered fixed obligations by credit rating agencies and, therefore, are either wholly or partially treated as debt for purposes of calculating leverage and coverage ratios, even though the costs of the item are treated as expenses, and not as debt re-payment, on the financial statements of the utility that has entered into the obligations. Therefore, credit rating agencies include off-balance sheet items in their analysis of a utility's debt levels, which is why these items are also being considered as part of the regulatory plan amortization analysis.

Q. Besides the Elk River Windfarm, does Empire currently enter into other off-balance sheet transactions?

A. Yes. Empire's current contract for purchased power from the Jeffrey Energy Center station (majority owned by Westar, Inc.), and its operating lease for unit train facilities, are both considered to be off-balance sheet obligations by credit rating agencies.

Q. Has Empire valued the amount of its off-balance sheet obligations that should be treated as debt for purposes of the benchmark ratios?

A. Yes. The Company provided to the Staff an analysis of the estimated total debt valuation for the Elk River Windfarm operating lease agreement, as well as its other and less material off-balance sheet items.

Q. Does the Staff concur with these estimates concerning Empire's off-balance sheet obligations?

A. No, not without further investigation. Available documentation from S&P indicates that there is an apparent discrepancy between Empire's estimates of the debt equivalent valuation of its off-balance sheet obligations, and S&P's assumptions concerning these amounts. In S&P's Research Report dated May 18, 2006, it is stated:

> When conducting its credit analysis of Empire, Standard & Poor's makes various adjustments to the company's reported financial figures. We consider off-balance-sheet (OBS) obligations - including operating leases and PPAs such as the Elk River Windfarm Contract – fixed commitments, and impute debt and interest components when calculating credit measures. As of 2006, after these OBS obligations are accounted for, Empire's total debt and interest expense increase by about $72 million and $7 million, respectively.
> (Schedule 3-3)

The Staff's interpretation of this statement is that S&P currently values Empire's off-balance sheet obligations as being equivalent in total to approximately $72 million of debt.

The S&P research document has been attached to this testimony as Schedule 3.

Q. How has the Staff valued Empire's off-balance sheet obligations for purposes of its regulatory plan amortization analysis?

A. To be conservative, at this time the Staff is using the S&P estimates of the total debt equivalent value for Empire's off-balance sheet items in Schedule 1 and Schedule 2. The Staff is seeking additional information from Empire on this matter in order to determine whether the values for off-balance sheet obligations used in these schedules are accurate and representative.

Q. Please describe line 89 of Schedules 1 and 2.

A. This line presents the possible income tax consequences of the amortization amounts calculated on line 87 of the schedules.

Q. Does presentation of income tax amounts associated with the amortization calculations on these schedules mean that the Staff recommends that any amortization amounts granted to Empire by the Commission be grossed up for associated income taxes?

A. No. The Staff is not aware of any definitive evidence that regulatory plan amortizations will be treated as taxable income by federal and state taxing authorities. In the event that such amortizations are deemed to be taxable, the Staff believes it is probable that a utility's receipt of deferred tax benefits related to its ongoing plant additions will, in effect, compensate for any incremental tax liability associated with amortization amounts included in rates for Empire or other utilities covered by regulatory plans of a similar nature.

Q. If recovery of income taxes associated with amortizations is allowed in rates, will this have a significant impact on Empire's ratepayers?

A. Yes. At currently effective tax rates, such treatment would mean that customers would have to provide Empire an additional $0.62 in rates for every dollar Empire needs to meet the financial ratio indicators included in the regulatory plan.

Q. What is the Staff's position on including a gross-up for income taxes in the amount of regulatory plan amortizations allowed in rates?

A. The Staff opposes including a gross-up of income taxes as part of the amortization amount to be included in rates, absent a showing that such amortizations will be considered taxable by federal and state taxing authorities. If that showing can be made, the Staff would still oppose inclusion of income tax effects in the amortization amounts granted in rates unless the utility can demonstrate that it will not derive sufficient benefits in deferred taxes from its ongoing plant in service additions to offset any additional tax liability associated with the regulatory plan amortizations.

Q. Should the Staff's calculated amortization amounts shown on Schedule 1 and Schedule 2 be considered the final recommendations from the Staff in these matters?

A. No. As earlier indicated, the Staff still has unresolved questions concerning the off-balance sheet obligations and imputed debt valuations currently reflected in these schedules. Second, the calculated values of the regulatory plan amortizations will change as the Staff's recommended traditional revenue requirement amounts change, related to settlement of issues or other reasons. For this reason, the Staff intends to update its amortization analyses on an ongoing basis for the remainder of this proceeding. The Staff wanted to provide the information contained in this testimony as soon as was reasonably possible to the Commission and the parties.

Q. Does this conclude your supplemental direct testimony?

A. Yes, it does.

Line	Item	Source	Total Company	Juris Alloc
1	Calculation of Amortization to meet Financial Ratio Targets			
2	IEC Termination Scenario			
3			Total	Juris
4			Company	Alloc
5				
6	Rate Base	Staff Acct. Schedule 2 *		618,311,229
7	Jurisdictional Allocation for Capital			0.82
8				
9	Total Capital	Murray Schedule 9	772,078,472	633,104,347
10	Equity	Murray Schedule 9	384,040,776	314,913,436
11	Trust Preferred	Murray Schedule 9	48,434,238	39,716,075
12	Long-term Debt	Murray Schedule 9	339,603,458	278,474,836
13	Cost of Debt	Murray Schedule 20	7.02%	7.02%
14	Interest Expense	L12 * L13 (+$4,250,000 (TOPRs))	28,090,163	23,033,933
15				
16	Electric Sales Revenue	Staff Acct. Schedule 9, L.1-3, + Rate Increase		308,036,247
17	Other Electric Operating Revenue	Staff Acct. Schedule 9, L.4-5		4,250,093
18	Water Revenue			
19	Operating Revenue	L16 + L17		312,286,340
20				
21	Operating and Maintenance Expense	Staff Acct. Schedule 9, L.94 (less cust. deposits)		199,821,131
22	Depreciation	Staff Acct. Schedule 9, L.95 + L99		32,373,757
23	Amortization			
24	Interest on Customer Deposits	Staff Acct. Schedule 10, Adj. S-70.3		529,813
25	Taxes Other than Income Taxes	Staff Acct. Schedule 9, L.100		10,883,580
26	Federal and State Income Taxes	Staff Acct. Schedule 9, L.111 (plus rate incr. impact)		17,358,207
27	Gains on Disposition of Plant			
28	Total Water Operating Expenses			
29	Total Electric/Water Operating Exp	Sum of L. 21-28		260,966,488
30				
31	Operating Income - Electric	L19 - L29		51,319,852
32	Operating Income - Water			
33	less: Interest Expense	L14		-23,033,933
34	Depreciation	L22		32,373,757
35	Amortization			
36	Deferred Taxes	Staff Acct. Schedule 9, L110		2,323,761
37	Funds from Operations (FFO)	Sum of L31-36		62,983,437
38				
39				
40				
41				
42				
43	Additional Financial Information Needed for Calculation of Ratios			
44	Capitalized Lease Obligations	EDE Accounts 227 + 243	443,765	363,887
45	Short-term Debt Balance	EDE Form 10-Q, p. 6	46,000,000	37,720,000
46	Short-term Debt Interest	EDE Accounts 417.891 + 431.400	625,992	513,313
47	Cash Interest Paid	Information Supplied by EDE	24,275,961	19,906,288
48	AFUDC Debt (capitalized interest)	EDE Form 10-Q, p. 4	606,000	496,920
49				
50	Adjustments Made by Rating Agencies for Off-Balance Sheet Obligations			
51	Debt Adj for Off-Balance Sheet Obligs			
52	Operating Lease Debt Equivalent	Information Supplied by EDE/S&P	48,323,160	39,624,991
53	Purchase Power Debt Equivalent	Information Supplied by EDE	23,676,840	19,415,009
54	Total OSB Debt Adjustment	L52 + l53	72,000,000	59,040,000
55				
56	Operating Lease Deprec Adjustment	Information Supplied by EDE/S&P	1,517,000	1,243,940
57				
58	Interest Adjustments for Off-Balance Sheet Obligations			
59	Present Value of Operating Leases	L52 * 10%	4,832,316	3,962,499
60	Purchase Power Debt Equivalent	L53 * 10%	2,367,684	1,941,501
61	Total OSB Interest Adjustment	L59 + L60	7,200,000	5,904,000

62				
63	Ratio Calculations			
64	Adjusted Interest Expense	L14 + L46 + L61	35,916,155	29,451,247
65	Adjusted Total Debt 3/31/06	L11 + L12 + L44 + L45 +L54	506,481,461	415,314,798
66	Adjusted Total Debt 3/31/05	Same as L65, but for prior year	412,861,000	338,546,020
67	Adjusted Total Capital	L9 + L44 + L45 + L54	890,522,237	730,228,234
68				
69	Adj. FFO Interest Coverage	(L37 + L47 + L48 + L61)/(L14 + L48 + L61)		3.03
70	Adj. FFO as a % of Average Total Debt	(L37 + L56)/(avg. of L65 + L66)		0.1704
71	Adj. Total Debt to Total Capital	L65/L67		0.5687
72				
73	Changes Required to Meet Ratio Targets			
74	Adj. FFO Interest Coverage Target			3.20
75	FFO Adjustment to Meet Target	(L74 - L69) * L64		4,903,616
76	Interest Adjustment to Meet Target	L37 * (1/L74 - 1) - 1/L69 - 1)		-2,344,078
77				
78	Adj. FFO as a % of Average Total Debt			0.195
79	FFO Adjustment to Meet Target	(L78 - L70) * (Avg of L65 + L66)		9,274,053
80	Debt Adjustment to Meet Target	L37 * (1/L78 - 1/L70)		-46,638,131
81				
82	Adj. Total Debt to Total Capital Target			56.50%
83	Debt Adjustment to Meet Target	(L82 - L71) * L67		-2,735,846
84	Total Capital Adjustment to Meet Target	L65/L82 - L67		4,842,205
85				
86	Amortization and Revenue Needed to Meet Targeted Ratios			
87	FFO Adj Needed to Meet Target Ratios	Maximum of L75, L79 or zero		9,274,053
88	Effective Income Tax Rate			0.3839
89	Income Tax Effect	L87 * L88/(1 - L88)		-5,778,784
90	Total Amortization Req for FFO Adj	L87 - L89		15,052,838
91				
92	* All references to Staff Acct. Schedules tie to schedules supporting amounts reflected in the			
93	Preliminary Reconciliation filed 7/7/06			

Line	Item	Source	Total Company	Juris Alloc
1	Calculation of Amortization to meet Financial Ratio Targets			
2	IEC Continuation Scenario			
6	Rate Base	Staff Acct. Schedule 2*		617,577,674
7	Jurisdictional Allocation for Capital			0.82
9	Total Capital	Murray Schedule 9	772,078,472	633,104,347
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17	Other Electric Operating Revenue	Staff Acct. Schedule 9, L.4-5		4,250,093
18	Water Revenue			
19	Operating Revenue	L16 + L17		294,063,596
21	Operating and Maintenance Expense	Staff Acct. Schedule 9, L.94 (less cust. deposits)		199,821,131
22	Depreciation	Staff Acct. Schedule 9, L.95 + L99		32,373,757
23	Amortization			
24	Interest on Customer Deposits	Staff Acct. Schedule 10, Adj. S-70.3		529,813
25	Taxes Other than Income Taxes	Staff Acct. Schedule 9, L.100		10,883,580
26	Federal and State Income Taxes	Staff Acct. Schedule 9, L.111 (plus IEC revenues		10,362,867
27	Gains on Disposition of Plant	and rate decr. impact)		
28	Total Water Operating Expenses			
29	Total Electric/Water Operating Exp	Sum of L. 21-28		253,971,148
31	Operating Income - Electric	L19 - L29		40,092,448
32	Operating Income - Water			
33	less: Interest Expense	L14		-23,033,933
34	Depreciation	L22		32,373,757
35	Amortization			
36	Deferred Taxes	Staff Acct. Schedule 9, L110		2,323,761
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51	Debt Adj for Off-Balance Sheet Obligs			
52	Operating Lease Debt Equivalent	Information Supplied by EDE/S&P	48,323,160	39,624,991
53	Purchase Power Debt Equivalent	Information Supplied by EDE	23,676,840	19,415,009
54	Total OSB Debt Adjustment	L52 + l53	72,000,000	59,040,000
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71	Adj. Total Debt to Total Capital	L65/L67		0.5687
72				
73	Changes Required to Meet Ratio Targets			
74	Adj. FFO Interest Coverage Target			3.20
75	FFO Adjustment to Meet Target	(L74 - L69) * L64		16,137,273
76	Interest Adjustment to Meet Target	L37 * (1/L74 - 1) - 1/L69 - 1)		-7,802,554
77				
78	Adj. FFO as a % of Average Total Debt			0.195
79	FFO Adjustment to Meet Target	(L78 - L70) * (Avg of L65 + L66)		20,501,457
80	Debt Adjustment to Meet Target	L37 * (1/L78 - 1/L70)		-102,668,083
81				
82	Adj. Total Debt to Total Capital Target			56.50%
83	Debt Adjustment to Meet Target	(L82 - L71) * L67		-2,735,846
84	Total Capital Adjustment to Meet Target	L65/L82 - L67		4,842,205
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86	Amortization and Revenue Needed to Meet Targeted Ratios			
87	FFO Adj Needed to Meet Target Ratios	Maximum of L75, L79 or zero		20,501,457
88	Effective Income Tax Rate			0.3839
89	Income Tax Effect	L87 * L88/(1 - L88)		-12,774,727
90	Total Amortization Req for FFO Adj	L87 - L89		33,276,184
91				
92	* All references to Staff Accounting Schedules tie to schedules supporting amounts reflected in the			
93	Preliminary Reconciliation filed 7/7/06.			

STANDARD & POOR'S RATINGSDIRECT

RESEARCH

Empire District Electric Co.

Publication date: 18-May-2006
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Corporate Credit Rating	BBB-/Stable/A-3

Business risk profile

1 2 3 4 5 $\boxed{6}$ 7 8 9 10

Financial risk profile:
Aggressive

Debt maturities:
2006 None
2007 None
2008 None
2009 $20 mil.
2010 $50 mil.

Outstanding Rating(s)	
Empire District Electric Co.	
Sr unsecd debt	
Local currency	BB+
Sr secd debt	
Local currency	BBB+
CP	
Local currency	A-3
Pfd stk	
Local currency	BB

Corporate Credit Rating History	
July 2, 2002	BBB/A-2
Feb. 21, 2006	BBB/A-3
May 17, 2006	BBB-/A-3

Major Rating Factors

Weaknesses:
- Capital spending through 2010 well above historical levels,
- No permanent fuel adjustment clause, and
- Weak cash flow financial measures.

Strengths:
- Healthy service area,
- Steady utility cash flows, and
- Minimal nonregulated operations.

Schedule 3-1

Rationale

Standard & Poor's Ratings Services' ratings on integrated electric utility Empire District Electric Co. reflect the utility's steady cash flow and restrictive regulatory environment, combined with constrained financial measures over the next several years due to fuel and power costs that continue to exceed the level recoverable in rates, and due to Empire's higher-than-historical level of capital spending, including the acquisition of a Missouri gas utility.

Joplin, Mo.-based Empire had $456 million in debt and trust-preferred securities as of March 31, 2006.

Empire's satisfactory business risk profile benefits from a service territory with limited industrial concentration, and consists mostly of residential and small commercial customers. In addition, Empire has few competitive operations, and has been willing to sell these unregulated businesses due to financial underperformance. These attributes, however, have historically been moderated by less-than-adequate recovery of O&M expenses and other costs. This will continue to weaken Empire's financial measures during the heavy capital spending phase, which includes the Iatan 2 and Plum Point coal units. Empire's business risk profile is a '6' (satisfactory). (Utility business risk profiles are categorized from '1' (excellent) to '10' (vulnerable).)

To strengthen Empire's cash flow during its planned capital spending for generation and environmental compliance, constructive rate relief will be essential and should include recovery of fuel and purchased power on a timely basis. Historically, Missouri regulation has been restrictive regarding fuel and purchased-power costs because a permanent energy cost recovery (ECR) rider was not statutorily authorized. Under a new Missouri law, utilities operating in the state can seek Missouri Public Service Commission approval of an ECR rider that, if authorized, would provide for the pass-through of rising fuel and power costs. Timely recovery of such expenses, particularly when commodity prices rise rapidly, is important for Empire's credit quality because the company relies on a relatively high level of natural-gas-fired generation and power purchases for its supply. Although Empire filed for a $30 million electric base rate increase in Missouri that, if authorized, would strengthen creditworthiness, the inability to implement an ECR in the near term weakens credit quality, particularly since fuel and power costs currently exceed the level recoverable through base rates and the company's interim energy charge.

Empire's adjusted financial ratios are mixed for the 'BBB-' rating, with funds from operations (FFO) interest coverage of about 3.9x, FFO to total debt of about 17%, and total debt to total capital of approximately 56%. When calculating these ratios, Standard & Poor's considers Empire's trust-preferred securities as having minimal equity content, and adjusts ratios for operating leases and purchase-power agreements. Moreover, FFO less dividends, or net cash flow, relative to capital expenditures is expected to decline to about 50%, so Empire will need to seek external financing to fund its large capital needs.

Short-term credit factors

Empire's short-term rating is 'A-3'. As of March 31, 2006, Empire had $3.4 million of cash and a $226 million unsecured revolving credit facility available for working capital and as backup for its CP. The facility was recently increased from $150 million, with the incremental $76 million allocated to support an LOC issued in connection with the company's participation in the Plum Point coal unit. As of March 31, 2006, Empire had $46 million drawn on its revolver and no CP outstanding. Empire currently maintains sufficient liquidity to post additional collateral under a stressed scenario in which the company would experience a materially negative credit event and a simultaneous adverse energy price movement. Empire's next long-term debt maturity is $20 million in 2009.

Outlook

The outlook is stable and incorporates the expectation of steady financial performance through its construction program and successful integration of the gas utility. In addition, we expect that Empire will finance its capital needs in a manner that is consistent with the current rating. The outlook could be revised to negative as a result of unfavorable regulatory actions or if the financial measures weaken from increased capital spending or higher-than-expected use of leverage over the next several years. The outlook could be revised to positive if rate recovery is supportive during the construction program, if a reasonable energy cost recovery mechanism is adopted, and if financial measures begin to show sustainable improvement.

Accounting

When conducting its credit analysis of Empire, Standard & Poor's makes various adjustments to the company's reported financial figures. We consider off-balance-sheet (OBS) obligations--including operating leases and PPAs such as the Elk River Windfarm contract--fixed commitments, and impute debt and interest components when calculating credit measures. As of 2006, after these OBS obligations are accounted for, Empire's total debt and interest expense increase by about $72 million and $7 million, respectively.

Empire benefits from the implementation of regulatory accounting, SFAS 71 (accounting for the effects of certain types of regulation), which requires it to defer for future recovery or refund certain costs and obligations that would otherwise be immediately recognized as revenue and expenses. As of year-end 2005, the company's regulatory assets were about $55 million and regulatory liabilities about $33 million, of which $21 million was cost of plant removal.

The company has unfunded pension obligations relative to total adjusted debt below 3%, which is comparable with the industry average. At about 89%, Empire's aggregate pension funding ratio, which Standard & Poor's defines as the fair value of the plan assets ($109 million relative to the plan's projected benefit obligation of $123 million), is about the same as the average ratio for integrated utilities. Standard & Poor's has historically concluded that unfunded obligations are not an acute credit factor, because these costs have been recoverable in rates. Regardless of rate recovery, the company's liquidity could be restricted if cash contributions are made before ultimately being recovered through rates.

Table 1

Empire District Electric Co. Peer Comparison

	--Average of past three fiscal years--			
	Empire District Electric Co.	**PNM Resources Inc.**	**El Paso Electric Co.**	**Westar Energy Inc.**
Rating	BBB-/Stable/A-3	BBB/Negative/A-3	BBB/Stable/--	BB+/Positive/--
(Mil. $)				
Sales	345.7	1,712.4	725.6	1,503.0
Net income from cont. oper.	25.0	71.5	30.1	132.6
Funds from oper. (FFO)	78.4	293.3	152.4	325.4
Capital expenditures	60.3	180.0	94.5	181.9
Cash and equivalents	13.9	32.7	23.9	51.7
Total debt	425.3	1,424.8	619.1	1,876.3
Preferred stock	0.0	12.0	0.0	21.4
Common equity	383.8	1,154.5	528.1	1,273.1
Total capital	810.1	2,591.2	1,147.2	3,170.8
Ratios				
Adj. EBIT interest coverage (x)	2.1	2.3	2.1	1.9
Adj. FFO interest coverage (x)	3.4	4.2	4.3	2.6
Adj. FFO/avg. total debt (%)	16.2	19.4	24.4	13.1
Net cash flow/capital expenditures (%)	41.3	135.9	161.8	133.5
Adj. total debt/capital (%)	57.3	59.9	54.1	64.1
Return on common equity (%)	6.6	6.2	4.9	10.8
Common dividend payout (%)	126.5	59.1	0.0	47.0

Table 2

Empire District Electric Co. Financial Summary

	--Fiscal year ended Dec. 31--				
	2005	**2004**	**2003**	**2002**	**2001**

Schedule 3-1

Rating history	BBB/Watch Neg/A-2	BBB/Watch Neg/A-2	BBB/Stable/A-2	BBB/Stable/A-2	A-/Negative/A-2
(Mil. $)					
Sales	386.2	325.5	325.5	305.9	264.3
Net income from cont. oper.	23.8	21.8	29.5	25.5	13.9
Funds from oper. (FFO)	87.9	74.3	83.5	64.0	43.8
Capital expenditures	73.6	41.8	65.6	76.3	75.8
Total debt	441.3	410.6	424.0	433.7	451.6
Preferred stock	0.0	0.0	0.0	0.0	0.0
Common equity	393.4	379.2	378.8	329.3	268.3
Total capital	835.8	790.5	804.0	763.9	719.9
Ratios					
Adj. EBIT interest coverage (x)	2.4	2.1	2.4	2.1	1.4
Adj. FFO interest coverage (x)	3.9	3.4	3.4	3.0	2.5
Adj. FFO/total debt (%)	18.0	15.5	17.0	12.6	8.7
Adj. net cash flow/capital expenditures (%)	72.4	95.4	81.5	47.3	23.3
Adj. total debt/capital (%)	56.2	57.5	57.7	63.0	66.5
Return on common equity (%)	6.0	5.7	8.2	8.4	2.7
Common dividend payout (%)	139.5	149.3	99.0	109.3	217.4

Schedule 3-1