

# EXHIBIT

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Case No.:

Rate of Return  
Burdette/Direct  
Public Counsel  
ER-2001-299

## DIRECT TESTIMONY

OF

MARK BURDETTE

Submitted on Behalf of  
the Office of the Public Counsel

THE EMPIRE DISTRICT ELECTRIC COMPANY

Case No. ER-2001-299

April 3, 2001

Exhibit No. 86  
Date 5/29/01 Case No. ER-2001-299  
Reporter KRM

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

In The Matter Of The The Empire District Electric )	
Company's Tariff Sheets Designed to Implement )	Case No. ER-2001-299
a General Rate Increase for retail Electric )	<u>Tariff No. 200100518</u>
Service Provided to Customers in the Missouri )	
Service Area of the Company. )	

**AFFIDAVIT OF MARK BURDETTE**

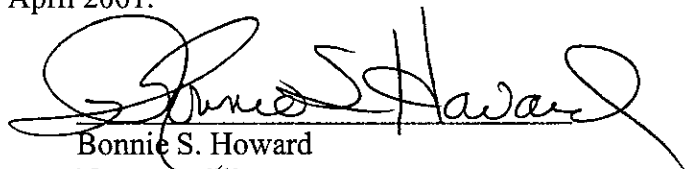
STATE OF MISSOURI    )  
                                  ) ss  
COUNTY OF COLE    )

Mark Burdette, of lawful age and being first duly sworn, deposes and states:

1. My name is Mark Burdette. I am a Financial Analyst for the Office of the Public Counsel.
2. Attached hereto and made a part hereof for all purposes is my direct testimony consisting of pages 1 through 10 and Schedules MB1 through MB10.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

  
\_\_\_\_\_  
Mark Burdette

Subscribed and sworn to me this 3<sup>rd</sup> day of April 2001.

  
\_\_\_\_\_  
Bonnie S. Howard  
Notary Public

My commission expires May 3, 2001.

**DIRECT TESTIMONY  
OF  
MARK BURDETTE**

**EMPIRE DISTRICT ELECTRIC COMPANY  
CASE NO. ER-2001-299**

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**EMPIRE DISTRICT ELECTRIC COMPANY**  
**CASE NO. ER-2001-299**

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by the Office of the Public Counsel of the State of Missouri (OPC or Public Counsel) as a Public Utility Financial Analyst. Also, I am an adjunct faculty member with Columbia College. I teach undergraduate Business Finance and graduate-level Managerial Finance.

A. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

Q. I earned a Bachelor of Science in Electrical Engineering from the University of Iowa in May 1988. I earned a Master's in Business Administration with double emphases in Finance and Investments from the University of Iowa Graduate School of Management in December 1994.

O. PLEASE DESCRIBE YOUR CONTINUING EDUCATION.

A. I have attended various regulatory seminars presented by the Financial Research Institute, University of Missouri-Columbia and the National Association of State Utility Consumer

1 Advocates. Also, I attended The Basics of Regulation: Practical Skills for a Changing  
2 Environment presented by the Center for Public Utilities, New Mexico State University.

3 Q. DO YOU HAVE ANY PROFESSIONAL AFFILIATIONS?

4 A. Yes. I am a member of the Society of Utility and Regulatory Financial Analysts (SURFA).

5 Q. DO YOU HOLD ANY PROFESSIONAL DESIGNATIONS?

6 A. Yes. I have been awarded the professional designation Certified Rate of Return Analyst  
7 (CRRRA) by the Society of Utility and Regulatory Financial Analysts. This designation is  
8 awarded based upon work experience and successful completion of a written examination.

9 Q. HAVE YOU PREVIOUSLY FILED TESTIMONY BEFORE THE MISSOURI PUBLIC  
10 SERVICE COMMISSION (MPSC OR THE COMMISSION)?

11 A. Yes.

12 Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

13 A. I will present a cost-of-capital analysis for the Empire District Electric Company (EDE,  
14 Empire, the Company). I will recommend and testify to the capital structure, embedded  
15 cost of long-term debt, fair return on common equity, and weighted average cost of capital  
16 that should be allowed in this proceeding.

17 Q. HAVE YOU PREPARED SCHEDULES IN SUPPORT OF YOUR TESTIMONY?

18 A. Yes. I have prepared an analysis consisting of ten schedules that is attached to this  
19 testimony (MB-1 through MB-10). This analysis was prepared by me and is correct to the  
20 best of my knowledge and belief.

ANALYSIS

Q. IS EMPIRE DISTRICT ELECTRIC COMPANY AN INDEPENDENT, PUBLICLY TRADED COMPANY?

A. Yes. Empire District Electric Company is a public utility with common stock and long term debt issued in its name. The common stock of Empire trades on the New York Stock Exchange under the ticker symbol EDE. Schedule MB-1 shows historical financial information for Empire.

Q. HOW DOES THE MERGER ACTIVITY IN THE ELECTRIC INDUSTRY AFFECT YOUR FINANCIAL ANALYSIS?

A. A major impact of this activity is a reduction in the number of companies to draw from for a comparable group, especially relatively small companies, because they have been merged into larger companies.

Even rumors of a merger can greatly effect a company's stock price, possibly tainting the company's financial information in terms of market-based analysis tools such as the discounted cash flow model. Therefore, I excluded companies that are involved in merger proceedings from my comparable group.

Q. HOW DID YOU CALCULATE A FAIR RETURN ON COMMON EQUITY FOR EMPIRE?

A. I utilized the standard Discounted Cash Flow (DCF) methodology and the Capital Asset Pricing Model (CAPM) applied directly to Empire's common stock and market-based information. Also, I applied the same analysis to the stocks of a comparable group of publicly traded electric utilities to gain insight as to the appropriate return on common equity for Empire.

**SUMMARY OF FINDINGS**

Q. PLEASE SUMMARIZE YOUR FINDINGS CONCERNING THE OVERALL COST OF CAPITAL FOR THE EMPIRE DISTRICT ELECTRIC COMPANY.

A. Empire should be allowed an overall return of between 8.78% and 8.88% on its net original cost rate base. This return has been determined using Empire's capital structure at 31 December 2000, a 7.895% embedded cost of long-term debt, and a return on common equity of between 10.0% and 10.25%. The capital structure and weighted average cost of capital are shown on Schedule MB-10.

**CAPITAL STRUCTURE**

Q. HOW IS EMPIRE CURRENTLY CAPITALIZED?

A. At 31 December 2000 (the test year in this case), Empire's capital structure consisted of 41.86% common equity and 58.14% long-term debt. This capital structure was utilized for my calculation of overall rate of return (ROR) and is shown on Schedule MB-2.

Q. PLEASE SHOW THE CAPITAL STRUCTURE THAT YOU RECOMMEND.

A. I recommend the following capital structure be used in this proceeding:

	<u>Percent</u>
Common equity	41.86%
Long-term debt	58.14%

Q. IS THE CURRENT CAPITAL STRUCTURE CONSISTENT WITH HOW EMPIRE HAS BEEN CAPITALIZED IN THE PAST?

A. Empire's historical capital structures are shown on Schedule MB-1. As a result of the failed merger attempt between UtiliCorp United and Empire, Empire altered its capital structure by redeeming its outstanding preferred stock. The Company also issued additional long term debt without issuing any balancing common equity. The result is that Empire's capital structure is currently more debt-heavy than it has been in the past.

1 Q. EMPIRE MADE THESE CHANGES TO ITS CAPITAL STRUCTURE DUE TO THE  
2 MERGER ATTEMPT WITH UTILICORP?

3 A. Yes. Empire retired its preferred stock, issued additional long term debt, and chose to NOT  
4 issue additional common stock, due to its involvement in the failed merger. Additionally,  
5 Empire's management chose to file a rate case at this time, with the current capital structure  
6 in place. The Company's actual capital structure is the capital structure that should be used  
7 in this proceeding.

8 Q. HOW DOES EMPIRE'S CURRENT CAPITAL STRUCTURE COMPARE WITH OTHER  
9 ELECTRIC UTILITIES?

10 A. Empire's current common equity ratio is very similar to the average level of common equity  
11 of my comparable group. Based on Value Line's methodology, Empire's common equity  
12 ratio was 40% for year 2000, compared to an average level of 40.8% for my comparable  
13 group. According the Value Line's Composite Statistics, Empire's levels of common  
14 equity for 1999 and 2000 were lower than the average common equity ratio for the electric  
15 industry overall (Schedule MB-4). The 29 Electric Utilities covered by C.A. Turner Utility  
16 Reports have an average common equity ratio of 38% - actually lower than Empire's level.

17 Q. DO THE LEVELS OF COMMON EQUITY FOR EMPIRE AND THE COMPARISON  
18 GROUP IMPLY SIMILAR LEVELS OF RISK?

19 A. In terms of risk due to capital structure, Empire's level of common equity would imply  
20 similar risk as the group of comparison companies. My group of comparison companies are  
21 all relatively small, as is Empire, and Empire's level of common equity is certainly similar  
22 to the levels held by these companies.

23 Q. COULD YOU DEFINE RISK?

24 A. Yes. Risk can be defined as the possibility that actual earnings from an asset or an  
25 investment may differ from expected earnings. The wider the range of possible earnings,



1 the greater the risk associated with that asset or investment. A comparison of various risk  
2 measures for EDE and the group of comparison companies is shown on Schedule MB-3.

3 **Business risk** is the uncertainty (variability) associated with earnings due to  
4 fundamental business conditions faced by the company, such as cyclical markets, weather-  
5 sensitive sales, changing technology, unforeseen events, or competition. Business risk is  
6 the *inherent riskiness of a firm's assets* due to the operations of the company and the  
7 industry in which it operates. In other words, business risk is not connected to the way the  
8 firm finances its assets.

9 **Financial risk** is the uncertainty associated with earnings available to common  
10 shareholders due to debt and/or preferred stock being used to finance the firm's assets. This  
11 additional risk stems from the fact that cash flows to common shareholders are subordinate  
12 to a firm's required debt service (i.e. a firm must pay its debt service and any preferred  
13 dividends before it can pay common dividends.) From a common shareholder's  
14 perspective, a firm with less debt and preferred stock in its capital structure has fewer bills  
15 to pay before it can allocate earnings to common dividends, and is therefore less risky.

16  
17 **EMBEDDED COST OF LONG TERM DEBT**

18 Q. WHAT IS THE APPROPRIATE EMBEDDED COST RATE FOR EMPIRE'S LONG-  
19 TERM DEBT?

20 A. The embedded cost rate is 7.895% for Empire's long-term debt. Calculation of the  
21 embedded cost of long-term debt is shown on Schedule MB-5.

**COST OF COMMON EQUITY**

Q. WHAT IS YOUR RECOMMENDED COST OF COMMON EQUITY FOR EMPIRE?

A. Empire should be allowed a return on common equity of 10.0% to 10.25%.

Q. PLEASE EXPLAIN HOW YOU ARRIVED AT YOUR RECOMMENDED COST OF COMMON EQUITY FOR EMPIRE.

A. I relied primarily on a Discounted Cash Flow (DCF) analysis performed on the common stock of EDE and six electric utilities in a comparison group to calculate a return on common equity (ROE) for Empire. Also, I performed a Capital Asset Pricing Model analysis (Schedule MB-9) for EDE and my comparable group.

**DISCOUNTED CASH FLOW MODEL**

Q. PLEASE DESCRIBE THE STANDARD DISCOUNTED CASH FLOW (DCF) MODEL YOU USED TO ARRIVE AT THE APPROPRIATE COST OF EQUITY CAPITAL.

A. The model is represented by the following equation:

$$k = D/P + g$$

where "k" is the cost of equity capital (i.e. investors' required return), "D/P" is the current dividend yield (dividend (D) divided by the stock price (P)) and "g" is the expected sustainable growth rate.

If future dividends are expected to grow at a constant rate (i.e., the constant growth assumption) and dividends, earnings and stock price are expected to increase in proportion to each other, the sum of the current dividend yield (D/P) and the expected growth rate (g) equals the required rate of return, or the cost of equity, to the firm. This form of the DCF model is commonly used in the regulatory arena and is known as the constant growth, or Gordon, DCF model. The constant growth DCF model is based on the following assumptions:

- 1) A constant rate of growth,
- 2) The constant growth will continue for an infinite period,
- 3) The dividend payout ratio remains constant,
- 4) The discount rate must exceed the growth rate, and
- 5) The stock price grows proportionately to the growth rate.

Although all of these assumptions do not always hold in a technical sense, the relaxation of these assumptions does not make the model unreliable.

The DCF model is based on two basic financial principals. First; the current market price of any financial asset, including a share of stock, is equivalent to the value of all expected future cash flows associated with that asset discounted back to the present at the appropriate discount rate. The discount rate that equates anticipated future cash flows and the current market price is defined as the rate of return or the company's cost of equity capital.

Cash flows associated with owning a share of common stock can take two forms: selling the stock and dividends. Just as the current value of a share of stock is a function of future cash flows (dividends), the *future* price of the stock at any time is also a function of future dividends. When a share of stock is sold, what is given up is the right to receive all future dividends. Therefore, the DCF model, using expected future dividends as the cash flows, is appropriate regardless of how long the investor plans to hold the stock. Determination of a holding period and an associated terminal price is unnecessary. Brealey and Myers emphasize the irrelevance of investors' time horizons:

How far out could we look? In principle the horizon period  $H$  could be infinitely distant. Common Stocks do not expire of old age. Barring such corporate hazards as bankruptcy or acquisition, they are immortal. As  $H$  approaches infinity, the present value of the terminal price ought to approach zero.... We can, therefore, forget about the terminal price entirely and express today's price as the present value of a perpetual stream of cash dividends. (Principles of Corporate Finance, Fourth Edition, page 52).

1 The other basic financial principle on which the DCF is grounded is the "time value of  
2 money." Investors view a dollar received today as being worth more than a dollar received  
3 in the future because a dollar today can immediately be invested. Therefore, future cash  
4 flows are discounted. The rate used by investors to discount future cash flows to the present  
5 is the discount rate or opportunity cost of capital.

## 6 7 GROWTH RATE

8 Q. TO WHAT DOES THE GROWTH COMPONENT OF THE DCF FORMULA REFER?

9 A. The growth rate variable,  $g$ , in the traditional DCF model is the dividend growth rate  
10 investors expect to continue into the *indefinite future* (i.e., the sustainable growth rate).  
11 This is not necessarily the same growth rate that a company or analysts expect over the next  
12 one year or even the next five years.

13 Q. HOW IS THE SUSTAINABLE GROWTH RATE DETERMINED?

14 A. Sustainable growth is determined by analyzing various historical and projected growth rates  
15 for the Company. These growth rates might be calculated from raw data or taken from  
16 financial resources such as Value Line Investment Survey. The growth rates analyzed can  
17 include historical and projected growth rates of, for example, earnings per share (EPS),  
18 dividends per share (DPS) and book value per share (BVPS). Analysts also consider  
19 retention growth (both historical and projected), which is a calculation of the level of  
20 earnings the company retains and does not pay out in dividends.

21 Q. PLEASE DESCRIBE RETENTION GROWTH IN MORE DETAIL.

22 A. It is important to recognize the fundamentals of long-term investor-expected growth when  
23 developing a sustainable growth rate. Retention growth and a company's dividend policy,  
24 including payout ratio, can be important when calculating a sustainable growth rate. Future

1 dividends will be generated by future earnings and a primary source of growth in future  
2 earnings is the reinvestment of present earnings back into the firm (for example, investment  
3 in new infrastructure components and other rate base assets). This reinvestment of earnings  
4 also contributes to the growth in book value. Furthermore, it is the earned return on  
5 reinvested earnings and existing capital (i.e., book value) that ultimately determines the  
6 basic level of future cash flows. Therefore, as measured by retention growth, the future  
7 growth rate called for in the DCF formula is found by multiplying the future expected  
8 earned return on book equity ( $r$ ) by the percentage of earnings expected to be retained in the  
9 business ( $b$ ). This calculation, known as the " $b \times r$ " method, or retention growth rate, results  
10 in a valid sustainable growth rate which can be used in the Discounted Cash Flow formula.  
11 While the retention growth rate can be calculated using historic data on earnings retention  
12 and equity returns, this information is relevant only to the extent that it provides a  
13 meaningful basis for determining the future sustainable growth rate. Consequently,  
14 *projected* data on earnings retention and return on book equity are generally more  
15 representative of investors' expectations.

16 Q. CAN YOU PROVIDE AN EXAMPLE THAT ILLUSTRATES THE FUNDAMENTALS  
17 OF SUSTAINABLE GROWTH AS MEASURED BY RETENTION GROWTH?

18 A. Yes. To better understand the principles of retention growth, it is helpful to compare the  
19 growth in a utility's cash flows to the fundamental causes of growth in an individual's  
20 passbook account. For an individual who has \$100 in a passbook account paying 5.0%  
21 interest, earnings will be \$5 for the first year. If this individual leaves 100% of the earnings  
22 in the passbook account (retention ratio equals 100%), the account balance at the end of the  
23 first year will be \$105. Total earnings in the second year will be \$5.25 ( $\$105 \times 5.0\%$ ), and  
24 the growth rate of the account in year two is 5.0% [ $100\%(b) \times 5\%(r)$ ]. On the other hand, if  
25 the individual withdraws \$3 of the earnings from the first year and reinvests only \$2

1 (retention ratio equals 40%) earnings in the second year will be only \$5.10 ( $\$102 \times 5.0\%$ ),  
2 with growth equaling 2.0% [ $(\$102-\$100)/\$100 = 2.0\% = 40\%(b) \times 5\%(r)$ ]. In both cases,  
3 the return, along with the level of earnings retained, dictate future earnings.

4 These exact principles regarding growth apply to a utility's common stock. When  
5 earnings are retained, they are available for additional investment and, as such, generate  
6 future growth. When earnings are distributed in the form of dividends, they are unavailable  
7 for reinvestment in those assets that would ultimately produce future growth. Either way,  
8 for both a utility's common stock or an individual's passbook account, the level of earnings  
9 retained, along with the rate of return, determine the level of sustainable growth.

10 Q. ARE THERE ANY OTHER FACTORS THAT INFLUENCE INVESTOR-EXPECTED  
11 SUSTAINABLE GROWTH?

12 A. Yes. Stock financing will cause investors to expect additional growth if a company is  
13 expected to issue new shares at a price above book value. The excess of market price over  
14 book value would benefit current shareholders, increasing their per share book equity.  
15 Therefore, if stock financing is expected at prices above book value, shareholders will  
16 expect their book value to increase, and that adds to the growth expectation stemming from  
17 earnings retention, or "b\*r" growth. A more thorough explanation of "external" growth is  
18 included in Appendix (I). This external growth factor has been included in all historic and  
19 projected retention growth rate calculations for Empire and the group of comparison  
20 utilities.

21 Q. ARE THERE OTHER GROWTH RATE PARAMETERS THAT ARE SOMETIMES USED  
22 BY ANALYSTS TO MEASURE GROWTH?

23 A. Yes. Other methods sometimes used as a proxy for determining the investor-expected  
24 sustainable growth rate utilized in the DCF model include: 1) *historical* growth rates, and 2)  
25 analysts' *projections* of expected growth rates. Three commonly employed historic growth

1 parameters are: 1) earnings per share, 2) dividends per share, and 3) book value per share.  
2 Additionally, analysts' *projections* of future growth in earnings per share, dividends per  
3 share, and book value per share are sometimes used as an estimate of the sustainable growth  
4 rate.

5 As a matter of completeness, all of the above-mentioned techniques for measuring  
6 growth were utilized: historical growth in EPS, DPS, and BVPS, historical retention  
7 growth, projections of growth in EPS, DPS, and BVPS, and projected retention growth. My  
8 growth rate calculations are summarized on Schedule MB-6, page 1. Calculations for  
9 individual companies are shown on Schedule MB-6, pages 2-8.

10 Q. THE DCF GROWTH RATE IS THE SUSTAINABLE GROWTH RATE FOR DIVIDENDS  
11 PER SHARE. IS THE HISTORIC GROWTH RATE IN DIVIDENDS PER SHARE AN  
12 APPROPRIATE PROXY FOR THE SUSTAINABLE GROWTH RATE?

13 A. Not necessarily. The historic growth rate in dividends per share will tend to overstate  
14 (understate) the sustainable growth rate when the dividend payout ratio has increased  
15 (decreased) over the measurement period. For an extended discussion and illustration of  
16 this phenomenon, please see Appendix I.

17  
18 **DETERMINATION OF SUSTAINABLE GROWTH**

19 Q. DID YOU RELY ON DATA FROM EMPIRE ONLY TO ARRIVE AT A  
20 RECOMMENDATION OF SUSTAINABLE GROWTH?

21 A. No. In addition to an analysis of Empire's growth rates, I analyzed the group of six  
22 comparable electric utilities to provide some insight as to the reasonableness of a  
23 sustainable growth rate recommendation. All of the comparable companies are covered by  
24 Value Line, which is readily available to the average investor and a recognized source of  
25 financial and investment information.

1           The following companies were included in the analysis: 1) Black Hills Corporation;  
2           2) Cleco Corporation; 3) DPL Inc.; 4) DQE, Inc.; 5) Hawaiian Electric Industries, Inc.; 6)  
3           IDACORP, Inc. Three of these companies (Cleco, Hawaiian and IDACORP) were also  
4           used by Company witness Murry as part of a comparable group. The other three companies  
5           in Mr. Murry's comparable group are not, in fact, comparable to Empire.

6       Q.   WHAT GROWTH RATE PARAMETERS HAVE YOU EXAMINED IN ORDER TO  
7           ESTABLISH INVESTOR-EXPECTED GROWTH FOR EMPIRE?

8       A.   The following growth parameters have been reviewed for EDE and the group of six  
9           comparison electric utilities: 1) my calculations of historic compound growth in earnings,  
10          dividends, and book value based on data from Value Line; 2) average of five-year and ten-  
11          year historic growth in earnings, dividends, and book value; 3) projected growth rate in  
12          earnings, dividends, and book value; 4) historic retention growth rate; and, 5) projected  
13          retention growth rate.

14      Q.   PLEASE EXPLAIN IN MORE DETAIL HOW THE HISTORIC GROWTH RATES OF  
15          EARNINGS, DIVIDENDS, AND BOOK VALUE WERE DETERMINED.

16      A.   Historic rates of growth in earnings per share (EPS), dividends per share (DPS), and book  
17          value per share (BVPS) were analyzed using two methods. First, compound growth rates  
18          were calculated for the five-year periods ending 1998, 1999 and 2000. These three five-  
19          year compound growth rates were then averaged and are labeled "Ave. Compound Gr." on  
20          line (16) of Schedule MB-6, pages 2-8.

21           The second measure of historic growth was taken from Value Line. I averaged  
22          Value Line's calculated 5-year and 10-year historical growth rates when both were  
23          available. If only one was available, I used that one. The historic rates of growth furnished  
24          by Value Line are included in this analysis because:

25           1) The Value Line growth rates are readily available for investor use;



1                   2) The Value Line rates of growth reflect both a five-year and ten-year time frame;  
2                   and

3                   3) The Value Line rates are measured from an average of three base years to an  
4                   average of three ending years, smoothing the results and limiting the impact of nonrecurring  
5                   events.

6                   Value Line historic growth measurements for EPS, DPS and BVPS appear on line  
7                   (19) of Schedule MB-6, pages 2-8.

8           Q.       PLEASE DISCUSS YOUR ANALYSIS OF PROJECTED GROWTH RATE DATA.

9           A.       Projected growth rates in EPS, DPS, and BVPS were taken from Value Line and are found  
10           on line 30 of Schedule MB-6, pages 2-8. Projected growth in EPS was also taken from  
11           First Call Corporation (line 32). If First Call did not issue a projection for a particular  
12           company, that space contains n/a. Information from First Call is available to the average  
13           investor. The projected growth in EPS found on line 36 is the average of earnings growth  
14           projections furnished by Value Line and First Call. Value Line's projected growth in  
15           dividends and book value are listed again on line 36.

16          Q.       PLEASE DISCUSS YOUR ANALYSIS OF HISTORIC AND PROJECTED RETENTION  
17                   GROWTH RATES.

18          A.       Historic retention growth was determined using the product of return (r) and retention rate  
19                   (b) for the years 1996-2000, and the average was calculated (line 10, final column). The  
20                   projected retention growth data, found on lines 25-27 of Schedule MB-6, pages 2-8 is based  
21                   on information from Value Line. Projected retention growth was calculated for 2001 and  
22                   the period 2003-05. An average of these growth rates was calculated and compared to the  
23                   growth rate for the 2003-05 period alone. The *larger* value, either the average or the 2003-  
24                   05 rate was utilized as the projected retention growth rate.

Investors' expectations regarding growth from external sources (i.e. sales of additional stock at prices above book value) has been included in the determination of both historic and projected growth.

Q. PLEASE SUMMARIZE YOUR GROWTH RATE CALCULATIONS FOR EDE AND THE GROUP OF COMPARISON COMPANIES.

A. The following table shows the results of the analysis of growth rates for EDE. The high growth rate is 4.77% and the low growth rate is 0.0%. The overall average of all growth rates is 2.19% (Schedule MB-6, page 1). Negative growth rates were **not** used in calculations of overall averages. The average rate of Empire's *projected* growth, not including the 0.0% DPS projection, is 3.42%.

**Growth rate summary (EDE): Overall average = 2.19%.**

	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
Historic Compound Growth	4.77%	0.0%	1.62%
Historic Value Line Growth	1.00%	2.25%	2.00%
Projected Growth	3.15%	0.00%	2.50%

	<u>Historic</u>	<u>Projected</u>
Retention Growth	2.25%	4.61%

The following table outlines the results of the analysis of growth rates for the comparison group. The high average growth rate is 7.96% and the low average growth rate is 1.78%. The overall average of all growth rates for all six comparison companies is 4.57% (Schedule MB-6, page 1). Negative growth rates were **not** used in calculations of overall averages. The average projected growth rate for the group is 5.61%.

**Growth rate summary (comparison group): Overall average = 4.57%**

	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
Historic Compound Growth	6.52%	1.78%	4.95%
Historic Value Line Growth	4.50%	3.29%	3.63%
Projected Growth	6.88%	2.00%	5.58%

	<u>Historic</u>	<u>Projected</u>
Retention Growth	3.22%	7.96%

Q. WHICH GROWTH RATE DO YOU CONSIDER TO BE REFLECTIVE OF THE INVESTOR-EXPECTED GROWTH FOR EMPIRE?

A. I believe the sustainable growth rate for Empire to be approximately 3.5%. This growth rate is greater than my calculated overall average, but similar to the average projected rate. In general, Empire's growth rates were lower than the comparable companies' averages.

#### DIVIDEND YIELD

Q. WHAT DIVIDEND YIELD TO CALCULATE FOR EMPIRE AND THE COMPARABLE GROUP?

A. Empire's dividend yield is 6.56%. That is the yield an investor could expect to receive based on my calculation of average stock price and Empire's expected dividend yield.

I calculated an average dividend yield of 4.55% for the group of six comparable companies. Schedule MB-7 shows the calculations of average stock prices and dividend yields for Empire and the group.

Q. EXPLAIN YOUR CALCULATION OF THE DIVIDEND YIELD.

A. The appropriate dividend yield to use in the DCF equation is equal to the *expected* dividend divided by *current* stock price. Schedule MB-7 shows average stock price over a recent six week period, expected dividends for 2001 (as taken from Value Line) and calculations of dividend yields.

I used a six-week period for determining the average stock price because I believe that period of time is long enough to avoid daily fluctuations and recent enough so that the stock price captured is representative of current expectations. The stock price is the average

1 of the Friday closing price from 2/16/01 to 3/23/01. Stock prices that are too old simply  
2 don't provide a current view of capital costs and are inappropriate to use in the DCF.

3  
4 **DCF COST OF EQUITY**

5 Q. WHAT IS THE DCF COST-OF-EQUITY FOR EMPIRE BASED ON THE PREVIOUSLY  
6 DETERMINED DIVIDEND YIELD AND GROWTH RATE?

7 A. Based on a dividend yield of 6.56% and a growth rate of 3.5%, Empire's DCF cost of  
8 equity is  $6.56\% + 3.5\% = 10.06\%$ . I chose to recommend an ROE range of 10.0% to  
9 10.25% for the retail electric operations of Empire. While Empire's growth rates tend to be  
10 lower than the group of companies, Empire's dividend yield is higher. DCF calculations  
11 are shown on Schedule MB-8.

12  
13 **CAPITAL ASSET PRICING MODEL**

14 Q. PLEASE DESCRIBE THE CAPITAL ASSET PRICING MODEL YOU USED TO  
15 SUBSTANTIATE YOUR RECOMMENDED RETURN ON COMMON EQUITY.

16 A. The Capital Asset Pricing Model (CAPM) is described by the following equation:

17 
$$K = R_f + \text{beta}(R_m - R_f)$$

18 where,

19 K = the cost of common equity for the security being analyzed,

20  $R_f$  = the risk free rate,

21 beta = the company's beta risk measure,

22  $R_m$  = market return, and

23  $(R_m - R_f)$  = market premium.

1 The formula states that the cost of common equity is equal to the risk free rate of interest,  
2 plus, beta multiplied by the difference between the return on the market and the risk free  
3 rate (the market premium).

4 The formula says that the cost of common equity is equal to the risk free rate plus  
5 some proportion of the market premium - that proportion being equal to beta. The market  
6 overall has a beta of 1.0. Firms with beta less than 1.0 are assumed to be less risky than the  
7 market; firms with beta greater than 1.0 are assumed to be more risky than the market. Beta  
8 for my group of comparison companies ranges from 0.55 to 0.60. Empire's beta is 0.50.

9 Q. DO YOU SUBSCRIBE TO THE CAPM AS AN ACCURATE MEASURE OF MARKET-  
10 BASED COST OF EQUITY?

11 A. I believe the CAPM and its dependence on the single risk measure beta has limitations in its  
12 ability to accurately take into account the risk factors faced by a company, and therefore  
13 that company's cost of equity. I do not believe the CAPM should be used as the primary  
14 cost-of-capital analysis tool. However, many investors continue to rely on the CAPM.  
15 Therefore, I included the CAPM as part of my analysis.

16 Q. HOW DID YOU ARRIVE AT THE VALUES OF THE RISK FREE RATE AND THE  
17 MARKET RETURN (OR MARKET PREMIUM) USED IN YOUR CAPM ANALYSIS?

18 A. The risk free interest rate I used of 4.76% is the rate on 10-year U.S. Government securities  
19 on 3/22/01, as reported by Value Line. I believe the 10-year Treasury is a better indication  
20 of the risk-free rate than the 30-year (the 30-year rate is 5.27%).

21 I used a market premium of 7.8% as calculated and reported by Ibbotson &  
22 Associates.

1 Q. WHAT IS THE CURRENT TREND IN U.S. GOVERNMENT SECURITY INTEREST  
2 RATES?

3 A. They are declining. The current 10-year rate is 4.76%. Three months previous (12/21/00)  
4 the rate was 5.02%, and one year ago (3/23/00) the rate was 6.08%.

5 The current 30-year rate is 5.27%. Three months previous the rate was 5.41%, and  
6 one year ago the rate was 5.91%.

7 Q. WHAT DO THESE CHANGES IMPLY FOR THE COST OF EQUITY CAPITAL?

8 A. As reflected in financial models such as the CAPM, a declining risk-free rate leads directly  
9 to a declining cost of equity

10 Moving forward in time does not automatically imply increased capital costs for a  
11 company, as is evidenced by the declining risk-free rate.

12 Q. WHAT DOES YOUR CAPM ANALYSIS SHOW?

13 A. I performed a CAPM analysis on EDE and my six comparison utilities (Schedule MB-9).

14 The CAPM cost of common equity for EDE is 8.66%. The average CAPM cost of  
15 common equity for DCF-comparison group is 8.86%, with a high of 9.44% and a low of  
16 8.66%.

**WEIGHTED AVERAGE COST OF CAPITAL**

1

2

3

Q. WHAT OVERALL, OR WEIGHTED AVERAGE, COST OF CAPITAL IS INDICATED  
BY YOUR ANALYSIS?

4

A. The weighted average cost of capital I calculated for Empire is between 8.78% and 8.88%.

5

The WACC calculation is shown on Schedule MB-10.

6

Q. WHAT PRE-TAX COVERAGE RATIO IS IMPLIED BY YOUR RECOMMENDATION?

7

A. Based on a WACC of 8.78%, the pre-tax coverage ratio is approximately 2.48 times. The

8

derivation of pre-tax coverage is shown on Schedule MB-10. Based on a WACC of 8.88%,

9

the pre-tax coverage ratio is 2.52 times.

10

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

11

A. Yes, it does.

**APPENDIX A**

**DEVELOPMENT & PURPOSES OF REGULATION**

Q. WHY ARE PUBLIC UTILITIES REGULATED?

A. The nature of public utility services generally requires a monopolistic mode of operation. Only a limited number of companies (and quite often only one) are normally allowed to provide a particular utility service in a specific geographic area. Public utilities are often referred to as "natural" monopolies; a state created by such powerful economies of scale or scope that only one firm can or should provide a given service. Even when a utility is not a pure monopoly, it still has substantial market power over at least some of its customers.

In order to secure the benefits arising from monopolistic-type operations, utilities are generally awarded an exclusive franchise (or certificate of public convenience) by the appropriate governmental body. Since an exclusive franchise generally protects a firm from the effects of competition, it is critical that governmental control over the rates and services provided by public utilities is exercised. Consequently, a primary objective of utility regulation is to produce market results that closely approximate the conditions that would be obtained if utility rates were determined competitively. Based on this competitive standard, utility regulation must: 1) secure safe and adequate service; 2) establish rates sufficient to provide a utility with the opportunity to cover all reasonable costs, including a fair rate of return on the capital employed; and 3) restrict monopoly-type profits.



**APPENDIX B**  
**CALCULATION OF THE WEIGHTED AVERAGE COST OF CAPITAL**

Q. PLEASE EXPLAIN HOW THE WEIGHTED AVERAGE COST OF CAPITAL IS USED IN TRADITIONAL RATEMAKING AND HOW IT IS DERIVED.

A. The basic standard of rate regulation is the revenue-requirement standard, often referred to as the rate base-rate of return standard. Simply stated, a regulated firm must be permitted to set rates that will cover operating costs and provide an opportunity to earn a reasonable rate of return on assets devoted to the business. A utility's total revenue requirement can be expressed as the following formula:

$$R = O + (V - D + A)r$$

where R = the total revenue required,

O = cost of operations,

V = the gross value of the property,

D = the accrued depreciation, and

A = other rate base items,

r = the allowed rate of return/weighted average cost of capital.

This formula indicates that the process of determining the total revenue requirement for a public utility involves three major steps. First, allowable operating costs must be ascertained. Second, the net depreciated value of the tangible and intangible property, or net investment in property, of the enterprise must be determined. This net value, or investment (V - D), along with other allowable items is referred to as the rate base. Finally, a "fair rate of return" or weighted average cost of capital (WACC) must be determined. This rate, expressed as a percentage, is multiplied by the rate base. The weighted average cost of capital (WACC) is applied to the rate base (V-D+A) since it is generally recognized

1 the rate base is financed with the capital structure and these two items are normally similar  
2 in size. The allowed rate of return, or WACC, is typically defined as follows:

3 
$$r = i(D/C) + l(P/C) + k(E/C)$$

4 where  $i$  = embedded cost of debt capital,

5  $D$  = amount of debt capital,

6  $l$  = embedded cost of preferred stock,

7  $P$  = amount of preferred stock,

8  $k$  = cost of equity capital,

9  $E$  = amount of equity capital, and

10  $C$  = amount of total capital.

11 This formula indicates that the process of determining WACC involves separate  
12 determinations for each type of capital utilized by a utility. Under the weighted cost  
13 approach, a utility company's total invested capital is expressed as 100 percent and is  
14 divided into percentages that represent the capital secured by the issuance of long-term  
15 debt, preferred stock, common stock, and sometimes short-term debt. This division of total  
16 capital by reference to its major sources permits the analyst to compute separately the cost  
17 of both debt and equity capital. The cost rate of each component is weighted by the  
18 appropriate percentage that it bears to the overall capitalization. The sum of the weighted  
19 cost rates is equal to the overall or weighted average cost of capital and is used as the basis  
20 for the fair rate of return that is ultimately applied to rate base.

**APPENDIX C**  
**ECONOMIC PRINCIPLES OF REGULATION**

Q. BRIEFLY DESCRIBE THE ECONOMIC RATIONALE FOR RATE BASE-RATE OF RETURN REGULATION.

A. Rate base-rate of return regulation is based, in part, on basic economic and financial theory that applies to both regulated and unregulated firms.

Although it is well recognized that no form of economic regulation can ever be a perfect substitution for competition in determining market prices for goods and services, there is nearly unanimous acceptance of the principle that regulation should act as a substitute for competition in utility markets. (Parcell, The Cost of Capital Manual p.1-4).

It is the interaction of competitive markets forces that holds the prices an unregulated firm can charge for its products or services in line with the actual costs of production. In fact, competition between companies is generally viewed as the mechanism that allows consumers to not only purchase goods and services at prices consistent with the costs of production but also allows consumers to receive the highest quality product. Since regulated utilities are franchised monopolies generally immune to competitive market forces, a primary objective of utility regulation is to produce results that closely approximate the conditions that would exist if utility rates were determined in a competitive atmosphere.

Under basic financial theory, it is generally assumed the goal for all firms is the maximization of shareholder wealth. Additionally, capital budgeting theory indicates that, in order to achieve this goal, an unregulated firm should invest in any project which, given a certain level of risk, is expected to earn a rate of return at or above its weighted average cost of capital.

Competition, in conjunction with the wealth maximization goal, induces firms to increase investment as long as the expected rate of return on an investment is greater than

1 the cost of capital. Competitive equilibrium is achieved when the rate of return on the last  
2 investment project undertaken just equals the cost of capital. When competitive equilibrium  
3 is achieved, the price ultimately received for goods or services reflects the full costs of  
4 production. Therefore, not only does competition automatically drive unregulated firms to  
5 minimize their capital costs (investment opportunities are expanded and competitive  
6 position is enhanced when capital costs can be lowered), it also ensures that the marginal  
7 return on investment just equals the cost of capital.

8 Given that regulation is intended to emulate competition and that, under  
9 competition, the marginal return on investment should equal the cost of capital, it is crucial  
10 for regulators to set the authorized rate of return equal to the actual cost. If this is  
11 accomplished, the marginal return on prudent and necessary investment just equals cost and  
12 the forces of competition are effectively emulated.

**APPENDIX D**  
**LEGAL REQUIREMENT FOR A FAIR RATE OF RETURN**

Q. IS THERE A JUDICIAL REQUIREMENT RELATED TO THE DETERMINATION OF THE APPROPRIATE RATE OF RETURN FOR A REGULATED UTILITY?

A. Yes. The criteria established by the U.S. Supreme Court closely parallels economic thinking on the determination of an appropriate rate of return under the cost of service approach to regulation. The judicial background to the regulatory process is largely contained in two seminal decisions handed down in 1923 and 1944. These decisions are,

Bluefield Water Works and Improvement  
Company v. Public Service Commission,  
262 U.S. 679 (1923), and

FPC v. Hope Natural Gas Co., 320 U.S., 591 (1944)

In the Bluefield Case, the Court states,

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.

Together, Hope and Bluefield have established the following standards,

1). A utility is entitled to a return similar to that available to other enterprises with similar risks;

2). A utility is entitled to a return level reasonably sufficient to assure financial soundness and support existing credit, as well as raise new capital; and

1                    3). A fair return can change along with economic conditions and capital markets.  
2                    Furthermore, in Hope, the Court makes clear that regulation does not guarantee utility  
3                    profits and, in Permian Basin Area Rate Cases, 390 US 747 (1968), that, while investor  
4                    interests (profitability) are certainly pertinent to setting adequate utility rates, those interests  
5                    do not exhaust the relevant considerations.

**APPENDIX E  
REGULATION IN MISSOURI**

Q. WHAT IS THE ORIGIN AND RATIONALE FOR THE REGULATION OF PUBLIC UTILITIES IN THE STATE OF MISSOURI?

A. All investor owned public utilities operating in the state of Missouri are subject to the Public Service Commission Act, as amended. The Public Service Commission Act was initially passed by the Forty-Seventh General Assembly on April 15, 1913. (Laws of 1913 pp. 557-651, inclusive).

In State ex rel Kansas City v. Kansas City Gas Co. 163 S.W. 854 (Mo.1914), the case of first impression pertaining to the Public Service Commission Act, the Missouri Supreme Court described the rationale for the regulation of public utilities in Missouri as follows:

That act (Public Service Commission Act) is an elaborate law bottomed on the police power. It evidences a public policy hammered out on the anvil of public discussion. It apparently recognizes certain generally accepted economic principles and conditions, to wit: That a public utility (like gas, water, car service, etc.) is in its nature a monopoly; that competition is inadequate to protect the public, and, if it exists, is likely to become an economic waste; that regulation takes the place of and stands for competition; that such regulation to command respect from patron or utility owner, must be in the name of the overlord, the state, and, to be effective, must possess the power of intelligent visitation and the plenary supervision of every business feature to be finally (however invisible) reflected in rates and quality of service. (Kansas City Gas Co. at 857-58).

The General Assembly has determined that the provisions of the Public Service Commission Act "shall be liberally construed with a view to the public welfare, efficient facilities and substantial justice between patrons and public utilities" (See: 386.610 RSMo 1994). Pursuant to the above legislative directive, when developing the cost of equity capital for a public utility operating in Missouri, it is appropriate to do so with a view toward the public welfare; giving the utility an amount that will allow for efficient use of its facilities and the proper balance of interests between the ratepayers and the utility.

**APPENDIX F**  
**MARKET-TO-BOOK RATIO ILLUSTRATION**

1  
2  
3 Q. COULD YOU PROVIDE AN EXAMPLE ILLUSTRATING THE IMPORTANCE OF  
4 MARKET-TO-BOOK RATIOS AND THEIR RELATIONSHIP TO THE COST OF  
5 EQUITY CAPITAL?

6 A. Yes. Assume that a utility's equity has a book value of \$10 per share and that, for  
7 simplicity, this utility pays out all its earnings in dividends. If regulators allow the utility a  
8 12% return, investors will expect the company to earn (and pay out) \$1.20 per share. If  
9 investors require a 12% return on this investment, they will be willing to provide a market  
10 price of \$10 per share for this stock ( $\$1.20 \text{ dividends} / \$10 \text{ market price} = 12\%$ ). In that  
11 case, the allowed/expected return is equal to the cost of capital and the market price is equal  
12 to the book value.

13 Now, assume the investors' required return is 10%. Investors would be drawn to a  
14 utility stock in a risk class for which they require a 10% return but was expected to pay out  
15 a 12% return. The increased demand by investors would result in an increase in the market  
16 price of the stock until the total share yield equaled the investors' required return. In our  
17 example, that point would be \$12 per share ( $\$1.20 \text{ dividends} / \$12 \text{ market price} = 10\%$ ). As  
18 such, the allowed/expected return (12%) is greater than the required return (10%) and the  
19 per share market price (\$12/share) exceeds book value (\$10/share), producing a market-to-  
20 book ratio greater than one ( $\$12 / \$10 = 1.20$ ). Consequently, when the market-to-book ratio  
21 for a given utility is greater than one, the earned or projected return on book equity is  
22 greater than the cost of capital.



**APPENDIX G  
DEVELOPMENT OF A COMPARISON GROUP**

Q. PLEASE EXPLAIN HOW YOU DEVELOPED A COMPARISON GROUP.

A. The following selection criteria have been used to develop a group of comparable utilities:

- 1). Publicly traded company;
- 2). No Missouri-regulated operations;
- 3). Greater than 70% of total revenues from regulated sales of electricity;
- 4). Total revenues less than \$2.5 billion;
- 5). Standard & Poor's Bond Rating BBB+ or above;
- 6). Covered by Value Line;
- 7). Non negative payout ratio for at least the past three years.

The following companies were included in the analysis: 1) Black Hills Corporation;  
2) Cleco Corporation; 3) DPL Inc.; 4) DQE, Inc.; 5) Hawaiian Electric Industries, Inc.; 6)  
IDACORP, Inc.

Q. HAVE YOU MADE ANY RISK EVALUATIONS FOR THE INDUSTRY GROUP?

A. Yes. As shown on Schedule MB-2, I have examined several measures that typically act as  
indicators of relative risk.

The beta coefficient;	Fixed charge coverage;
Value Line Safety rating;	Bond Rating from Standard & Poor's;
Average common equity ratio;	Value Line Financial Strength.

Also, many of the selection criteria also act as risk measures, such as the level of revenues  
from regulated electric operations.

## APPENDIX H

### EFFICIENT NATURE OF THE CAPITAL MARKETS

1  
2  
3 Q. IS THE DISCOUNTED CASH FLOW MODEL INHERENTLY CAPABLE OF  
4 ADJUSTING FOR THE LEVEL OF REAL OR PERCEIVED RISKINESS TO A GIVEN  
5 SECURITY?

6 A. Yes. It is impossible for any one analyst to systematically interpret the impact that each and  
7 every risk variable facing an individual firm has on the cost of equity capital to that firm.  
8 Fortunately, this type of risk-by-risk analysis is not necessary when determining the  
9 appropriate variables to be plugged into the DCF formula.

10 As stated earlier, the DCF model can correctly identify the cost of equity capital to  
11 a firm by adding the current dividend yield (D/P) to the correct determination of investor-  
12 expected growth (g). Thus, the difficult task of determining the cost of equity capital is  
13 made easier, in part, by the relative ease of locating dividend and stock price information  
14 and the efficient nature of the capital markets.

15 Q. PLEASE EXPLAIN THAT STATEMENT.

16 A. The DCF model is based on the assumption that investors (1) calculate intrinsic values for  
17 stocks on the basis of their interpretation of available information concerning future cash  
18 flows and risk, (2) compare the calculated intrinsic value for each stock with its current  
19 market price, and (3) make buy or sell decisions based on whether a stock's intrinsic value is  
20 greater or less than its market price.

21 Only if its market price is equal to or lower than its intrinsic value as calculated by  
22 the marginal investor will a stock be demanded by that investor. If a stock sells at a price  
23 significantly above or below its calculated intrinsic value, buy or sell orders will quickly  
24 push the stock towards market equilibrium. The DCF model takes on the following form  
25 when used by investors to calculate the intrinsic value of a given security,

1                    $P^{\wedge} = D/k - g$

2           where  $P^{\wedge}$  = the intrinsic value of the security,

3                    $D$  = the current dividend,

4                    $g$  = the expected growth rate, and

5                    $k$  = the required return on the security

6           Since the required rate of return for any given investor is based on both the perceived  
7           riskiness of the security and return opportunities available in other segments of the market,  
8           it can be easily demonstrated that when perceived riskiness is increased, the investors'  
9           required return is also increased and the market value of the investment falls as it is valued  
10          less by the marginal investor. Returning to the form of the DCF model used to determine  
11          the cost of equity capital to the firm,

12                    $k = D/P + g$

13          we see that the required return rises as an increase in the perceived risk associated with a  
14          given security drives the price down. Within this context, the DCF formula incorporates all  
15          known information, including information regarding risks, into the cost of equity capital  
16          calculation. This is known as the "efficient market" hypothesis.

17   Q.   IS THE "EFFICIENT MARKET" HYPOTHESIS SUPPORTED IN THE FINANCIAL  
18       LITERATURE?

19   A.   Yes. Modern investment theory maintains that the U.S. capital markets are efficient and, at  
20       any point in time, the prices of publicly traded stocks and bonds reflect all available  
21       information about those securities. Additionally, as new information is discovered, security  
22       prices adjust virtually instantaneously. This implies that, at any given time, security prices  
23       reflect "real" or intrinsic values. This point is further clarified in Investments, by Bodie,  
24       Kane, and Marcus. According to Bodie, et.al.,

1 A large body of empirical evidence supports a theory called the **efficient**  
2 **markets hypothesis** (EMH), which among other things says that active  
3 management of both types should not be expected to work for very long.  
4 The basic reasoning behind the EMH is that in a competitive financial  
5 environment successful trading strategies tend to “self-destruct.” Bargains  
6 may exist for brief periods, but with so many talented highly paid analysts  
7 scouring the markets for them, by the time you or I “discover” them, they  
8 are no longer bargains. (pg. 3-4)  
9

10 According to Brealy and Myers;

11 In an efficient market you can trust prices. They impound all available  
12 information about the value of each security. (Principles of Corporate  
13 Finance, Fourth Edition, page 300)

APPENDIX I

DETERMINATION OF RETENTION GROWTH &  
SUSTAINABLE GROWTH vs. EARNINGS AND DIVIDEND GROWTH RATES

Q. PREVIOUSLY YOU STATED THAT IT IS CRITICAL TO UNDERSTAND THE SOURCES OF GROWTH WHEN DEVELOPING A SUSTAINABLE GROWTH RATE RECOMMENDATION. PLEASE PROVIDE AN EXAMPLE THAT ILLUSTRATES HOW SUSTAINABLE GROWTH IS MEASURED USING THE RETENTION GROWTH METHOD.

A. To understand how investors develop a growth rate expectation, it is helpful to look at an illustration that shows how expected growth is measured. To do this, assume that a hypothetical utility has a first period common equity, or book value per share of \$20.00; the investor-expected return on that equity is 12 percent; and the stated company policy is to pay out 50 percent of earnings in dividends. The first period earnings per share are expected to be \$2.40 (\$20 per share book equity x 12% equity) and the expected dividend is \$1.20. The amount of earnings not paid out to shareholders (\$1.20), referred to as retained earnings, raises the book value of the equity to \$21.20 in the second period. The following table continues the hypothetical for a three-year period and illustrates the underlying determinants of growth.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Gr.</u>
Book Value	\$20.00	\$21.20	\$22.47	6.00%
Equity Return	12%	12%	12%	
Earnings/Sh.	\$2.40	\$2.54	\$2.67	6.00%
Payout Ratio	50%	50%	50%	
Dividend/Sh.	\$1.20	\$1.27	\$1.34	6.00%

As can be seen, earnings, dividends, and book value all grow at the same rate when the payout ratio and return on equity remain stable. Moreover, key to this growth is the amount of earnings retained or reinvested in the firm and the return on equity.

Letting "b" equal the retention ratio of the firm (or 1 minus the payout ratio) and letting "r" equal the firm's expected return on equity, the DCF growth rate "g" (also referred to as the sustainable growth rate) is equal to their product, or

1                     $g = br.$

2                    As shown in the example, the growth rate for the hypothetical company is 6.00 percent  
3                    (12% ROE x 50% payout ratio).

4                    Dr. Gordon has determined that this equation embodies the underlying  
5                    fundamentals of growth and, therefore, is a primary measure of growth to be used in the  
6                    DCF model (Gordon, The Cost of Capital to a Public Utility, 1974, p.81). It should be  
7                    noted, however, Dr. Gordon's research also indicates that analysts' growth rate projections  
8                    are useful in estimating investors' expectations. As a result, analysts' published growth rate  
9                    projections, along with other historic and projected growth rates, are considered in this  
10                    analysis for the purpose of reaching an accurate estimation of the expected sustainable  
11                    growth rate.

12                    Q.        CAN THE RETENTION GROWTH RATE MODEL BE FURTHER REFINED IN ORDER  
13                    TO BEST REPRESENT INVESTORS' EXPECTATIONS?

14                    A.        Yes. The above hypothetical example does not allow for the existence of external sources  
15                    of equity financing (i.e., sales of common stock). Stock financing will cause investors to  
16                    expect additional growth if the company is expected to issue additional shares at a market  
17                    price that exceeds book value.

18                    The excess of market value over book value per share would benefit current  
19                    shareholders by increasing their per share equity value. Therefore, if the company is  
20                    expected to continue to issue stock at a price that exceeds book value per share, the  
21                    shareholders would continue to expect their book value to increase and would add that  
22                    growth expectation to that stemming from the retention of earnings, or internal growth.

23                    On the other hand, if a company is expected to issue new common equity at a price  
24                    below book value, that would have a negative effect on shareholders' current growth rate  
25                    expectations. Finally, with little or no expected equity financing or a market-to-book ratio

1 at or near one, investors would expect the long-term sustainable growth rate for the  
2 company to equal the growth from earnings retention.

3 Dr. Gordon identifies the growth rate which includes both expected internal and  
4 external financing as,

5 
$$g = br + sv$$

6 where,  $g$  = DCF expected growth rate,

7  $r$  = return on equity,

8  $b$  = retention ratio,

9  $v$  = fraction of new common stock sold that accrues to the current shareholder,

10  $s$  = funds raised from the sale of stock as a fraction of existing equity.

11 Additionally,

12 
$$v = 1 - BV/MP$$

13 where,

14  $MP$  = market price,

15  $BV$  = book value.  
16

17 The second term ( $sv$ ), which represents the external portion of the expected growth rate,  
18 does not normally represent a major source of growth when compared to the expected  
19 growth attributed to the retention of earnings. For example, the FERC Generic Rate of  
20 Return Model estimates the ( $sv$ ) component in the range of 0.1% to 0.2%. However, I have  
21 used this equation as the basis for determining sustainable growth for both Empire and the  
22 comparison groups.

23 Q. IS HISTORIC OR PROJECTED GROWTH IN EARNINGS OR DIVIDENDS  
24 APPROPRIATE FOR DETERMINING THE DCF GROWTH RATE?

25 A. No, not always. As I have stated, growth derived from earnings or dividends alone can be  
26 unreliable for ratemaking purposes due to external influences on these parameters such as

changes in the historic or expected rate of return on common equity or changes in the payout ratio. An extended example will demonstrate this point.

If we take the example above and assume that, in year two, the expected return on equity rises from 12 percent to 15 percent, the resulting growth rate in earnings and dividends per share dramatically exceeds what the company could sustain indefinitely. The error that can result from exclusive reliance on earnings or dividends growth is illustrated in the following table:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Gr.</u>
Book Value	\$20.00	\$21.20	\$22.79	6.75%
Equity Return	12%	15%	15%	
Earnings/Sh.	\$2.40	\$3.18	\$3.42	19.37%
Payout Ratio	50%	50%	50%	
Dividends/Sh.	\$1.20	\$1.59	\$1.71	19.37%

Due to the change in return on equity in year two, the compound growth rate for dividends and earnings is greater than 19 percent, which is the result only of a short-term increase in the equity return rather than the intrinsic ability of the firm to grow continuously at a 19 percent annual rate.

For year one, the sustainable rate of growth ( $g=br$ ) is 6.00 percent, just as it was in the previous example. On the other hand, in years two and three, the sustainable growth rate increases to 7.50 percent. ( $15\% \text{ ROE} \times 50\% \text{ retention rate} = 7.50\%$ ). Consequently, if the utility is expected to continually earn a 15 percent return on equity and retain 50 percent of earnings for reinvestment, a growth rate of 7.50 percent would be a reasonable estimate of the long-term sustainable growth rate. However, the compound growth rate in earnings and dividends, which is over 19 percent, dramatically exceeds the actual investor-expected growth rate.

As can be seen in the hypothetical, the 19 percent growth rate is simply the result of the change in return on equity from year one to year two, not the firm's ability to grow



1 sustainably at that rate. Consequently, this type of growth rate cannot be relied upon to  
2 accurately measure investors' sustainable growth rate expectations. In this instance, to rely  
3 on either earnings or dividend growth would be to assume the return on equity could  
4 continue to increase indefinitely. This, of course, is a faulty assumption; the recognition of  
5 which emphasizes the need to analyze the fundamentals of actual growth.

6 Q. IS HISTORIC GROWTH IN DIVIDENDS AN ACCURATE INDICATOR OF  
7 INVESTORS' GROWTH EXPECTATIONS WHEN THE HISTORICAL PAYOUT RATIO  
8 HAS BEEN ERRATIC OR TRENDED DOWNWARD OVER TIME?

9 A. As stated, no. It can also be demonstrated that a change in our hypothetical utility's payout  
10 ratio makes the past rate of growth in dividends an unreliable basis for predicting investor-  
11 expected growth. If we assume the hypothetical utility consistently earns its expected equity  
12 return but in the second year changes its payout ratio from 50 percent to 75 percent, the  
13 resulting growth rate in dividends far exceeds a reasonable level of sustainable growth.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Gr.</u>
15 Book Value	\$20.00	\$21.20	\$21.84	4.50%
16 Equity Return	12%	12%	12%	
17 Earnings/Sh.	\$2.40	\$2.54	\$2.62	4.50%
18 Payout Ratio	50%	75%	75%	
19 Dividends/Sh.	\$1.20	\$1.91	\$1.97	28.13%

20  
21 Although the company has registered a high dividend growth rate (28.13%), it is not  
22 representative of the growth that could be sustained, as called for in the DCF model. In  
23 actuality, the sustainable growth rate (br) has declined due to the increased payout ratio. To  
24 utilize a 28 percent growth rate in a DCF analysis for this hypothetical utility would be to  
25 assume that the payout ratio could continue to increase indefinitely and lead to the unlikely  
26 result that the firm could consistently pay out more in dividends than it earns. The  
27 problems associated with sole reliance on historic dividend growth has been recognized in  
28 the financial literature. According to Brigham and Gapenski,  
29

1  
2 If earnings and dividends are growing at the same rate, there is no problem,  
3 but if these two growth rates are unequal, we do have a problem. First, the  
4 DCF model calls for the expected dividend growth rate. However, if EPS  
5 and DPS are growing at different rates, something is going to have to  
6 change: these two series cannot grow at two different rates indefinitely  
7 (Intermediate Financial Management, p.145).

**BURDETTE - DIRECT**  
**ER-2001-299 Empire District Electric Company**

**Historical Financial Information**

**ROE**

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>Average</u>
Empire District Electric	10.09%	8.49%	11.28%	9.95%

**Capital Structure**

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>Average</u>
Common Equity	42.4%	40.4%	45.2%	48.9%	44.2%
Preferred Stock	0.0%	0.0%	6.4%	7.3%	3.4%
Long Term Debt	57.6%	59.6%	48.4%	43.8%	52.3%
	100.0%	100.0%	100.0%	100.0%	100.0%

These percentages are calculated differently than my recommended capital structure.

**Financial Ratios**

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>Average</u>
EPS \$	1.35	\$ 1.13	\$ 1.53	\$ 1.29	\$ 1.33
DPS \$	1.28	\$ 1.28	\$ 1.28	\$ 1.28	\$ 1.28
Payout	94.8%	113.3%	83.7%	99.2%	96.6%
BVPS \$	13.62	\$ 13.44	\$ 13.40	\$ 13.03	\$ 13.37
Interest Coverage (pre-tax)	3.04	3.21	3.52	3.39	3.29

Source: Company response to data requests 2011, 2013, 2014

**BURDETTE - DIRECT****ER-2001-299 Empire District Electric Company****Empire District Electric Company****Capital Structure as of 31 December 2000**

	<u>Amount</u>	<u>Percent</u>
Common Stock Equity	\$ 240,152,911	41.86%
Long Term Debt	\$ 333,603,856	58.14%
	<u>\$ 573,756,767</u>	<u>100.00%</u>

**Common Stock Equity**

Common Stock	\$ 17,596,530
Paid-in capital	\$ 168,439,089
Retained Earnings	\$ 54,117,292
	<u>\$ 240,152,911</u>

Source: Company response to OPC DR2001 and 2002; Schedule MB-5

**BURDETTE - DIRECT**

**ER-2001-299 Empire District Electric Company**

**Risk Measures**

		(millions)	% Rev		Missouri
	<u>Public</u>	<u>Revenue</u>	<u>Elec</u>	<u>S&amp;P</u>	<u>Regulation?</u>
Black Hills Corporation	Yes	\$ 1,255.9	81.0%	A+	No
Cleco Corporation	Yes	\$ 741.4	81.0%	A+	No
DPL Inc.	Yes	\$ 1,437.0	77.0%	BBB+	No
DQE, Inc.	Yes	\$ 1,333.9	80.0%	BBB+	No
Hawaii Electric	Yes	\$ 1,719.0	73.0%	BBB+	No
IDACORP	Yes	\$ 768.1	96.0%	AA-	No
<b>Average</b>		<b>\$ 1,209.2</b>	<b>81.3%</b>	<b>A</b>	
<b>Empire District Electric</b>	<b>Yes</b>	<b>\$ 250.3</b>	<b>99.0%</b>	<b>A-</b>	<b>Yes</b>

		Payout	Common			Interest	Fixed Charge	Financial
	<u>Beta</u>	<u>Ratio</u>	<u>Equity</u>	<u>Safety</u>	<u>MTB</u>	<u>Coverage</u>	<u>Coverage</u>	<u>Strength</u>
Black Hills Corporation	0.50	48.0%	38.0%	2	3.33	5.1	400%	B++
Cleco Corporation	0.55	63.0%	38.0%	2	2.2	4.0	288%	B++
DPL Inc.	0.60	41.0%	23.0%	2	4.7	3.5	362%	B++
DQE, Inc.	0.50	72.0%	33.0%	2	1.99	4.0	198%	A
Hawaii Electric	0.50	98.0%	21.0%	3	1.37	3.8	215%	B+
IDACORP	<u>0.50</u>	<u>50.0%</u>	<u>45.0%</u>	<u>2</u>	<u>1.73</u>	<u>4.8</u>	<u>233%</u>	<u>B++</u>
Average	0.53	64.4%	30.6%	2.20	2.72	4.08	293%	B++
Empire District Electric	0.50	93.0%	39.0%	2	1.51	2.5	240%	B++

Source: C.A. Turner Utility Reports

Source: Value Line Investment Survey

**BURDETTE - DIRECT****ER-2001-299 Empire District Electric Company****Comparable Companies' Percent Common Equity  
Value Line Investment Survey Composite Index**

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>Average</u>
Black Hills Corporation	54.0%	54.7%	56.1%	55.7%	55.1%
Cleco Corporation	40.0%	41.0%	51.9%	49.2%	45.5%
DPL Inc.	30.0%	51.6%	56.0%	56.4%	48.5%
DQE, Inc.	34.0%	41.2%	47.1%	47.7%	42.5%
Hawaii Electric	40.0%	41.4%	43.1%	44.0%	42.1%
IDACORP	<u>46.5%</u>	<u>44.8%</u>	<u>44.2%</u>	<u>46.8%</u>	<u>45.6%</u>
<b>Average</b>	<b>40.8%</b>	<b>45.8%</b>	<b>49.7%</b>	<b>50.0%</b>	<b>46.6%</b>
<b>Empire District Electric</b>	<b>40.0%</b>	<b>40.4%</b>	<b>45.2%</b>	<b>48.9%</b>	<b>43.6%</b>

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>Average</u>
<b>Value Line Composite Index</b>	<b>44.5%</b>	<b>41.9%</b>	<b>44.5%</b>	<b>44.9%</b>	<b>44.0%</b>
<i>(Electric Utility Industry)</i>					
<b>Empire District Electric</b>	<b>40.0%</b>	<b>40.4%</b>	<b>45.2%</b>	<b>48.9%</b>	<b>43.6%</b>

Note: Calculations do not include short term debt

Source: Value Line Investment Survey

**BURDETTE - DIRECT**
**ER-2001-299 Empire District Electric Company**
**Empire District Electric Company**
**Embedded Cost of Long Term Debt as of 31 December 2000**

Description:	Issue Date	Maturity Date	a Amount Outstanding	b Interest Rate	c Annual Interest	d Unamortized Issuance Expense/ Premium	e Accrual Adjustment	f Annual Amortization Issuance Expenses/ Premium	g Unamortized Loss/ Discount	h=c+f Total Annual Issuance Cost and Interest	i=a-d-g Carrying Value
General mortgage	12/01/90	12/01/20	\$2,250,000	9.750%	\$ 219,375	\$ 25,382		\$ 1,650	\$ 7,480	\$ 221,025	\$ 2,217,138
	07/01/92	07/01/02	\$37,500,000	7.500%	\$ 2,812,500	\$ 73,571		\$ 228,559	\$ 269,267	\$ 3,041,059	\$ 37,157,162
	04/01/98	04/01/10	\$50,000,000	6.500%	\$ 3,250,000	\$ 427,429		\$ 73,542	\$ 252,833	\$ 3,323,542	\$ 49,319,738
	11/01/94	11/01/09	\$20,000,000	8.125%	\$ 1,625,000	\$ 146,538		\$ 24,924	\$ 73,611	\$ 1,649,924	\$ 19,779,851
	10/01/93	10/01/23	\$45,000,000	7.000%	\$ 3,150,000	\$ 476,859		\$ 239,717	\$4,976,695	\$ 3,389,717	\$ 39,546,446
	06/01/93	06/01/28	\$13,330,000	7.250%	\$ 966,425	\$ 616,502		\$ 22,486		\$ 988,911	\$ 12,713,498
	11/01/93	11/01/13	\$8,000,000	5.300%	\$ 424,000	\$ 310,368	\$ (156)	\$ 38,440	\$ 182,940	\$ 462,440	\$ 7,506,692
	11/01/93	11/01/13	\$5,200,000	5.200%	\$ 270,400	\$ 242,745	\$ (120)	\$ 27,363	\$ 108,407	\$ 297,763	\$ 4,848,848
	04/01/95	04/01/05	\$10,000,000	7.600%	\$ 760,000	\$ 88,714		\$ 20,874		\$ 780,874	\$ 9,911,286
	12/01/96	12/01/16	\$25,000,000	7.200%	\$ 1,800,000	\$ 377,899		\$ 23,742		\$ 1,823,742	\$ 24,622,101
	06/01/95	06/01/25	\$30,000,000	7.750%	\$ 2,325,000	\$ 357,500	\$ 8,796	\$ 133,239	\$2,895,751	\$ 2,458,239	\$ 26,746,749
Unsecured	11/01/99	11/15/04	\$100,000,000	7.700%	\$ 7,700,000	\$ 626,120		\$ 199,736	\$ 139,533	\$ 7,899,736	\$ 99,234,347
			\$346,280,000		\$25,302,700	\$3,769,627	\$ 8,520	\$1,034,272	\$8,906,517	\$ 26,336,972	\$333,603,856

Total carrying value \$ 333,603,856

Total annual expense \$ 26,336,972 =c+e+f

 Overall embedded cost **7.895%**

**BURDETTE - DIRECT**  
**ER-2001-299 Empire District Electric Company**

**Summary - Discounted Cash Flow Growth**

Note: Negative growth is not included in averages.

Historic Growth		Compound Growth			Value Line		
COMPANY	br + sv	EPS	DPS	BVPS	EPS	DPS	BVPS
Black Hills Corporation	7.88%	10.99%	3.77%	5.62%	6.00%	4.00%	5.00%
Cleco Corporation	4.25%	4.37%	2.58%	4.69%	3.25%	3.00%	4.00%
DPL Inc.	1.15%	5.70%	3.19%	6.53%	4.00%	4.25%	4.25%
DQE, Inc.	0.94%	7.67%	0.00%	2.84%	6.50%	6.00%	4.50%
Hawaii Electric	1.67%	2.69%	1.14%	7.20%	2.50%	2.00%	2.25%
IDACORP	3.45%	7.67%	0.00%	2.84%	4.75%	0.50%	1.75%
Average	3.22%	6.52%	1.78%	4.95%	4.50%	3.29%	3.63%
Empire District Electric Company	2.25%	4.77%	0.00%	1.62%	1.00%	2.25%	2.00%

Projected Growth		Value Line/First Call			
COMPANY	br + sv	EPS	DPS	BVPS	
Black Hills Corporation	10.33%	9.50%	3.50%	10.00%	
Cleco Corporation	4.71%	3.75%	2.50%	6.00%	
DPL Inc.	16.39%	10.75%	1.00%	8.00%	
DQE, Inc.	7.61%	6.25%	5.00%	2.00%	
Hawaii Electric	3.50%	4.25%	0.00%	2.00%	
IDACORP	5.24%	6.75%	0.00%	5.50%	
Average	7.96%	6.88%	2.00%	5.58%	
Empire District Electric Company	4.61%	3.15%	0.00%	2.50%	5.61%

Ranges		Overall		Hi/Low	
COMPANY	Average	High	Low*	Average	Median
Black Hills Corporation	6.96%	10.99%	3.50%	7.24%	6.00%
Cleco Corporation	3.92%	6.00%	2.50%	4.25%	4.00%
DPL Inc.	5.93%	16.39%	1.00%	8.70%	4.25%
DQE, Inc.	4.48%	7.67%	0.00%	3.84%	5.00%
Hawaii Electric	2.66%	7.20%	0.00%	3.60%	2.25%
IDACORP	3.50%	7.67%	0.00%	3.84%	3.45%
Average	4.57%	9.32%	1.17%	5.24%	4.16%
Empire District Electric Company	2.19%	4.77%	0.00%	2.39%	2.25%

Note: Negative growth rates not included in averages and are excluded from determination of "Low".



**BURDETTE - DIRECT**  
**ER-2001-299 Empire District Electric Company**

**Discounted Cash Flow Growth Parameters**  
**Empire District Electric Company**

<u>Historic Growth</u>					<u>Retention Growth</u>		
<u>Compound Growth</u>					<u>Retention</u>	<u>Equity</u>	<u>Growth</u>
	<u>Historic Data</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>	<u>Ratio (b)</u>	<u>Return (r)</u>	<u>(b*r)</u>
1	1994	1.32	1.28	12.47	0.030		
2	1995	1.18	1.28	12.69	-0.085		
3	1996	1.23	1.28	12.96	-0.041	9.20%	-0.37%
4	1997	1.29	1.28	13.06	0.008	9.80%	0.08%
5	1998	1.53	1.28	13.43	0.163	12.30%	2.01%
6	1999	1.46	1.28	13.51	0.123	11.90%	1.47%
7	2000	1.50	1.28	13.70	0.147	11.00%	1.61%
8							
9	<u>Compound Growth Rates</u>					<u>Ave. Internal</u>	
10	'94-98	3.76%	0.00%	1.87%		<u>Growth (br):</u>	1.29%
11							
12	'95-99	5.47%	0.00%	1.58%		<u>ADD: External</u>	
13						<u>Growth (sv):</u>	0.96%
14	'96-00	5.09%	0.00%	1.40%			
15						<u>Historic</u>	
16	<u>Ave. Compound Gr.</u>	<u>4.77%</u>	<u>0.00%</u>	<u>1.62%</u>		<u>"br + sv" Gr.</u>	<u>2.25%</u>
17							
18	<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>			
19	<u>Historic Gr.</u>	<u>1.00%</u>	<u>2.25%</u>	<u>2.00%</u>			
20	(Avg of 5 and 10 yr. if both are available)						
21							
22	<u>Projected Growth</u>						
23	<u>Retention Growth Calculation</u>				<u>Retention</u>	<u>Equity</u>	<u>Growth</u>
24	<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>	<u>Ratio (b)</u>	<u>Return (r)</u>	<u>(b*r)</u>
25	2001 est'd	\$1.65	\$1.28	\$13.80	0.224	12.00%	2.69%
26							
27	2003-05 est'd	2.00	1.32	15.50	0.340	13.00%	4.42%
28							
29	<u>Analyst's Estimates</u>					<u>Projected</u>	
30	<u>Value Line</u>	6.00%	0.00%	2.50%		<u>Growth (br):</u>	4.42%
31							
32	<u>First Call</u>	0.30%				<u>ADD: External</u>	
33	<u>Zack's</u>					<u>Growth (sv):</u>	0.19%
34							
35	<u>Average</u>					<u>Projected</u>	
36	<u>Proj'd Growth</u>	<u>3.15%</u>	<u>0.00%</u>	<u>2.50%</u>		<u>"br + sv" Gr.</u>	<u>4.61%</u>

Note: Negative (b\*r) growth is not included in retention growth averages.

SOURCE: The Value Line Investment Survey; C.A. Turner Utility Reports;  
 First Call Corporation

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**BURDETTE - DIRECT**  
**ER-2001-299 Empire District Electric Company**

**Discounted Cash Flow Growth Parameters**  
**Black Hills Corporation**

**Historic Growth**

**Compound Growth**

<u>Historic Data</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
1994	1.11	0.88	8.13
1995	1.19	0.89	8.43
1996	1.40	0.92	8.91
1997	1.49	0.95	9.46
1998	1.60	1.00	9.58
1999	1.70	1.04	10.14
2000	2.37	1.08	12.10

**Compound Growth Rates**

'94-98	9.57%	3.25%	4.19%
'95-99	9.33%	3.97%	4.73%
'96-00	14.07%	4.09%	7.95%

Ave. Compound Gr. **10.99%** **3.77%** **5.62%**

Value Line	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
Historic Gr.	<b>6.00%</b>	<b>4.00%</b>	<b>5.00%</b>

(Avg of 5 and 10 yr. if both are available)

**Projected Growth**

**Retention Growth Calculation**

<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
2001 est'd	\$2.30	\$1.12	\$13.50
2003-05 est'd	3.00	1.24	18.50

**Analyst's Estimates**

Value Line	9.50%	3.50%	10.00%
------------	-------	-------	--------

First Call n/a

Average  
Proj'd Growth **9.50%** **3.50%** **10.00%**

**Retention Growth**

<u>Retention Ratio (b)</u>	<u>Equity Return (r)</u>	<u>Growth (b*r)</u>
0.207		
0.252		
0.343	15.70%	5.38%
0.362	15.80%	5.73%
0.375	16.70%	6.26%
0.388	16.80%	6.52%
0.544	19.00%	10.34%

Ave. Internal  
Growth (br): 6.85%

ADD: External  
Growth (sv): 1.03%

Historic  
"br + sv" Gr. **7.88%**

<u>Retention Ratio (b)</u>	<u>Equity Return (r)</u>	<u>Growth (b*r)</u>
0.513	17.00%	8.72%
0.587	16.00%	9.39%

Projected  
Growth (br): 9.39%

ADD: External  
Growth (sv): 0.95%

Projected  
"br + sv" Gr. **10.33%**

Note: Negative (b\*r) growth is not included in retention growth averages.

SOURCE: The Value Line Investment Survey; C.A. Turner Utility Reports;  
 First Call Corporation

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**BURDETTE - DIRECT**  
**ER-2001-299 Empire District Electric Company**

**Discounted Cash Flow Growth Parameters**  
**Cleco Corporation**

<u>Historic Growth</u>					<u>Retention Growth</u>		
<u>Compound Growth</u>					<u>Retention Ratio (b)</u>	<u>Equity Return (r)</u>	<u>Growth (b*r)</u>
	<u>Historic Data</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>			
1	1994	1.92	1.45	15.12	0.245		
2	1995	2.08	1.49	15.82	0.284		
3	1996	2.23	1.53	16.60	0.314	13.40%	4.21%
4	1997	2.18	1.57	17.36	0.280	12.90%	3.61%
5	1998	2.24	1.61	18.13	0.281	12.70%	3.57%
6	1999	2.37	1.65	18.88	0.304	12.90%	3.92%
7	2000	2.80	1.69	20.10	0.396	14.50%	5.75%
8							
9	<u>Compound Growth Rates</u>					<u>Ave. Internal Growth (br):</u>	4.21%
10	'94-98	3.93%	2.65%	4.64%			
11						<u>ADD: External Growth (sv):</u>	0.03%
12	'95-99	3.32%	2.58%	4.52%			
13							
14	'96-00	5.86%	2.52%	4.90%			
15						<u>Historic "br + sv" Gr.</u>	<u>4.25%</u>
16	<u>Ave. Compound Gr.</u>	<u>4.37%</u>	<u>2.58%</u>	<u>4.69%</u>			
17							
18	<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>			
19	<u>Historic Gr.</u>	<u>3.25%</u>	<u>3.00%</u>	<u>4.00%</u>			
20	(Avg of 5 and 10 yr. if both are available)						
21							
22	<u>Projected Growth</u>						
23	<u>Retention Growth Calculation</u>						
24	<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>	<u>Retention Ratio (b)</u>	<u>Equity Return (r)</u>	<u>Growth (b*r)</u>
25	2001 est'd	\$2.95	\$1.73	\$21.35	0.414	14.50%	6.00%
26							
27	2003-05 est'd	3.50	1.85	25.75	0.471	10.00%	4.71%
28							
29	<u>Analyst's Estimates</u>					<u>Projected Growth (br):</u>	4.71%
30	<u>Value Line</u>	7.50%	2.50%	6.00%			
31						<u>ADD: External Growth (sv):</u>	0.00%
32	<u>First Call</u>	10.10%					
33	<u>Zack's</u>						
34							
35	<u>Average</u>					<u>Projected "br + sv" Gr.</u>	<u>4.71%</u>
36	<u>Proj'd Growth</u>	<u>3.75%</u>	<u>2.50%</u>	<u>6.00%</u>			

Note: Negative (b\*r) growth is not included in retention growth averages.

SOURCE: The Value Line Investment Survey; C.A. Turner Utility Reports;  
 First Call Corporation

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**BURDETTE - DIRECT****ER-2001-299 Empire District Electric Company****Discounted Cash Flow Growth Parameters****DPL Inc.****Historic Growth****Compound Growth**

	<u>Historic Data</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
1	1994	1.03	0.79	7.03
2	1995	1.09	0.83	7.28
3	1996	1.15	0.87	7.55
4	1997	1.20	0.91	8.03
5	1998	1.24	0.94	8.58
6	1999	1.35	0.94	9.20
7	2000	1.50	0.94	10.45

**Compound Growth Rates**

9				
10	'94-98	4.75%	4.44%	5.11%
11				
12	'95-99	5.49%	3.16%	6.03%
13				
14	'96-00	6.87%	1.95%	8.47%

16	<u>Ave. Compound Gr.</u>	<u>5.70%</u>	<u>3.19%</u>	<u>6.53%</u>
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18	Value Line	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
19	Historic Gr.	<u>4.00%</u>	<u>4.25%</u>	<u>4.25%</u>

(Avg of 5 and 10 yr. if both are available)

**Projected Growth****Retention Growth Calculation**

	<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>	<u>Retention Ratio (b)</u>	<u>Equity Return (r)</u>	<u>Growth (b*r)</u>
23							
24							
25	2001 est'd	\$1.80	\$0.94	\$11.40	0.478	26.00%	12.42%
26							
27	2003-05 est'd	2.40	1.00	13.80	0.583	23.00%	13.42%

**Analyst's Estimates**

28							
29							
30	Value Line	11.50%	1.00%	8.00%		<u>Projected Growth (br):</u>	13.42%
31							
32	First Call	10.00%				<u>ADD: External Growth (sv):</u>	2.98%
33							
34							
35	Average					<u>Projected "br + sv" Gr.</u>	<u>16.39%</u>
36	<u>Proj'd Growth</u>	<u>10.75%</u>	<u>1.00%</u>	<u>8.00%</u>			

Note: Negative (b\*r) growth is not included in retention growth averages.

SOURCE: The Value Line Investment Survey; C.A. Turner Utility Reports;  
First Call Corporation

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**BURDETTE - DIRECT****ER-2001-299 Empire District Electric Company****Discounted Cash Flow Growth Parameters****DQE, Inc.****Historic Growth****Compound Growth**

<u>Historic Data</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
1994	1.99	1.13	16.27
1995	2.20	1.22	17.13
1996	2.32	1.30	18.01
1997	2.40	1.38	19.30
1998	2.52	1.46	19.18
1999	2.65	1.54	18.78
2000	1.62	1.62	14.95

**Compound Growth Rates**

'94-98	6.08%	6.62%	4.20%
'95-99	4.76%	6.00%	2.33%
'96-00	-8.59%	5.66%	-4.55%

<u>Ave. Compound Gr.</u>	<u>5.42%</u>	<u>6.09%</u>	<u>3.26%</u>
--------------------------	--------------	--------------	--------------

<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
<u>Historic Gr.</u>	<u>6.50%</u>	<u>6.00%</u>	<u>4.50%</u>

(Avg of 5 and 10 yr. if both are available)

**Projected Growth****Retention Growth Calculation**

<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>
2001 est'd	\$2.85	\$1.70	\$16.10
2002 est'd	3.00	1.78	17.30
2004-06 est'd	3.65	2.03	21.65

**Analyst's Estimates**

<u>Value Line</u>	<u>5.50%</u>	<u>5.00%</u>	<u>2.00%</u>
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<u>First Call</u>	<u>7.00%</u>
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<u>Average</u>			
<u>Proj'd Growth</u>	<u>6.25%</u>	<u>5.00%</u>	<u>2.00%</u>

**Retention Growth**

<u>Retention</u>	<u>Equity</u>	<u>Growth</u>
<u>Ratio (b)</u>	<u>Return (r)</u>	<u>(b*r)</u>
0.432		
0.445		
0.440	12.00%	5.28%
0.425	11.60%	4.93%
0.421	12.10%	5.09%
0.419	14.80%	6.20%
0.000	12.00%	0.00%

<u>Ave. Internal</u>	
<u>Growth (br):</u>	<u>4.05%</u>

<u>ADD: External</u>	
<u>Growth (sv):</u>	<u>-3.11%</u>

<u>Historic</u>	
<u>"br + sv" Gr.</u>	<u>0.94%</u>

<u>Retention</u>	<u>Equity</u>	<u>Growth</u>
<u>Ratio (b)</u>	<u>Return (r)</u>	<u>(b*r)</u>
0.404	17.50%	7.06%
0.407	17.50%	7.12%
0.444	17.00%	7.55%

<u>Projected</u>	
<u>Growth (br):</u>	<u>7.55%</u>

<u>ADD: External</u>	
<u>Growth (sv):</u>	<u>0.07%</u>

<u>Projected</u>	
<u>"br + sv" Gr.</u>	<u>7.61%</u>

Note: Negative (b\*r) growth is not included in retention growth averages.

SOURCE: The Value Line Investment Survey; C.A. Turner Utility Reports;  
First Call Corporation

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**BURDETTE - DIRECT**  
**ER-2001-299 Empire District Electric Company**

**Discounted Cash Flow Growth Parameters**  
**Hawaii Electric**

<u>Historic Growth</u>					<u>Retention Growth</u>		
<u>Compound Growth</u>					<u>Retention</u>	<u>Equity</u>	<u>Growth</u>
	<u>Historic Data</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>	<u>Ratio (b)</u>	<u>Return (r)</u>	<u>(b*r)</u>
1	1994	2.60	2.33	5.96	0.104		
2	1995	2.66	2.37	6.26	0.109		
3	1996	2.60	2.41	6.41	0.073	10.20%	0.75%
4	1997	2.76	2.44	7.00	0.116	10.60%	1.23%
5	1998	2.96	2.48	7.39	0.162	11.40%	1.85%
6	1999	2.89	2.48	8.35	0.142	11.00%	1.56%
7	2000	2.52	2.48	8.92	0.016	10.00%	0.16%
8							
9	<u>Compound Growth Rates</u>					<u>Ave. Internal</u>	
10	'94-98	3.30%	1.57%	5.52%		<u>Growth (br):</u>	1.11%
11							
12	'95-99	2.09%	1.14%	7.47%		<u>ADD: External</u>	
13						<u>Growth (sv):</u>	0.56%
14	'96-00	-0.78%	0.72%	8.61%			
15						<u>Historic</u>	
16	<u>Ave. Compound Gr.</u>	<u>2.69%</u>	<u>1.14%</u>	<u>7.20%</u>		<u>"br + sv" Gr.</u>	<u>1.67%</u>
17							
18	<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>			
19	<u>Historic Gr.</u>	<u>2.50%</u>	<u>2.00%</u>	<u>2.25%</u>			
20	(Avg of 5 and 10 yr. if both are available)						
21							
22	<u>Projected Growth</u>						
23	<u>Retention Growth Calculation</u>				<u>Retention</u>	<u>Equity</u>	<u>Growth</u>
24	<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>	<u>Ratio (b)</u>	<u>Return (r)</u>	<u>(b*r)</u>
25	2001 est'd	\$3.30	\$2.48	\$26.40	0.248	12.50%	3.11%
26							
27	2003-05 est'd	3.50	2.48	29.25	0.291	11.50%	3.35%
28							
29	<u>Analyst's Estimates</u>					<u>Projected</u>	
30	<u>Value Line</u>	3.50%	0.00%	2.00%		<u>Growth (br):</u>	3.35%
31							
32	<u>First Call</u>	5.00%				<u>ADD: External</u>	
33	<u>Zack's</u>					<u>Growth (sv):</u>	0.15%
34							
35	<u>Average</u>					<u>Projected</u>	
36	<u>Proj'd Growth</u>	<u>4.25%</u>	<u>0.00%</u>	<u>2.00%</u>		<u>"br + sv" Gr.</u>	<u>3.50%</u>

Note: Negative (b\*r) growth is not included in retention growth averages.

SOURCE: The Value Line Investment Survey; C.A. Turner Utility Reports;  
 First Call Corporation

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**BURDETTE - DIRECT**  
**ER-2001-299 Empire District Electric Company**

**Discounted Cash Flow Growth Parameters**  
**IDACORP Inc.**

<u>Historic Growth</u>					<u>Retention Growth</u>		
<u>Compound Growth</u>					Retention	Equity	Growth
	<u>Historic Data</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>	<u>Ratio (b)</u>	<u>Return (r)</u>	<u>(b*r)</u>
1	1994	1.80	1.86	17.91	-0.033		
2	1995	2.10	1.86	18.15	0.114		
3	1996	2.21	1.86	18.47	0.158	11.90%	1.88%
4	1997	2.32	1.86	18.93	0.198	12.20%	2.42%
5	1998	2.37	1.86	19.42	0.215	12.20%	2.63%
6	1999	2.43	1.86	20.02	0.235	12.10%	2.84%
7	2000	3.50	1.86	21.60	0.469	16.50%	7.73%
8							
9	<u>Compound Growth Rates</u>					Ave. Internal	
10	'94-98	7.12%	0.00%	2.04%		<u>Growth (br):</u>	3.50%
11							
12	'95-99	3.72%	0.00%	2.48%		ADD: External	
13						<u>Growth (sv):</u>	-0.05%
14	'96-00	12.18%	0.00%	3.99%			
15						Historic	
16	<u>Ave. Compound Gr.</u>	<u>7.67%</u>	<u>0.00%</u>	<u>2.84%</u>		<u>"br + sv" Gr.</u>	<u>3.45%</u>
17							
18	Value Line	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>			
19	Historic Gr.	<u>4.75%</u>	<u>0.50%</u>	<u>1.75%</u>			
20	(Avg of 5 and 10 yr. if both are available)						
21							
22	<u>Projected Growth</u>						
23	<u>Retention Growth Calculation</u>				Retention	Equity	Growth
24	<u>Value Line</u>	<u>EPS</u>	<u>DPS</u>	<u>BVPS</u>	<u>Ratio (b)</u>	<u>Return (r)</u>	<u>(b*r)</u>
25	2001 est'd	\$3.15	\$1.86	\$22.85	0.410	14.00%	5.73%
26							
27	2003-05 est'd	3.30	1.86	27.05	0.436	12.00%	5.24%
28							
29	<u>Analyst's Estimates</u>					Projected	
30	Value Line	5.50%	0.00%	5.50%		<u>Growth (br):</u>	5.24%
31							
32	First Call	8.00%				ADD: External	
33						<u>Growth (sv):</u>	0.00%
34							
35	Average					Projected	
36	<u>Proj'd Growth</u>	<u>6.75%</u>	<u>0.00%</u>	<u>5.50%</u>		<u>"br + sv" Gr.</u>	<u>5.24%</u>

Note: Negative (b\*r) growth is not included in retention growth averages.

SOURCE: The Value Line Investment Survey; C.A. Turner Utility Reports;  
 First Call Corporation

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**BURDETTE - DIRECT****ER-2001-299 Empire District Electric Company****Stock Prices and Dividend Yields****Stock Price**

	Fri <u>2/16/01</u>	Fri <u>2/23/01</u>	Fri <u>3/2/01</u>	Fri <u>3/9/01</u>	Fri <u>3/16/01</u>	Fri <u>3/23/01</u>	<u>Average</u>
<b>Empire District Electric Company</b>	\$ 20.660	\$ 19.980	\$ 20.250	\$ 19.540	\$ 18.910	\$ 17.750	<b>\$ 19.515</b>
Black Hills Corporation	\$ 39.550	\$ 38.390	\$ 40.200	\$ 43.380	\$ 43.500	\$ 43.000	<b>\$ 41.337</b>
Cleco Corporation	\$ 46.020	\$ 45.500	\$ 45.480	\$ 45.720	\$ 44.120	\$ 42.000	<b>\$ 44.807</b>
DPL Inc.	\$ 28.250	\$ 28.320	\$ 29.200	\$ 29.010	\$ 27.500	\$ 25.800	<b>\$ 28.013</b>
DQE, Inc.	\$ 33.000	\$ 31.750	\$ 32.320	\$ 32.010	\$ 30.690	\$ 28.820	<b>\$ 31.432</b>
Hawaii Electric	\$ 36.440	\$ 35.670	\$ 36.540	\$ 36.400	\$ 35.630	\$ 34.700	<b>\$ 35.897</b>
IDACORP	\$ 38.000	\$ 36.750	\$ 37.200	\$ 37.500	\$ 35.500	\$ 34.840	<b>\$ 36.632</b>

**Expected Dividend and Dividend Yield**

	<u>Average</u> <u>Stk. Price</u>	<u>Expected</u> <u>Dividend</u>	<u>Dividend</u> <u>Yield</u>
<b>Empire District Electric Company</b>	\$ 19.515	\$ 1.28	<b>6.56%</b>
Black Hills Corporation	\$ 41.337	\$ 1.12	<b>2.71%</b>
Cleco Corporation	\$ 44.807	\$ 1.73	<b>3.86%</b>
DPL Inc.	\$ 28.013	\$ 0.94	<b>3.36%</b>
DQE, Inc.	\$ 31.432	\$ 1.70	<b>5.41%</b>
Hawaii Electric	\$ 35.897	\$ 2.48	<b>6.91%</b>
IDACORP	\$ 36.632	\$ 1.86	<b>5.08%</b>

**Comparable company average:****4.55%**

Source: Value Line Investment Survey; Wall Street Journal.



**BURDETTE - DIRECT****ER-2001-299 Empire District Electric Company****DCF Cost of Common Equity Calculations**

	Dividend	Growth		Cost of Equity	
	<u>Yield</u>	<u>Low</u>	<u>High</u>	<u>Low</u>	<u>High</u>
<b>Empire District Electric</b>	<b>6.56%</b>	<b>0.00%</b>	<b>4.77%</b>	<b>6.56%</b>	<b>11.33%</b>
Black Hills Corporation	2.71%	3.50%	10.99%	6.21%	13.70%
Cleco Corporation	3.86%	2.50%	6.00%	6.36%	9.86%
DPL Inc.	3.36%	1.00%	16.39%	4.36%	19.75%
DQE, Inc.	5.41%	0.00%	7.67%	5.41%	13.08%
Hawaii Electric	6.91%	0.00%	7.20%	6.91%	14.11%
IDACORP	<u>5.08%</u>	<u>0.00%</u>	<u>7.67%</u>	<u>5.08%</u>	<u>12.75%</u>
<b>Average</b>	<b>4.55%</b>	<b>1.17%</b>	<b>9.32%</b>	<b>5.72%</b>	<b>13.87%</b>

**Comparison companys' DCF Hi/Low average: 9.80%****Empire District Electric Company**

**BURDETTE - DIRECT****ER-2001-299 Empire District Electric Company****Capital Asset Pricing Model (CAPM) Cost of Common Equity (Ke)**

$$\text{Formula: } K_e = R_f + \text{beta}(R_m - R_f)$$

Risk Free Rate (Rf) = 4.76%

Market Premium (Rm - Rf) = 7.80%

**Value Line Investment Survey Water Companies**

	<u>Beta</u>	<u>CAPM Ke</u>
Empire District Electric Company	0.50	8.66%
Black Hills Corporation	0.50	8.66%
Cleco Corporation	0.55	9.05%
DPL Inc.	0.60	9.44%
DQE, Inc.	0.50	8.66%
Hawaii Electric	0.50	8.66%
IDACORP	0.50	8.66%
Average CAPM cost of equity:		<u>8.66%</u>
Overall Average:		<span style="border: 1px solid black;">8.86%</span>

Source: Value Line Investment Survey; Ibbotson Associates;

**BURDETTE - DIRECT****ER-2001-299 Empire District Electric Company****Empire District Electric Company****Weighted Average Cost of Capital**

	<u>Amount</u>	<u>Percent</u>	<u>Cost Rate</u>	Weighted <u>Cost</u>	<u>Cost Rate</u>	Weighted <u>Cost</u>
Common Stock Equity \$	240,152,911	41.86%	10.00%	4.19%	10.25%	4.29%
Long Term Debt \$	333,603,856	58.14%	7.895%	4.59%	7.895%	4.59%
	<u>\$ 573,756,767</u>	<u>100.00%</u>		<u>8.78%</u>		<u>8.88%</u>

**Pre-Tax Interest Coverage**

Tax factor = 1.62308

	Weighted <u>Cost</u>	Pre-tax Weighted <u>Cost</u>	Weighted <u>Cost</u>	Pre-tax Weighted <u>Cost</u>
Common Stock Equity	4.19%	6.79%	4.29%	6.96%
Long Term Debt	4.59%	4.59%	4.59%	4.59%
Total	8.78%	11.38%	8.88%	11.55%
Pre-tax weighted cost:		11.38%	Pre-tax wtd. cost:	11.55%
Cost of Debt:		4.59%	Cost of Debt:	4.59%
Pre-tax Interest Coverage		<u>2.48</u>		<u>2.52</u>

Source: Schedules MB-2, MB-5, MB-6, MB-7.