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Witness: Robert W. Sager
Type of Exhibit: Direct Testimony
Sponsoring Party: Empire District Electric
Case No. ER-2012-0345
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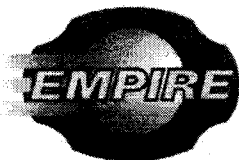
**Before the Public Service Commission
of the State of Missouri**

Direct Testimony

of

Robert W. Sager

July 2012



SERVICES YOU COUNT ON

Empire Exhibit No. 4
Date 9-10-12 Reporter XF
File No. ER-2012-0345

TABLE OF CONTENT
DIRECT TESTIMONY
OF
ROBERT W. SAGER
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
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INTRODUCTION 1
STOCK ISSUANCE COSTS 2
CAPITAL STRUCTURE 2
FINANCIAL IMPACT OF TORNADO 4

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1 **INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. Robert W. Sager, 602 South Joplin Avenue, Joplin, Missouri 64801.

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

5 A. The Empire District Electric Company ("Empire" or "Company") is my employer.

6 I hold the positions of Controller, Assistant Treasurer, and Assistant Secretary.

7 **Q. WHAT ARE YOUR QUALIFICATIONS AND PREVIOUS WORK**
8 **EXPERIENCES?**

9 A. I am a licensed Certified Public Accountant and hold a Bachelor of Science
10 Degree in Accounting from Pittsburg State University, Pittsburg, Kansas. I have
11 been employed by Empire since October of 2006 and was the Director of
12 Financial Services prior to being named to my current position in August of 2011.
13 I worked for a regional public accounting firm for approximately ten years prior
14 to coming to Empire. While practicing public accounting, I was a senior manager
15 providing auditing and consulting services to various clients including
16 corporations that filed with the Securities & Exchange Commission ("SEC").

17 **Q. HAVE YOU PREVIOUSLY PARTICPATED IN ANY REGULATORY**
18 **PROCEEDINGS?**

1 A. Yes, I have. I provided testimony before the Missouri Public Service Commission
2 (“Commission”) in the Company’s previous electric rate cases, Case Nos. ER-
3 2011-0004, ER-2010-0130, and ER-2008-0093, and in The Empire District Gas
4 Company’s rate case, Case No. GR-2009-0434.

5 **Q. PLEASE EXPLAIN THE PURPOSE OF YOUR DIRECT TESTIMONY.**

6 A. I will support the rate case adjustments related to stock issuance costs, support
7 Empire’s capital structure and the adjustments to it, discuss Empire’s actual
8 earnings over the last ten years, and provide an analysis of the financial impact of
9 the May 22, 2011 Joplin tornado.

10 **RATE CASE ADJUSTMENT - STOCK ISSUANCE COSTS**

11 **Q. PLEASE DESCRIBE THE STOCK ISSUANCE ADJUSTMENT.**

12 A. The adjustment for stock issuance costs considers the transactions recorded in
13 account 214100, Stock Issuance Costs, for the five-year period ending 3/31/12.
14 Stock issuance costs have been allocated between our electric and gas operations
15 based on the ratio of plant in service as of 3/31/12. This allocation necessitates an
16 adjustment increasing expense by \$1.4 million.

17 **CAPITAL STRUCTURE**

18 **Q. WHAT CAPITAL STRUCTURE IS EMPIRE PROPOSING IN THIS**
19 **RATE CASE?**

20 A. Empire’s filing is based upon the Company’s consolidated capital structure at
21 March 31, 2012, with two adjustments. The capital structure, as adjusted, is as
22 follows:

ROBERT W. SAGER
DIRECT TESTIMONY

Pro Forma Capital Structure:	Amount Outstanding	% of Total	Cost Rate	Weighted Return on Tariffs Filed
Long-term Debt	\$669,016,299	49.00%	5.94%	2.91%
Common Equity	696,418,294	51.00%	10.60%	5.41%
Short-term Debt	0	0.00%	0.87%	0.00%
Total	\$1,365,434,593	100.00%		8.32%

1 **Q. PLEASE EXPLAIN THE PROPOSED ADJUSTMENTS TO THE MARCH**
2 **31, 2012 CONSOLIDATED CAPITAL STRUCTURE.**

3 A. Consistent with the Company’s previous electric rate cases, Empire has excluded
4 short-term debt from the capital structure. In past rate cases, this exclusion was
5 accepted since the balance of short-term debt was assumed to fund construction
6 work in progress (“CWIP”) and is less than the thirteen month average balance of
7 CWIP. Like short-term debt, CWIP is excluded from the calculation of revenue
8 requirement in the rate case.

9 On April 1, 2012, the Company commenced a refinancing of approximately \$88
10 million. Approximately \$13 million of tax-exempt pollution control bonds and
11 \$75 million of 7% series first mortgage bonds were refinanced with 3.578% first
12 mortgage bonds. \$38 million of the new bonds were issued on April 2, 2012 and
13 the remaining \$50 million were issued on June 1, 2012. The Company’s adjusted
14 capital structure takes these transactions into consideration.

15 **Q. SHOULD THE CAPITAL STRUCTURE FOR PURPOSES OF THIS CASE**
16 **BE UPDATED THROUGH THE REQUESTED TRUE-UP PERIOD?**

17 A. Yes. Empire seeks an update to the capital structure as of the requested true-up
18 date of December 31, 2012.

1 **EARNINGS**

2 **Q. WHAT RETURNS ON EQUITY HAS THE COMMISSION AUTHORIZED**
3 **FOR EMPIRE DURING THE LAST TEN YEARS?**

4 A. In those Empire rate cases during the last ten years where the Commission made
5 findings concerning return on equity, the Commission authorized returns on
6 equity of 11 percent in 2005, 10.9 percent in 2006, and 10.8 percent in 2009.

7 **Q. HAS EMPIRE BEEN ABLE TO EARN ITS AUTHORIZED RETURN ON**
8 **EQUITY DURING THE LAST TEN YEARS?**

9 A. No. Empire's highest earned rate of return during the last ten years was in
10 calendar year 2006, when Empire earned 8.4 percent. I have attached Schedule
11 RWS-1 to my testimony, which displays Empire's actual earnings over the last
12 ten years. As indicated on Schedule RWS-1, Empire's actual earnings over the
13 last ten years have only exceeded 8 percent in one year.

14 **FINANCIAL IMPACT OF TORNADO**

15 **Q. WHAT WAS EMPIRE'S FINANCIAL CONDITION PRIOR TO THE**
16 **MAY 2011 JOPLIN TORNADO?**

17 A. Empire's historical earnings had been below those levels authorized by the
18 Commission for an extended period of time. As a result, at the time of the
19 tornado, Empire's retained earnings were at a very low level, and Empire was
20 unable to sustain the financial impact of the tornado without taking immediate
21 cost-saving measures.

22 **Q. WHY WAS EMPIRE'S RETAINED EARNINGS AT A LOW LEVEL?**

1 A. Several factors over the years contributed to the low level of retained earnings.
2 Prior to the Commission's September 2008 approval of a fuel adjustment
3 mechanism or "FAC" for Empire, one of the major drivers that negatively
4 affected earnings was volatile fuel and energy prices. As Commission Staff
5 witness Lena Mantle, pointed out in testimony in Case No. ER-2008-0093,
6 Empire had absorbed over \$85 million in increased energy costs prior to the
7 implementation of the FAC. In addition to volatile fuel and energy costs, a variety
8 of other factors, including a very large construction program, the costs from two
9 major ice storms in 2007, tax write-offs due to changes in the tax laws, and
10 weather variations from year to year, all affected Empire's earnings.

11 **Q. HOW DID EMPIRE'S CONSTRUCTION PROGRAM IMPACT**
12 **EARNINGS?**

13 A. Empire's construction program and its reflection in rates involved a certain
14 amount of regulatory lag. This lag placed downward pressure on earnings. Just
15 prior to the tornado, Empire was in the final stages of the largest construction
16 program in the Company's history and had just completed the final rate case
17 contemplated by Empire's Regulatory Plan. The five year construction process
18 had placed pressure on Empire's overall financial metrics, but these metrics had
19 been improving as the Company periodically implemented rate increases to
20 recover the cost of the various construction projects. Throughout the five years of
21 the construction program, Empire's credit ratings had been the lowest investment
22 grade ratings (BBB- (Standard & Poors (S&P) and Fitch)) and Baa (Moody's)).

1 S&P had just raised the Company's credit rating outlook from stable to positive in
2 March 2011.

3 **Q. WHAT FINANCIAL ACTION DID EMPIRE TAKE IMMEDIATELY**
4 **AFTER THE MAY 2011 TORNADO?**

5 A. Given the low level of retained earnings, the expected lost revenue from lost and
6 displaced customers due to the tornado, and the fact that Empire's ability to pay
7 dividends was tied to retained earnings through a covenant in the Company's
8 mortgage indenture, the Empire board met three days after the storm and
9 suspended the dividend for two quarters.

10 **Q. HAS MISSOURI'S REGULATORY MODEL CHANGED DURING THE**
11 **LAST TEN YEARS?**

12 A. Yes.

13 **Q. PLEASE DESCRIBE SOME OF THE MORE SIGNIFICANT CHANGES**
14 **IMPLEMENTED BY THE COMMISSION WITH REGARD TO EMPIRE.**

15 A. In addition to the implementation of an electric fuel adjustment mechanism, the
16 Commission approved a Regulatory Plan for Empire during the construction of
17 Iatan 2. This involved the use of regulatory amortization and construction
18 accounting to help maintain Empire's financial metrics and financial profile
19 during the construction process. Also, the Commission has authorized the use of
20 expense tracking mechanisms that enable Empire to defer changes in specific cost
21 categories between rate cases and reflect those cost changes in future rate cases.
22 In Empire's case the Commission has authorized tracking mechanisms for:

1 pension costs; other post-retirement welfare (“OPEB”) costs; vegetation
2 management costs; and Iatan and Plum Point operation and maintenance costs.

3 **Q. HAVE THE MISSOURI REGULATORY MODEL CHANGES YOU**
4 **OUTLINED ABOVE IMPROVED THE OPPORTUNITY FOR OVERALL**
5 **COST RECOVERY?**

6 A. Yes. The impact of these changes can be seen on Schedule RWS-1. Prior to
7 2008, Empire’s earnings were volatile, with earnings swinging from 7.8 percent in
8 2003 to 5.8 percent in 2004 and to 8.4 percent by 2006. Subsequent to the
9 implementation of the fuel adjustment mechanism in late 2008, earning swings
10 have stabilized. However, these changes are not designed to assist with the
11 recovery of extraordinary events such as the May 2011 Joplin tornado.

12 **Q. DID EMPIRE FILE A REQUEST WITH THE COMMISSION**
13 **ASSOCIATED WITH RECOVERY OF THE MAY TORNADO?**

14 A. Yes, Empire filed for an Accounting Authority Order in June following the
15 tornado.

16 **Q. DID THE TORNADO ACCOUNTING AUTHORITY ORDER ENABLE**
17 **EMPIRE TO OFFSET ITS TORNADO LOSSES?**

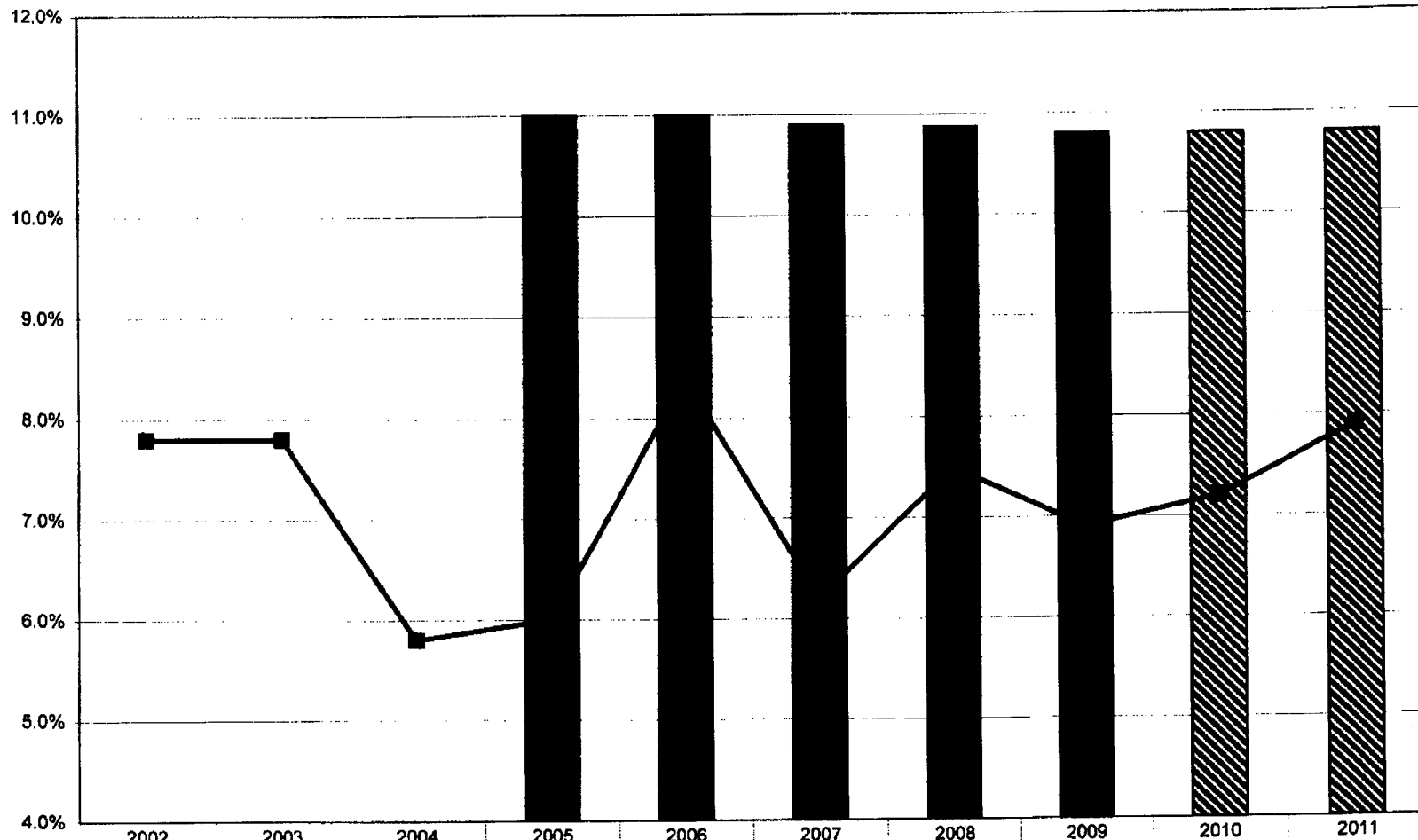
18 A. No. The AAO allowed Empire to defer incremental Operating & Maintenance
19 expenses, depreciation, and carrying costs. The level of carrying costs included in
20 the deferral was well below Empire’s cost of capital, and the deferral does not
21 include margin lost due to the decline in customers, which means Empire’s
22 earnings are still under pressure.

23 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

1 A. Yes, it does.

ROBERT W. SAGER
DIRECT TESTIMONY

Authorized ROE vs Actual ROE



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Authorized ROE				11.0%	11.0%	10.9%	10.9%	10.8%	10.8%	10.8%
Actual ROE	7.80%	7.80%	5.80%	6.00%	8.40%	6.20%	7.50%	6.90%	7.20%	7.90%



Due to black box settlements in 2010 & 2011, Authorized ROE for those years are continued from 2009 authorized levels

