

Exhibit No.
Issue: Financing
Witness: James H. Vander Weide
Type of Exhibit: Direct Testimony
Sponsoring Party: Empire District
Case No. EO-2005-0263
Date Testimony Prepared: June 22, 2005

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

**DIRECT TESTIMONY
OF
JAMES H. VANDER WEIDE**

JUNE 2005

“*_____” Designates “Highly Confidential” Information.
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Pursuant To The Protective Order In This Proceeding

AFFIDAVIT

STATE OF NORTH CAROLINA)
) ss
COUNTY OF DURHAM)

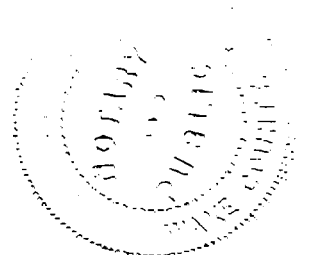
On the 21st day of June, 2005, before me appeared James H. Vander Weide, to me personally known, who, being by me first duly sworn, states that he is Research Professor of Finance and Economics at the Fuqua School of Business of Duke University and also President of Financial Strategy Associates and acknowledged that he has read the above and foregoing document and believes that the statements therein are true and correct to the best of his information, knowledge and belief.

James H. Vander Weide
James H. Vander Weide

Subscribed and sworn to before me this 21st day of June, 2005

My [Signature]
Notary Public

My commission expires: Sept. 25, 2007



DIRECT TESTIMONY
OF
DR. JAMES H. VANDER WEIDE
ON BEHALF OF
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. EO-2005-0263

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

2 A. My name is James H. Vander Weide. I am Research Professor of Finance
3 and Economics at the Fuqua School of Business of Duke University. I am
4 also President of Financial Strategy Associates, a firm that provides
5 strategic and financial consulting services to business clients. My business
6 address is 3606 Stoneybrook Drive, Durham, North Carolina. A statement
7 of my qualifications is attached as Schedule JVW-1 to this testimony.

8 **Q. ARE YOU FAMILIAR WITH THE EMPIRE DISTRICT ELECTRIC**
9 **COMPANY'S (EMPIRE'S) PROPOSED REGULATORY PLAN IN THIS**
10 **PROCEEDING?**

11 A. Yes, I am. Empire's proposed Regulatory Plan is described in the testimony
12 of Mr. Gipson.

13 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

14 A. I have been asked by Empire to provide an independent appraisal of the
15 effect of Empire's proposed Regulatory Plan on its ability to raise the debt

1 and equity required to finance Empire's capital investment plan for the
2 period 2005 – 2010.

3 **Q. WHY IS IT IMPORTANT THAT EMPIRE BE ABLE TO RAISE**
4 **ADDITIONAL DEBT AND EQUITY IN THE CAPITAL MARKETS?**

5 A. As part of its Regulatory Plan in this proceeding, Empire will commit to an
6 investment plan which contains forecasted capital requirements of
7 approximately * _____ * over the period 2005 - 2010, including an
8 investment of * _____ * for Empire's participation in the construction of a
9 base load generation plant, latan 2. To finance its capital investments over
10 this period, Empire forecasts that it will have to raise approximately * ____
11 _____ * of additional debt and equity in the capital markets. If Empire is
12 unable to raise this additional debt and equity, its financial health will
13 deteriorate rapidly, and it will be unable to complete the investments
14 specified in its capital investment plan.

15 **Q. HOW DO THE FORECASTED EXPENDITURES OF APPROXIMATELY**
16 **\$685 MILLION OVER THE PERIOD 2005 – 2010 COMPARE TO**
17 **EMPIRE'S ACTUAL CAPITAL EXPENDITURES IN 2004?**

18 A. As shown in Table 1 below, the forecasted capital expenditures represent a
19 significant increase over Empire's actual capital expenditures in 2004.
20 Specifically, while Empire's actual capital expenditures were only \$40 million
21 in 2004, its capital expenditures are forecasted to range from * ____
22 _____

1

2

*

3

Table 1

4

**Empire's Capital Expenditures 2004 – 2010
(\$millions)**

5

	2004	2005	2006	2007	2008	2009	2010
New Plant Construction	* ____ *	* ____ *	* ____ *	* ____ *	* ____ *	* ____ *	* ____ *

6

7

Q. HOW DO EMPIRE'S FORECASTED EXTERNAL FINANCING

8

REQUIREMENTS OF APPROXIMATELY * _____ *N OVER THE

9

PERIOD 2005 – 2010 COMPARE TO EMPIRE'S TOTAL CAPITAL AT THE

10

END OF 2004?

11 A.

At year end 2004, Empire had approximately \$780 million of total capital on its books. Thus, its forecasted * _____ * external financing requirements represent approximately * __ * of Empire's total capital at year end 2004.

12

13

14

Q. WHAT ARE THE MAJOR FEATURES OF EMPIRE'S PROPOSED

15

REGULATORY PLAN?

16

A. Empire's proposed Regulatory Plan contains the following features:

17

1. Empire will rely upon the provisions of SB 179 for its recovery of fuel and purchased power costs, or, alternatively, an Interim Energy Charge (IEC).

18

19

20

2. Empire proposes that its capital investment plan for the period 2005 –

21

2010 be accepted as prudent by the Commission. That is, its proposed

22

projects will be accepted as necessary, and its proposed technologies

23

will be accepted as being appropriate.

1 3. Empire's rate case filings will include an amortization expense that is
2 sufficient to allow Empire to achieve the financial ratio guidelines
3 consistent with a Standard & Poor's bond rating of BBB.

4 **Q. WHY DOES EMPIRE PLAN TO RELY ON THE PROVISIONS OF SB 179**
5 **OR AN IEC TO RECOVER ITS FUEL AND PURCHASED POWER**
6 **COSTS?**

7 A. Empire plans to rely on the provisions of SB 179 or an IEC to recover its fuel
8 and purchased power costs because its fuel and purchased power costs
9 have been rising rapidly in recent years. The provisions of SB 179 or an IEC
10 would allow Empire to adjust its rates periodically to reflect its actual fuel and
11 purchased power expenditures. Thus, with a fuel adjustment clause, the
12 financial community would have some assurance that Empire would be able
13 to recover its fuel costs on a timely basis.

14 **Q. HAS THE FINANCIAL COMMUNITY PREVIOUSLY RECOGNIZED THE**
15 **IMPORTANCE OF THE TIMELY RECOVERY OF FUEL COSTS IN**
16 **ASSESSING A COMPANY'S RISK?**

17 A. Yes. In its evaluation of Empire's bond rating prior to the passage of
18 SB 179, Standard & Poor's has cited Missouri's lack of a fuel adjustment
19 clause as a negative factor affecting its assessment of Empire's business
20 risk profile.

21 **Q. WHY IS IT IMPORTANT THAT THE COMMISSION ACCEPT EMPIRE'S**
22 **INVESTMENT PLAN FOR THE PERIOD 2005 – 2010 AS BEING**
23 **PRUDENT?**

1 A. The Commission's acceptance of the prudence of Empire's investment plan
2 would assure the financial community that Empire will have a reasonable
3 opportunity to recover its prudently incurred costs and to earn a fair rate of
4 return on its proposed capital investments. The financial community is well
5 aware that in earlier periods of heavy capital spending, some regulatory
6 commissions frequently used disallowances of capital expenditures as a
7 means to reduce rates. Indeed, the threat of significant disallowances, such
8 as those that occurred in the 1980's, is one of the reasons so few new base
9 load generating plants have been built over the last 15 to 20 years.

10 **Q. WHAT IS EMPIRE'S CURRENT STANDARD & POOR'S BOND RATING?**

11 A. Empire currently has a Standard & Poor's bond rating of BBB with a
12 business risk profile of 6. Since BBB- is the lowest investment grade bond
13 rating, Empire's current rating is only two notches above non-investment
14 grade.

15 **Q. WHAT IS THE SIGNIFICANCE OF HAVING AN INVESTMENT GRADE**
16 **BOND RATING?**

17 A. Having an investment grade bond rating is highly significant because
18 institutional investors are generally prohibited from investing in non-
19 investment grade securities, and many individual investors voluntarily limit
20 their bond investments to investment-grade securities. Thus, if Empire's
21 debt were rated below investment grade, Empire would be unable to obtain
22 financing from these investors, and its access to the capital markets would
23 be severely limited and more costly. For example, issuers of junk bonds

1 typically pay 200 to 400 basis points more for long-term debt than issuers of
2 BBB-rated bonds.

3 **Q. WHAT ARE THE KEY FINANCIAL RATIOS THAT AFFECT EMPIRE'S**
4 **STANDARD & POOR'S BOND RATING?**

5 A. Although Standard & Poor's states that its bond ratings are based on a host
6 of both quantitative and qualitative factors, Standard & Poor's specifically
7 describes three key financial ratios that play a significant role in its ratings
8 process, including: adjusted funds from operations/interest coverage,
9 adjusted funds from operations/average total debt, and adjusted total
10 debt/total capitalization.

11 **Q. THE DESCRIPTION OF THESE RATIOS SUGGESTS THAT AN**
12 **ADJUSTMENT IS MADE BEFORE THE RATIOS ARE CALCULATED.**
13 **CAN YOU DESCRIBE THIS ADJUSTMENT?**

14 A. Yes. Standard & Poor's adjusts each company's interest expense and debt
15 levels to account for its view that long-term purchased power contracts are
16 similar to debt contracts. Thus, Standard & Poor's considers some portion
17 of purchased power contracts, approximately 30% for companies with fuel
18 adjustment clauses, to be equivalent to a debt obligation; and they adjust
19 the ratios to take the debt-equivalent amount of purchased power contracts
20 into account in calculating financial ratios.

21 **Q. WHAT ARE STANDARD & POOR'S FINANCIAL RATIO TARGETS FOR**
22 **A COMPANY WITH A BBB BOND RATING AND A BUSINESS RISK**
23 **PROFILE OF 6?**

1 A. Standard & Poor's financial ratio targets for a company with a BBB bond
2 rating and a business risk profile of 6 are shown below in Table 2.

3 **Table 2**
4 **Standard & Poor's Financial Guidelines for a BBB-Rating**

<i>Ratio</i>	<i>Target Range</i>
Adjusted Funds from Operation/Interest Coverage	3.0x - 4.2x
Adjusted Funds from Operations/Average Total Debt	18%– 28%
Adjusted Total Debt/Total Capital	58%– 48%

5 **Q. HAS EMPIRE PREPARED A FINANCIAL FORECAST FOR THE PERIOD**
6 **2005 – 2010 UNDER THE ASSUMPTION THAT ITS PROPOSED**
7 **REGULATORY PLAN IS ACCEPTED BY THE COMMISSION?**

8 A. Yes. Empire's financial forecast is attached as Schedule JVW-2.

9 **Q. DOES EMPIRE FORECAST THAT IT WILL HAVE FINANCIAL RATIOS**
10 **CONSISTENT WITH A BBB BOND RATING IF ITS PROPOSED**
11 **REGULATORY PLAN IS APPROVED?**

12 A. Yes. Empire forecasts that it will have financial ratios consistent with a BBB
13 bond rating over the period of the proposed Regulatory Plan. However,
14 Empire's forecast depends on its assumption that it will receive cash flows
15 from the amortization provision of the proposed Regulatory Plan on a total
16 Company basis of approximately * _____

17 _____ * These amortization amounts are based
18 on Empire's achieving ratios consistent with the lower end of the middle third
19 of the BBB range.

20 **Q. WHAT IS THE PURPOSE OF THE PROVISION IN THE PROPOSED**
21 **REGULATORY PLAN THAT EMPIRE'S RATE FILINGS WILL INCLUDE**

1 **AN AMORTIZATION EXPENSE THAT ALLOWS EMPIRE TO ACHIEVE**
2 **THE FINANCIAL RATIO TARGETS REQUIRED FOR A BBB BOND**
3 **RATING?**

4 A. The provision for an amortization expense provides some assurance to the
5 financial community that Empire will actually achieve the financial ratio
6 targets required to maintain a Standard & Poor's BBB bond rating. As noted
7 above, Empire forecasts that it will only be able to achieve Standard &
8 Poor's financial ratio targets for a BBB bond rating if the amortization
9 provision of the proposed Regulatory Plan is approved.

10 **Q. BASED ON YOUR REVIEW, WHAT IS YOUR CONCLUSION**
11 **REGARDING THE EFFECT OF THE PROPOSED REGULATORY PLAN**
12 **ON EMPIRE'S ABILITY TO RAISE THE DEBT AND EQUITY REQUIRED**
13 **TO FINANCE ITS CAPITAL INVESTMENT PLAN FOR THE PERIOD 2005**
14 **– 2010?**

15 A. I conclude that approval of the proposed Regulatory Plan is essential for
16 Empire to be able to raise the additional debt and equity required to finance
17 its capital investment plan for the period 2005 to 2010. Specifically, if the
18 proposed Regulatory Plan were not approved, Empire would be unable to
19 raise the debt and equity required to finance its capital investment plan over
20 this period.

21 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

22 A. Yes, it does.