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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.
Such Information Should Be Treated Confidentially
Pursuant To The Protective Order In This Proceeding

Exhibit No. 41
Case No(s) EG-2005-0273
Date 7-21-05 Rptr KF

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

4

5

Table 1
Empire's Capital Expenditures 2004 – 2010
(\$millions)

	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.

James H. Vander Weide is Research Professor of Finance and Economics at the Fuqua School of Business, Duke University. Dr. Vander Weide is also founder and President of Financial Strategy Associates, a consulting firm that provides strategic, financial, and economic consulting services to corporate clients, including cost of capital and valuation studies.

Dr. Vander Weide holds a Ph.D. in Finance from Northwestern University and a Bachelor of Arts from Cornell University. In January 1972, he joined the faculty of the School of Business at Duke University and was named Assistant Professor, Associate Professor, and then Professor. In 1982, he assumed the position of Associate Dean of Faculty Affairs at the Fuqua School. He resigned this position in July 1983 and is now Research Professor of Finance and Economics.

Since joining the faculty at Duke University, Dr. Vander Weide has taught courses in corporate finance, investment management, and management of financial institutions. He has also taught courses in statistics, economics, and operations research, and a Ph.D. seminar on the theory of public utility pricing. Dr. Vander Weide has also been active in executive education at Duke, lecturing in executive development seminars on the cost of capital, financial analysis, capital budgeting, mergers and acquisitions, real options, cash management, short-run financial planning, depreciation policies, financial strategy, and competitive strategy. Dr. Vander Weide helped design the Duke Advanced Management Program at the Fuqua School of Business and served as Program Director for this program for five years. Dr. Vander Weide also serves as Program Director and teacher in various other executive programs designed to prepare managers for the competitive environment in American industry.

Publications. Dr. Vander Weide has written a book entitled *Managing Corporate Liquidity: An Introduction to Working Capital Management* published by John Wiley and Sons, Inc. He has also written a chapter titled, "Financial Management in the Short Run" for *The Handbook of Modern Finance*, and written research papers on such topics as portfolio management, capital budgeting, investments, the effect of regulation on the performance of public utilities, and cash management. His articles have been published in *American Economic Review*, *Financial Management*, *International Journal of Industrial Organization*, *Journal of Finance*, *Journal of Financial and Quantitative Analysis*, *Journal of Bank Research*, *Journal of Portfolio Management*, *Journal of Accounting Research*, *Journal of Cash Management*, *Management Science*, *Atlantic Economic Journal*, *Journal of Economics and Business*, and *Computers and Operations Research*.

Professional Consulting Experience. Dr. Vander Weide has provided financial and economic consulting services to firms in the electric, gas, insurance, telecommunications, and water industries for more than 20 years. He has testified on the cost of capital, competition, risk, incentive regulation, forward-looking economic cost, economic pricing guidelines, depreciation, accounting, valuation, and other financial and economic issues in more than 350 cases before the U.S. Congress, the Canadian Radio-Television and Telecommunications Commission, the Federal Communications Commission, the National Telecommunications and Information Administration, the Federal Energy Regulatory Commission, the public service commissions of 40 states and the District of Columbia, the insurance commissions of five states, the Iowa State Board of Tax Review, North Carolina Property Tax Commission, the National Association of Securities Dealers, and the United States Securities and Exchange Commission. In addition, he has testified as an expert

witness in proceedings before the U.S. District Court, District of Nebraska; U.S. District Court, District of New Hampshire; U.S. District Court, Eastern District of North Carolina; Superior Court, North Carolina, the U.S. Bankruptcy Court, Southern District of West Virginia; and the United States District Court, Eastern District of Michigan. With respect to implementation of the Telecommunications Act of 1996, Dr. Vander Weide has testified in 30 states on issues relating to the pricing of unbundled network elements and universal service cost studies and has consulted with Bell Canada, Deutsche Telekom, and Telefónica on similar issues. He has also provided expert testimony on issues related to electric and natural gas restructuring. He has worked for Bell Canada on a special task force to study the effects of vertical integration in the Canadian telephone industry and has worked for Bell Canada as an expert witness on the cost of capital. Other Professional Experience

Other Professional Experience. Dr. Vander Weide conducts in-house seminars and training sessions on topics such as financial analysis, competitive strategy, real options, financial strategy, managing growth, mergers and acquisitions, capital budgeting, cost of capital, cash management, depreciation policies, and short and long-run financial planning. Among the firms for whom he has designed and taught tailored programs and training sessions are ABB Asea Brown Boveri, Accenture, Allstate, Ameritech, AT&T, Bell Atlantic, BellSouth, Carolina Power & Light, Contel, Fisons, Glaxo Wellcome, GTE, Lafarge, MidAmerican Energy, New Century Energies, Norfolk Southern, Pacific Bell Telephone, The Rank Group, Siemens, Southern New England Telephone, TRW, and Wolseley Plc. Dr. Vander Weide has also hosted a nationally prominent conference/workshop on estimating the cost of capital. In 1989, at the request of Mr. Fuqua, Dr. Vander Weide designed the Duke Program for Manager Development for managers from the former Soviet

Union, the first in the United States designed exclusively for managers from Russia and the former Soviet republics.

In the 1970's, Dr. Vander Weide helped found University Analytics, Inc., which at that time was one of the fastest growing small firms in the country. As an officer at University Analytics, he designed cash management models, databases, and software packages that are still used by most major U.S. banks in consulting with their corporate clients. Having sold his interest in University Analytics, Dr. Vander Weide now concentrates on strategic and financial consulting, academic research, and executive education.