BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of Aquila, Inc. d/b/a Aquila Networks – L&P and Aquila Networks – MPS, to Implement a General Rate Increase in Electricity

Case No. ER-2004-0034

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In the Matter of the Request of Aquila, Inc., d/b/a Aquila Networks - L&P, to Implement a General Rate Increase in Steam Rates.	)Case No.)HR-2004-0024))

BEFORE:
KENNARD L. JONES,
REGULATORY LAW JUDGE.

REPORTED BY:
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ASSOCIATED COURT REPORTERS

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FOR: Staff of the Missouri Public Service Commission

JUDGE JONES: We are now going on the record. Good morning. This is the hearing for Case No. ER-2004-0034. Today is March 11, 2004.

It's my understanding that you all have not settled all of the issues involved in that Rate of Return and Capital Structure, I assume is one of those issues; is that correct?

MR. SWEARENGEN: Excuse me, Judge?

JUDGE JONES: You all haven't settled the issue of Rate of Return and Capital Structure?

Mr. Coffman, go ahead.

MR. COFFMAN: Yes. Not yet. Parties continue to inch ever closer to a global settlement.

JUDGE JONES: And what other issues have not been settled or is it all of them are inches away?

MR. SWEARENGEN: Well, let me speak to that, if I could, please. In the event that we do reach a global settlement, and we are moving in that direction, all issues will be resolved. Some will be specifically resolved, others will be resolved in a black box type context. But --

JUDGE JONES: What does that mean?

MR. SWEARENGEN: Well, that means that there will just be a dollar settlement that disposes of the unnamed issues, and Rate of Return and Capital Structure would be one of those issues.

But since we don't have an agreement yet and the company cannot represent that we have an agreement in principle with all parties, we feel that we need to go forward with the other issues that have not been settled in principle, and one of those is the Cost of Capital Issue.

JUDGE JONES: Well, before we get started, I need to ask this question -- well, I guess we're already started. This issue of Interim Energy Charge, have you all settled that in principle?

MR. SWEARENGEN: Judge, that issue would be taken up in the context of the overall Fuel Issue, which we'll probably have -- if we don't get a global settlement, we will be trying the Fuel Issue next week.

JUDGE JONES: On the 15th?

MR. SWEARENGEN: That would be my recommendation. And there are approximately 15 witnesses to testify on that issue. And the Interim Energy Charge is a part of that. We do have some other what I would refer to as Miscellaneous Issues, which I do not think that we have settled such as the 20 West Ninth Issue, the Severance Issue and there may be several others that we would litigate at some point in time.

JUDGE JONES: Okay. It sounds like then I need to deal with this Motion to Strike Staff's Surrebuttal Testimony regarding Interim Energy Charge.

MR. SWEARENGEN: Well, I don't think so, Judge. I think you can wait on that until we get to the Fuel Issue. And that would occur some time next week and only in the event we don't get a global settlement.

MR. COFFMAN: I would join in that sentiment. I think that that issue could wait until next week. If, in fact, we do reach a settlement, I would -- which I think is possible this week -- that would not be necessary. I would not ask that the Bench necessarily rule on that this week. I mean, you could if -- I mean, if that's your intention, but if we settle, it really isn't necessary to reach that. As I said, the settlement, as we're discussing it currently, would include an Interim Energy Charge component.

JUDGE JONES: We can wait to rule on it.

MR. COFFMAN: I would recommend that possibly that be delayed until the beginning of the Fuel Issues.

I think it might be good if we got an understanding of where we went -- if we were to continue today and finish with Capital Structure, Rate of Return, what it is your understanding of where we go. It would help us plan our resources.

JUDGE JONES: Okay. If we're starting today with Rate of Return and Capital Structure, it looks like 20th West Ninth Street Building would be the next issue.

MR. COFFMAN: Okay. That's what I was

expecting.

JUDGE JONES: And then Customer Charges, then Severance, then Payroll, straight -- then we go -- we finish the rest of the Miscellaneous Issues. I believe we've already covered the Missouri Regulated Company Rates. Let's go ahead and see if we can finish this issue today.

Is Aquila ready to call their first witness?

MR. SWEARENGEN: We are, Judge.

JUDGE JONES: You can call him up.

MR. SWEARENGEN: Call Don Murry.

(Witness sworn.)

JUDGE JONES: Thank you. You may be seated.

MR. SWEARENGEN: May I proceed?

JUDGE JONES: Yes, you may, Mr. Swearengen.

MR. SWEARENGEN: Thank you.

DONALD MURRY testified as follows:

DIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Would you state your name for the record?

A. My name is Donald A. Murry.

Q. And what is your occupation?

A. I'm an economist with C.H. Guernsey and Company in Oklahoma City, professor emeritus at the University of Oklahoma.

Q. Have you caused to be prepared for purposes of this proceeding certain Direct, Rebuttal and Surrebuttal

Testimony in question and answer form?

A. I have.

Q. And was it your understanding -- and I will tell you that I believe the record will reflect -- that your Direct Testimony concerning the Light & Power operations has been marked for identification as Exhibit 80, your Direct Testimony concerning the Aquila Networks - MPS and L&P operations has been marked as Exhibit 81. Are there any changes that you need to make in any of those pieces of -- either of those pieces of testimony?

A. No, there are not.

Q. And I will represent to you that your Rebuttal Testimony has two numbers, one is Exhibit 82 and the other is 1082 and your Surrebuttal Testimony has two numbers likewise, one is Exhibit No. 83 and the other is 1083. Do you have any changes that you wish to make at this time with respect to either your Rebuttal or Surrebuttal Testimonies?

A. I do not.

Q. Thank you. And if I asked you the questions in all of this testimony, would your answers today under oath be substantially the same?

A. Yes, they would.

Q. Thank you.

MR. SWEARENGEN: With that, your Honor, I would offer into evidence the Exhibits 80, 81, 82, 1082, 83, and 1083 and tender the witness for cross-examination.

JUDGE JONES: Thank you. Are there any objections?

MR. MEYER: Yes.

Is this on?

JUDGE JONES: I don't know if it's on.

MR. MEYER: It's on, but I can't hear.

Your Honor, I have an objection to Rebuttal Testimony exhibit -- previously marked as Exhibit 82 and 1082 specifically with respect to Rebuttal Schedule DAM-5, which is referred to as the testimony of Mark Burdette, the former Office of Public Counsel witness.

Specifically, that testimony was prepared as part of this case, but has not been submitted by that witness, but rather is being submitted by another witness, apparently for the contents of that testimony. And I would draw the court's attention to Section 536.070, which I believe does govern this proceeding. And I have copies of that statutory section which I can provide the court.

JUDGE JONES: Can you go ahead and provide that now, counsel, so I can look at it?

MR. MEYER: I can.

JUDGE JONES: Thank you.

MR. MEYER: Specifically subsection 11 of 536.070 has a discussion of when the results of statistical examinations or studies, compilations of figures, information involving examination of records and other such descriptive terms of what appears to comprise Mr. Burdette's testimony that is attached as this exhibit are being put into an administrative proceeding, that examination, study, audit, etc. should be only put in and accepted and admitted if it was made under the supervision of a witness who is present at the hearing, who testifies to the accuracy of such results and who is subject to cross-examination. And I believe Mr. Burdette is not here for that purpose.

JUDGE JONES: Are you objecting because it's hearsay?

MR. MEYER: That would be correct. And it appears to be not admissible under 536.070, sub 11.

MR. SWEARENGEN: May I speak to that, your Honor?

JUDGE JONES: Yes, you may.

MR. SWEARENGEN: I do not intend to offer Mr. Burdette's Direct Testimony under the provision that counsel has cited.

Let me give you my theory here. The Public Counsel, in his opening statement, made reference to the fact that he did not have a cost of capital witness to sponsor testimony and at that time indicated that the Public Counsel was supporting the Staff's recommendation with respect to an appropriate return on equity in this proceeding.

The Staff's recommended range on return on equity is 8.64 percent to 9.64 percent. The testimony that Mr. Burdette filed while he was, in fact, an employee of the Office of the Public Counsel recommended on the high side of 10.1 percent return on equity.

And so I think what we have here is clearly what I will characterize as an admission by someone who had express or implied authority to make a statement on this particular topic on behalf of the Office of the Public Counsel, which appears now to be at odds with the stated position of the Office of the Public Counsel. It's an admission by a party opponent, which I think I am entitled to use in that regard.

MS. O'NEILL: May I respond to that, your Honor?

JUDGE JONES: Yes, you may.

MS. O'NEILL: There's a couple of things. One is, you know, I'm not sure my office would have as many concerns about this if Mr. Swearengen had just represented to you that he was adopting Mr. Burdette's Direct Testimony and this witness was adopting the positions that Mr. Burdette had made in his Direct Testimony because, frankly, we believe that's more favorable to the outcome of this case than this witness's position, as I understand it.

However, we are concerned about the fact that, as Mr. Meyer pointed out, there seems to be statutory discussion about what type of evidence is admissible in these hearings and the statute that he cited.

Also, I would point out that to the extent that Mr. Swearengen is trying to use this to suggest that Public Counsel has evidently -- it sounds like he wants to impeach the Office of the Public Counsel's position in the case.

Point out to you that this is only Direct Testimony, that Mr. Burdette left our office before he was able to consider other matters that came to light in the course of investigating the case and reviewing other testimony. Quite often what is filed in Direct Testimony is modified by subsequent information and developments. And Mr. Burdette had not had the opportunity to do that before he left our employ.

Also, even his Direct Testimony I would note that there is an overlap in the recommendation of an acceptable range for return on equity which overlaps the high -- his low end of his initial recommendation does overlap the high end of the Staff's recommendation.

There's a significant possibility that given further investigation, we would have been even if not squarely in line with the Staff's recommendation, much closer and much -- there would have been much more overlap.

Mr. Burdette is not available, that's why we're not offering his testimony. Mr. Swearengen has known for quite some time that Mr. Burdette was leaving the office and that he had left the office and could have subpoenaed Mr. Burdette here if he wanted his testimony in so that he could testify directly. Aquila chose not to do that for whatever reason and that's their choice.

We don't have the -- you know, we did not do that, that was our decision upon review of all the information prior to hearing. We determined that based on subsequent information, that we would be comfortable supporting the Staff's position in this case.

Mr. Burdette is not someone who prepared this information under Mr. Murry's direction and control. If the purpose of having this in here is to criticize the Office of the Public Counsel without giving us an opportunity to cross-examine, Mr. Murry here on the stand doesn't know -- I presume doesn't know what was going on with Mr. Burdette's processes at the time he filed his initial testimony and so we would not be able to cross-examine him about those things.

JUDGE JONES: You wouldn't be --

MS. O'NEILL: And Mr. Meyer would not be able to cross-examine him about matters related to Mr. Burdette's testimony and that is why I think 536.070 says that if -- that material that's introduced must be presented by the witness who prepared it or who supervised the preparation so that someone who was directly involved can be subject to cross-examination to test that information.

If this is being attached so that Mr. Murray on the stand here can attack the Office of the Public Counsel without having this witness here to explain his prior statements which are not otherwise in evidence in this case, we believe that that would be unfair as well. So we would join with the Staff.

JUDGE JONES: What does the schedule speak to?

MS. O'NEILL: The schedule being objected to is -- or appears to me to be the Direct Testimony of Mark Burdette that was pre-filed in this case but which has not been admitted and is not being sponsored by the Office of the Public Counsel at this time.

MR. SWEARENGEN: Judge, may I respond very briefly?

JUDGE JONES: Yes, you may.

MR. SWEARENGEN: What Mr. Burdette might have said in additional testimony or under cross-examination if he appeared and testified is pure speculation and not really relevant to the issue that I'm raising.

The Missouri Supreme Court has said, and I will read this, As a general rule, it may be said that an admission of an agent or employee may be received in evidence against his principal where the agent in making the admission was acting within the scope of his authority and the transaction or negotiation to which the admission relates was pending at the time when it was made.

I can give you several citations to that. That's the purpose for which I'm offering it. It's a statement by a person with express or implied authority to make a statement concerning the subject matter. And it's an admission by a party opponent and I'm offering it again on that basis.

JUDGE JONES: Is it necessary, Public Counsel, that Mr. Burdette's testimony be admitted into evidence for him to have made a statement?

MS. O'NEILL: Well, all of us make statements every day, your Honor. I make statements at the cafe when I order lunch, but I think that there's a couple -- I have a couple of concerns about what Mr. Swearengen just said.

One is that the -- once again, this is not someone who's being offered -- this is not a witness that's being offered. This is not -- and if this witness was being offered and he had a different statement in subsequent testimony, certainly Mr. Swearengen could cross-examine him about statements he had made earlier. Mr. Burdette is not here to be cross-examined. And he is not an employee of the Office of the Public Counsel, he is not our agent at this time and so --

JUDGE JONES: I don't understand --

MS. O'NEILL: -- we believe it's inappropriate.

JUDGE JONES: -- how that's relevant.

MS. O'NEILL: How it's not relevant that he's not here?

JUDGE JONES: How it's relevant that he's not an agent or employee of the Office of Public Counsel. He was at the time he made the statement or prepared the testimony.

MS. O'NEILL: True. But the way pre-filed testimony generally works here is that Direct Testimony is filed, there is then Rebuttal and Surrebuttal Testimony. nd during the process of testimony being prepared for pre-filing, quite often subsequent investigation -- and, frankly, always with our office, there's still investigation going on. New information comes into play that may or may not have been known to Mr. Burdette at the time he filed his Direct Testimony. It may have changed the statements that he would make.

If he was here, he could testify, you know, such and -- you know, I said something in Direct, that's been corrected by Rebuttal, my subsequent investigation. He could explain if there's a change in his position why that happened.

He's not available to do that. I don't have any witness who's available to do that. I don't have anybody who's qualified to talk about that. So we're basically left with not being able to challenge whatever assertions Mr. Swearengen's going to make based on the testimony of Mr. Burdette.

And evidently it sounds to me like, and maybe I'm wrong, he's going to introduce it and then have Mr. Murry here talk about, you know, problems with Mr. Burdette's testimony because that's what's contained in his Rebuttal. So I think that's inappropriate at this point in time that, you know, Mr. Swearengen should present his evidence and --

JUDGE JONES: So let me make sure I understand. This schedule is the actual testimony of Mr. Burdette, which isn't in contradiction to the Office of Public Counsel's position?

MS. O'NEILL: I don't know that that's the case.

JUDGE JONES: Well --

MS. O'NEILL: I don't -- I mean. Okay. I'm sorry. Go ahead and finish.

JUDGE JONES: It seems like there's an exception to the hearsay rule I'm hearing, and that is a statement against -- a statement against interest.

MS. O'NEILL: I don't know that it's against our interest. I'm not sure where he's saying that it is a statement against our interest. I'm saying that to the extent he's going to suggest it's a statement against our interest, that there may have -- that subsequent investigation may have changed a position.

I will also say that in Mr. Burdette's testimony, his recommendation of a range for return on equity, which if that's what he's going to talk about, overlaps the Staff. So I don't think that's a big change in position at all.

MR. SWEARENGEN: Judge, I'm reading from the transcript of the opening statement. Mr. Coffman said, The Staff recommended range of 8.64 to 9.64 is a recommendation that is clearly reasonable and we are supporting that.

And Mr. Burdette, who was an employee of the Office of the Public Counsel when he filed his verified testimony, his position is that 10.1 percent is a reasonable return on equity. And I think that's an admission and I can use it. The fact that the Public Counsel didn't bring him down here by subpoena or otherwise to impeach their own witness in cross-examination, even assuming they could do that, is not our problem. Thank you.

MS. O'NEILL: Your Honor, for clarification, Mr. Burdette's recommendation was not 10.1. It was a proposed of range of 9.6 to 10.1. The 9.6 is clearly within the range of Staff.

JUDGE JONES: Yeah, but it's higher than the highest that was stated in opening statement by Public Counsel.

MR. COFFMAN: And the fact that there may initially be a range that says -- under an analysis a certain range is acceptable does not mean that we are not going to recommend a portion of that range. We do that a lot.

JUDGE JONES: Well, isn't this an exception to the hearsay rule? This objection is on hearsay grounds, is that right, Mr. Meyer?

MR. MEYER: That is correct. And I'd note that the statutory language that governs this does seem to be very specifically and precisely developed for this exact scenario.

JUDGE JONES: What does the last sentence in that subsection mean?

MR. MEYER: I'm sorry. The last sentence of subsection 11?

JUDGE JONES: Subsection 11.

MR. MEYER: All the circumstances relating to the making of such an examination, study, audit, compilation of figures or survey including the nature and extent of the qualifications of the maker may be shown to affect the weight of such evidence, but such showing shall not affect its admissibility.

JUDGE JONES: Does that state to whether it's admissible?

MR. MEYER: I believe that it does still -- I mean, I think that does address the admissibility, but I don't think it overcomes the problem of the witness not being here, specifically where it says that the witness should be available for cross-examination. I don't believe that that overcomes the specific language of the statute.

MS. O'NEILL: Your Honor, I believe that this provision of the -- this is a statutory discussion of when hearsay may be admissible in administrative proceedings. And this is a witness who is not here, but which the proponent of this evidence has not shown is actually unavailable because they haven't shown they've made any efforts to bring him here, so they haven't demonstrated unavailability of this witness. They could have brought him here as they're the proponent of it.

MR. SWEARENGEN: I'm not required to do that under the rule, your Honor, under this exception. I'm not required to demonstrate that the witness is unavailable under this exception.

MS. O'NEILL: Generally that may be the case, but when you have a specific statutory requirement for admissibility as you do in 536.070, sub 11, which says, That any results of statistical examinations or studies or audits, compilations of figures or surveys must be made by the person who's testifying or under their supervision -- and that didn't happen in this case.

JUDGE JONES: The only place in that subsection -- well, I guess there's two places where admissibility is discussed, but the last sentence seems to say that the weight of the evidence is what shall be considered over its admissibility.

MS. O'NEILL: Your Honor, I think that's clearly, as it is in general hearsay language, a situation where you first find that it is admissible at all. And then if other parties wish to challenge the voracity, that it goes to the weight of the evidence. And that would be the situation regarding circumstances relating to the making. But I think that's the second step. I think first you have to determine whether or not this exhibit was prepared by this witness or under his supervision.

JUDGE JONES: Well, it's obvious that

Mr. Murry did not supervise Mr. Burdette's testimony. The objection was made on grounds of hearsay. There seems to be a hearsay exception to this. The statement by the party was made and the statement it's not consistent with what was made also by the Office of Public Counsel. That, to me, seems to be an exception to the hearsay rule. I haven't been convinced that the exception does not apply.

MS. O'NEILL: The problem, your Honor, is that -- I'm not trying to engage you in argument, your Honor, I'm really not, but this is not just a common law hearsay objection. There's also statutory hearsay objection and I think you need to look at the statute.

And I think clearly the first part of the statute is first for a reason, which is first you have to determine that it's admissible at all and then the circumstances of preparation are subject to -- are fair game for cross-examination. But we also object to the admission of this exhibit.

JUDGE JONES: Okay. Well, the objection's overruled and we'll move on.

Cross-examination of Mr. Murry, we'll begin with the Department of Natural Resources?

MS. WOODS: I have nothing, your Honor.

JUDGE JONES: Will there be any cross from the Office of Public Counsel?

MS. O'NEILL: Briefly, your Honor.

CROSS-EXAMINATION BY MS. O'NEILL:

Q. Good morning, Mr. Murry.

A. Good morning.

Q. Do you know Mark Burdette?

A. I've met Mark Burdette.

Q. Have you ever worked with Mark Burdette?

A. Not in the context of working with him, no.

Q. Did you supervise the preparation of any exhibits or analysis that he may have done while he worked for the Office of the Public Counsel?

A. No.

MS. O'NEILL: No further questions.

JUDGE JONES: Thank you.

Cross-examination from the Staff of the Commission?

MR. MEYER: Thank you.

CROSS-EXAMINATION BY MR. MEYER:

Q. Morning.

A. Good morning.

Q. Dr. Murry, you selected a sample of companies to demonstrate the reasonableness of Aquila's 47.5 percent equity ratio; is that correct?

A. I selected a group of companies. And in selection criteria -- one of the selection criteria was a

60 percent debt equity ratio at maximum and so the companies I selected had a comparable -- had an equity ratio that was similar to the target equity ratio of Aquila.

Q. So your selection process was designed to demonstrate the reasonableness of that 47.5 percent equity ratio; is that correct?

A. That isn't what I said. I said I used a criterion of the capital structure to select the companies. And the purpose of that was to select a group of companies that would have a financial risk that would be similar to the financial risk of the target capital structure of Aquila.

Q. Do you have a copy of your Direct Testimony?

A. Yes.

Q. And just to clarify, on page 10 of that, lines 18 and 19, you make a statement that you selected electric utilities that had common equity ratios similar to the equity ratios of MPS and SJLP; is that correct?

A. That's correct.

Q. Okay.

A. And if you look at the line 1 of that same page, and actually it starts at the bottom of line 9, it says, To use comparable companies that have similar financial risk, I selected companies that did not have a long-term debt ratio in excess of 60 percent. That was a criterion for selecting the companies.

The statement you're referring to at lines 18 and 19 are a confirmation that I think having comparable financial risk especially in this case was very important.

Q. According to your testimony is what you did then to compare companies with similar common equity ratios to MPS and L&P with MPS and L&P? Is that what you're saying?

A. Because Aquila, Inc. is -- especially in prior years is a very diversified company, to set rates for Missouri, one needs to look at, in my opinion, companies that are utilities -- electric utilities that would be similar to MPS and L&P. And one of the important criteria would be the capital structure. And the capital structure was the capital structure associated with the debt that was used to build the assets that are used to serve Missouri ratepayers.

Q. Dr. Murry, do you have a copy of David Murray's testimony that was scheduled in -- filed earlier in this proceeding, his Rebuttal Testimony specifically?

A. Yes, I do.

Q. Could I ask you to take a look at Schedule 1 that was attached to that testimony?

MR. SWEARENGEN: Excuse me. Are you on his Rebuttal Testimony?

MR. MEYER: Yes. And it was attached to both versions that were filed.

THE WITNESS: I think I have it. As I recall, that schedule was sent to me electronically and it was very difficult to read.

BY MR. MEYER:

Q. It's fairly small type.

A. And then I had it faxed to me, so if I'm looking at the right one, I have a fax copy and it's fuzzy, so I may need a little help or look at another copy.

Q. Is the first line of what you have Historical Consolidated Capital Structures for Aquila, Inc.?

A. Yes. That part I can read.

Q. Would you like a clearer copy?

A. It would be -- might be helpful. Might speed this along.

MR. MEYER: May I approach this witness?

JUDGE JONES: Yes, you may.

THE WITNESS: Thank you.

BY MR. MEYER:

Q. With the ability to see it, sir, do you have any reason to dispute the accuracy of the contents of that exhibit -- schedule, I'm sorry?

A. At this point I have no basis to dispute that.

Q. And certainly allowing time for you to be able to look at it closely, is Mr. Murray's recommended common equity ratio within the range of equity ratios indicated in that Schedule 1? And I think the common equity ratios are in the bottom half, first line.

A. Yes. You're saying his approximately 35 percent is within that range? Is that your question?

Q. I think the average is actually on the right-hand corner. Looks like the average is 38.41.

A. Right.

Q. And you would agree that Mr. Murray's recommended number is within that?

A. It's within the range of the common equities shown in that period.

Q. Okay.

A. And it's -- yes.

Q. Okay. Thank you.

And your recommended equity ratio in this case is 47.5 percent; is that correct?

A. That's correct.

Q. Is that in the range of the common equity ratios over the course of 1990 to 2001 that is shown in that schedule?

A. No. Because I -- I used the capital as allocated to the operating divisions of Missouri. I did not use the capital structure of Aquila, Inc.

Q. Dr. Murry, do you know when Aquila got heavily involved in nonregulated international operations, roughly?

A. Well, I'm -- I guess I don't want to try to pick a date because I -- I can't -- I can't say with precision on what date it was.

Q. Certainly. Would you agree that it was in the mid-1990's, for example?

A. Yes.

Q. Do you know the average equity ratio from 1990 to 1995?

A. I haven't made that calculation.

Q. Would you agree that it could be derived from Schedule 1 of Mr. Murray's Rebuttal Testimony?

A. Without further investigation, I have no basis at this point to say those do not represent the corporate capital structure.

Q. Would you agree that the early 1990's, 1990 through 1995, were a period when -- was a time when Aquila was not heavily invested in nonregulated international activities relative to the late 1990's?

A. As I understand the question, I agree with that. It increased at the end of the '90s.

Q. Thank you.

And would you agree that an equity ratio from the early 1990's might be closer to Mr. Murray's recommended

equity ratio then perhaps your equity ratio of 47.5 percent?
A. Then -- it's a number that's closer to his number. Doesn't make -- doesn't mean I think it's the number we should use in this case.
Q. Certainly.
In your Rebuttal Testimony at page 3, lines 8 through 10 you state that, Aquila's consolidated capital structure is not representative of capital structure that will support L&P and MPS in the future; is that correct?
A. Well, I think --
Q. I think I'm summarizing there. Is that a correct summary?
A. Yes. I think I accept that statement. It's consistent.
Q. And are you aware of what type of operation Aquila is attempting to revert back to?
A. Generally, yes.
Q. Okay. Do you have a sense of what that might be?
A. I guess we could generally summarize and say that Aquila's policy is to return to a utilities company --
Q. Okay.
A. -- primarily.
Q. Do you have a sense of what the equity ratio might be for Aquila in the next few years?

A. I'm not privy to corporate plans for future financing. Based on what other utilities are doing around the country and I think the financial markets acceptance of capital and the awareness of rating requirements for utilities, I know we have testimony in this case from Susan Abbott on that very point. I think I know the direction they're going to have to go with their capital in the future, but I'm not privy to inside information.

Q. Dr. Murry, are you aware of any Commission orders where the Commission has ruled that consolidated capital structure does not expose MPS ratepayers to any additional risk from the broader company's nonregulated activities?

A. Are you asking me to cite?

Q. Just if you have any awareness of a Commission ruling in that vein.

A. Well, I think in my testimony I think I cited at least one Commission ruling on this company when it was still UtiliCorp that addressed that question, yes.

Q. And would that from Case ER-90-101?

A. I can't answer that without investigating my testimony. I'm not going to challenge the -- I'm not going to challenge the number, but I'd have to investigate my testimony to verify that.

Q. Okay. Do you consider nonregulated energy marketing trading operations that Aquila was involved in to be riskier than the traditional regulated utility operations?

A. Yes, I do.

Q. When companies such as S&P evaluate the creditworthiness of Aquila, do you believe they look at their consolidated operation?

A. Well, I think S&P is looking at the credit rating of the securities in the marketplace and those are Aquila, Inc. securities.

Q. And is it correct to say that MPS and L&P have to rely on Aquila for the debt assigned to those divisions?

A. If I understand the question correctly, yes

MR. MEYER: May I approach the witness?

JUDGE JONES: May you what?

MR. MEYER: Approach the witness.

JUDGE JONES: Yes, you may.

MR. MEYER: And I guess I also have an exhibit to be marked.

JUDGE JONES: That will be fine.

MR. MEYER: Would that be Exhibit 182?

JUDGE JONES: Yes, it is 182.

(Exhibit No. 182 was marked for identification.)

BY MR. MEYER:

Q. Dr. Murry, are you familiar with the Standard and Poor's service?

A. Yes.

Q. Okay. Would this be a type of document that you would ordinarily come across in doing research in corporate matters?

A. Yes.

Q. Okay. And could you tell us what the date of the document that I just handed you that I believe has been marked as Exhibit 182?

A. It says publication date was July 15th, 1999.

Q. Okay. And could you read the last two sentences of the second full paragraph I believe beginning with the word, UtiliCorp?

A. UtiliCorp's emergence as a leading energy marketer and trader, with a careful emphasis on risk management, has become a driver of the company's corporate strategy. Despite the success, it has been slightly negative for credit quality with its high-risk business profile.

Q. Are you aware if there are any debt assignments that have been assigned to MPS and L&P that would be the subject of this research report, noting that the first line does reference a $250 million issuance of senior notes?

A. Whether any of this 250 million was assigned to these two divisions?
Q. Correct.
A. I don't offhand. I might have information that would --
Q. Okay. I may be able to speed it along. If I could direct your attention to your Direct Testimony, Schedule DAM-3.
A. I have it.
Q. I think that's the same in both versions of your testimony.
A. Yes.
Q. And specifically the third line from the bottom -- if I can get to it myself -- would you agree that that states, Senior 7.0 percent due 7/15/04?
A. That's what it says, yes.
Q. And would you agree that that does appear to be the subject of this article that was previously marked as Exhibit 182?
A. It would -- it would appear that that's the case. I can't be positive.
Q. Certainly.
Would you agree that the debt was issued and assigned at 7 percent interest rate?
A. The debt on line 3 is assigned at 7 percent

effective rate, yes.

Q. Correct. Would you agree that that debt issuance would reflect Aquila's consolidated operations at the time?

A. Well, the debt was issued by Aquila Consolidated, yes.

Q. Okay. In your calculations did you make any downward adjustments to the cost of this debt in your calculations to take into account that the cost would reflect the consolidation operations -- consolidated operations of Aquila including the high-risk component that was referenced in the research article?

A. Let me make sure I'm understanding the question. Did I make any special adjustments for this particular issue, is that the question?

Q. Correct.

A. No.

MR. MEYER: Okay. And I would move for the entry into evidence of Exhibit 182.

JUDGE JONES: Any objection to Exhibit 182?

MS. O'NEILL: No objection.

MR. SWEARENGEN: We have none. Thanks.

JUDGE JONES: Exhibit 182 is admitted into the record.

(Exhibit No. 182 was received into evidence.)

BY MR. MEYER:

Q. Dr. Murry, in your DCF model what growth rate do you recommend be applied to MPS and L&P?

A. Well, I'm not -- I'm not sure that I can make that statement that specifically. I looked at a range -- as you know, I looked at a range of growth rates and I -- I do strongly recommend looking at a forecasted growth rate of earnings per share. And if that's the thrust of your question, that's my answer.

Q. You have no specific growth rate. is that correct, for MPS and L&P?

A. Oh, that's correct.

Q. That's correct?

A. They're not traded securities.

Q. Okay. And do you have a dividend yield you would apply to MPS and L&P?

A. They don't have traded securities. That's the reason for using comparable companies in a case like this.

Q. Thank you.

Did you make any DCF calculation in your schedules that you chose not to give any weight to?

A. I don't think I made any calculations I didn't give some weight to. I think our testimony very clearly specifies that because of market conditions, I think the forecasted earnings per share is by far the more dominant influencing factor in the DCF calculation. And that doesn't apply just to this company. It's a general statement of current conditions.

Q. I'd like to draw your attention to Schedule DAM-8 in your Direct Testimony, if I could.

A. All right.

Q. And just to clarify, what are you DCF averages on that --

A. The --

Q. -- just in a general sense?

A. Well, they range from 5.66 to 8.4-- 8.43 as a cost of capital using a dividend growth rate. And that's -- that number is implausibly low and which indicates the market recognition of earnings per share as opposed to dividend growth.

Q. And, again, Schedule DAM-11 of your Direct Testimony?

A. The same -- same situation.

Q. Thank you.

A. The different -- the difference there is the yield number. Indicates that investors are self-selecting themselves currently. That's -- that's a bond rate.

Q. And just to clarify, you're recommending -- what range are you recommending in this?

A. Well, I -- in looking at this if you cited the other numbers, I got DCF results over 13 percent. And the actual returns of a couple companies, including those of Staff witness David Murray, were the same order. And I recommended 12 to 12 1/2 point estimate as the midpoint of that range.

Q. Is your recommendation primarily -- I believe you've already stated that your recommendation is primarily based on the DCF model?

A. I put more credence in the DCF model and calculation, yes, but I think it requires some professional judgment.

Q. So you would say you relied primarily, but not solely, on the DCF model; is that correct?

A. I guess that's -- that's -- that's close.

Q. Okay. And is the DCF model the cost of capital model?

A. Of course.

Q. Could you explain what did you do to test the reasonableness of your DCF results?

A. I made -- excuse me. I made a quick calculation of the after-tax interest coverage was the most -- most direct and quickest analysis. And I used -- I used the same calculations for the comparable companies to verify that the number I was recommending would not produce a coverage that was outside the bounds of those comparable companies. In fact, it was -- it was lower than that group.

Q. Did you make any attempt to determine what the credit rating of MPS and L&P would be on a stand-alone basis?

A. No, I didn't. I think -- I think Ms. Abbott can address that question.

Q. Can I direct your attention to Schedule DAM-17 to your Direct Testimony?

A. Yes.

Q. If you know, would you agree that the last rate cases for MPS and L&P would have occurred before the first date shown on that schedule, March 29, 2002?

A. I don't recall that, but I'd accept that.

Q. And could you give -- let me ask this. What has happened to interest rates on third-year treasuries and on Moody's triple A bond since the date indicated at the beginning of your schedule of March 29, 2002?

A. I'm not sure I follow the question. Are you asking me what does that chart show?

Q. Is there a trend? Yes. Is there a trend?

A. The purpose of that chart primarily is to show that -- that -- that the yield curve has not shifted down as much as some people would expect because of the publicity and recognition of short-term interest rates controlled by the Federal Reserve. And this chart shows that, it shows a sharper decline.

As a matter of fact, if you go out to October, November, so forth of 2002, it shows an adjustment downward in the short-term rates which was a Federal Reserve policy and approximately the same time the long-term rates actually increased. And -- and the point here is the movement of the short-term market is not really competitive with the equity ratios or equity returns of a utility and we should be looking at the long end of the market.

Q. So is that an explanation of why your recommendation in this case was higher versus the recommendation that Aquila had made in its previous rate case?

A. I can't speak to their recommendation in previous rate case.

Q. Okay.

MR. MEYER: I have no further questions at this time.

JUDGE JONES: Thank you.

Will there be redirect from Aquila?

MR. SWEARENGEN: Yes, your Honor.

REDIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Dr. Murry, counsel for the Staff asked you a question about the fact that you testified that you have selected, for your cost of capital analysis, companies with a similar financial risk to Aquila. Do you recall that question?

A. I recall the questioning along that line, yes, sir.

Q. In connection with that for your analysis, were you looking for comparative companies with corresponding risks?

A. Yes.

Q. And why is that important?

A. In this case, MPS and L&P are companies that are part of the larger company, Aquila, Incorporated. And Aquila, Incorporated has been a very integrated plus multi-state international company. And so their securities represent the risks of that company. So to regulate the piece in Missouri, we need to look at comparable companies that are stand-alone utilities to see what those companies would earn.

Q. Are you familiar with the Hope Natural Gas case and the other cases -- decisions by the United States Supreme Court concerning what an appropriate return on equity is?

A. Yes.

Q. And is it your understanding that one of the criteria from the Hope decision is that for purposes of establishing a rate of return, one should look at companies with corresponding risks?

A. Absolutely. That's very clearly stated in the Hope decision, as I understand as an economist.

Q. And is that what you attempted to do, once again, when you were looking for companies with corresponding financial risk?

A. Absolutely.

Q. Are there any other types of risks that you would take into account in that analysis in addition to financial risk?

A. Well, I think there are at least two other broad categories. And one is the -- probably the more important is business risk, the risk of operations to a utility such things as weather, cost of fuel that they could pass through. A second category is often under the rubric of regulatory risk and that's the treatment of a company and how it can recover costs in its operation through regulation.

Q. Was your analysis focused on those latter two types of risks or was it focused primarily on financial risk, as you said earlier?

A. Well, the selection of the companies using it is -- that ratio was used as financial risk. I took into account the business risk. I didn't attempt to evaluate the regulatory risk directly.

Q. I think counsel referred you to a schedule that Mr. Murray for the Staff had sponsored, his Rebuttal Schedule 1. Do you have that in front of you?

A. I do.

Q. And what is your understanding of the purpose of that schedule?

A. I believe that schedule was used to show the capital structure over a period of time to last really from 1990 through 1995 of the capital structure of Aquila, Incorporated. And it's -- it's titled Historical Consolidated Capital Structures.

Q. I recall that he asked you the question whether or not Aquila, Inc.'s current corporate capital structure is within the range set out in that schedule. Do you recall that question?

A. He did ask that question, yes.

Q. And what was your response?

A. My response was it fell within the range, because there was a 34.65 percent or there was -- looked to me there was a number below his recommendation.

Q. Let me ask you this question. For purposes of attempting to determine the appropriate capital structure for the Missouri regulated operations, the MPS operations and the L&P operations, does it matter whether or not on a historical basis Aquila, Inc.'s equity ratio may have fallen into the range --

A. No.

Q. -- set out in this schedule?

A. Not at all.

Q. And why --

A. It's irrelevant.

Q. And why is that?

A. It's the -- I think one has to look at the -- at the financing of the assets that went into the ground or that are on the ground to serve Missouri ratepayers.

And the fact that the parent has an equity ratio or capital structure that differs from a utility is not really relevant in trying to regulate the utility or trying to find the cost of capital of what MPS and L&P would be if they were stand-alone utilities and they'd be operating as utilities with a typical capital structure of the utility.

And the target cap structure the company uses and used prior to this case was 47 1/2 percent. That was a number which I verified by looking at other stand-alone utilities and was very satisfied it was a reasonable number.

I also had to satisfy myself that I thought the process was a reasonable process. And as I understand it, the company, when it is making an investment in a division such as MPS and L&P, determines the capital they need, the parent issues debt or common stock. Where the parent gets the revenue or the funds that support that construction is almost irrelevant. That's the -- it's the cost of capital that actually goes to put in the physical asset in the ground.

And that's why the Staff's number is so -- in my opinion, is so analytically wrong because the fact that the parent has had trouble in nonregulated areas is not relevant to the regulated facilities of Missouri. They're on the ground, they have a net book value and it's the cost of capital of those assets that's important. That's the rate base.

Q. When you're talking about "those assets," are you talking about things like power plants and transmission and distribution lines and things of that sort?

A. Exactly.

Q. Do you recall in the company's last rate case before this Commission -- its last electric rate case a couple of years ago, what the common equity ratio of the corporate capital structure may have been at that time?

A. I've read that -- I've read some testimony or some matters related to that. I thought the capital structure -- the corporate capital structure I thought at that time was 46 percent, but I'm not positive.

Q. It's in that range --

A. It is.
Q. -- would that be your judgment?
A. That's correct.
Q. And what's the capital structure that the Staff is recommending in this case, which is the corporate capital structure I believe at the end of the year 2002?
A. I'd have to look --
Q. What is the equity ratio?
A. I'd have to look at the precise number, but it's over just slightly the 35 percent.
Q. And so that would represent at least a 10 or 11 point swing from just two years ago; is that true?
A. As I understand the facts, that's correct.
Q. And what would the reason for that be, do you know?
A. It's the write-down of the parent. And I'm convinced that's the reason and the -- the loss of value at the corporate level.
Q. And why did that write-down occur at the corporate level?
A. Because the company took -- took some -- wrote down some very serious losses on their -- primarily I guess in their trading operations, their nonregulated sector.
Q. And did that have anything at all to do with the regulated assets in Missouri, the hard assets in the

ground that you talked about, the MPS transmission, distribution lines, generating stations, the L&P generating stations and other facilities?

A. As I can tell, it had no relationship at all.

Q. Those hard assets that are in the ground now that you talked about, how were they financed?

A. They were financed as -- as I understand the process of the company, they were financed with the issuance of debt when the division needs capital for its projects. This flows up to the parent. The parent then bundles it up.

It appears to me it's -- has the earmarks of being a very efficient way to finance in a large company, that they're accumulating the capital requirements and then they go through a single financing and the lawyer costs, the prospectus, the cost of going to issuance that then are all bundled together.

So there should be economies associated with that financing and that's the debt piece. And what's not debt is equity and that's held by the parent. Where the parent gets funds to pay that other piece of building this power plant is almost irrelevant. It is equity. It's equity that the parent holds of this affiliate.

Q. Is it your understanding that the company initiated this capital allocation process back in the '80s during the time it began making acquisitions of other utility properties and specifically the West Cutney properties up in Canada?

A. I can't speak to particular properties, but the time is consistent with what I understand and what I've read.

Q. And what is your understanding as to the reason that they initiated this capital allocation process?

A. I don't know that I've talked to anyone in detail about the motivation. What I inferred that it was a -- both an efficient way to finance as well as a way to manage -- manage the cash within the company. And to me that seems to be a -- a good business strategy.

And it -- from a regulatory standpoint, it seems to be more reflective of the actual costs of debt that go into the facilities then just choosing a hypothetical capital structure as something that you use for regulation, which is often done in the case of an integrated company.

Q. Counsel for the Staff asked you a question about a prior Commission decision and I think he referenced you to Case No. ER-90-101 with the suggestion that perhaps that was in your testimony. Could you turn to page 6 of your Rebuttal Testimony, please? Are you there?

A. I have it, yes.

Q. There at the top of page 6 you reference some language from a Commission decision in Case No. ER-93-337?

A. That's correct.

Q. Is that the language that you were thinking about when counsel asked you the question about ER-90-101?

A. Yes. I told him I couldn't verify the number, yes.

Q. And what is your understanding of what the Commission held in that case with respect to the capital structure issue?

A. My understanding that the Commission -- and this was in a UtiliCorp Commission -- or case that I was referring to, that the use of -- and it says -- language is, The use of UtiliCorp's consolidated capital structure may be a valid approach. However, this is not the best approach for this case because UtiliCorp is comprised of both operating divisions and unregulated subsidiaries and its capital structure reflects that mix.

Q. And then further on on page 83 of that decision you note what the Commission held about the use of the assigned capital structure?

A. It's page 38.

Q. Excuse me, page 38.

A. And the statement is that the -- that was held was, Use of MoPub's assigned capital structure will help insulate it to some extent from UtiliCorp's unregulated subsidiaries and the assigned capital structure's actually analogous to the capital structures of comparable electric companies.

Q. Counsel for the Staff offered into evidence Exhibit 182, a Standard and Poor's document. Do you have that in front of you?

A. Yes, I do.

Q. And looking at that document what does that say with respect to the credit rating that was assigned to that particular financing?

A. It says that that financing was triple B.

Q. And is it your understanding that at that point in time there was no change in Aquila's rating; in other words, at that time it did have a triple B rating?

A. It did have triple B rating. And I was -- I was reading this, that there was not a -- not a downgrade at that point in time, so I think that was the extant rating.

Q. So given the fact that there was no change in the rating, would you agree that that would be a reason that no downward adjustment would be needed in any of your calculations with respect to that debt issuance?

A. That would be one of the reasons, yes.

Q. And, finally, you were asked a couple of questions about your discounted cash flow or DCF calculation. And you said for the growth rate you looked at a range and used a forecast. Do you recall that?

A. I said I used a forecast of earnings per share specifically.

Q. And why did you use a forecast?

A. Because the DCF is based on expected returns both as a -- as a stream of returns, either -- either as dividends or capital gains. And there's even empirical work to demonstrate that forecasted numbers are more accurate representations of evaluations by investors than historical numbers.

MR. SWEARENGEN: Fine. That's all I have. Thank you.

I would re-offer into evidence Dr. Murry's exhibits. Thank you.

JUDGE JONES: Exhibits 80, 81, 82, 83, 1082 and 1083 are admitted into the record.

(Exhibit Nos. 80, 81, 82, 83, 1082 and 1083 were received into evidence.)

MR. MEYER: Just to clarify, your Honor, that's over Staff's objection; is that --

JUDGE JONES: Yes.

MS. O'NEILL: And also over Public Counsel's objection.

JUDGE JONES: Yes.

MR. SWEARENGEN: Did you get 1081, Judge? I'm sorry. I didn't hear that.

JUDGE JONES: And 1081.

(Exhibit No. 1081 was received into evidence.)

MR. SWEARENGEN: Thank you. May the witness may be excused?

JUDGE JONES: Yes, you may, Dr. Murry.

Will Aquila call its next witness?

MR. SWEARENGEN: Call John Reed.

(Witness sworn.)

JUDGE JONES: Thank you. You may be seated.

JOHN REED testified as follows:

DIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Would you state your name for the record, please?

A. My name is John J. Reed.

Q. By who are you employed, Mr. Reed?

A. Concentric Energy Advisors.

Q. And what is the nature of the business of that company?

A. Concentric Energy Advisors and its subsidiary, Concentric Capital Partners, provide financial advisory services and economic analysis services to the utility and energy industry in North America.

Q. Have you caused to be prepared for purposes of this proceeding two pieces of testimony?

A. Yes.

Q. And one is Rebuttal Testimony of John J. Reed. Do you have that in front of you?
A. Yes, I do.
Q. And if I represented to you that that had been marked for purposes of identification as Exhibit 6 and also Exhibit 1086 -- excuse me, Exhibit 86 and 1086, would you accept that?
A. Yes.
Q. Do you have any changes you need to make in that Rebuttal Testimony at this time?
A. No, I do not.
Q. Did you also prepare for this proceeding certain Surrebuttal Testimony?
A. Yes, I did.
Q. And if I represented to you that that had been marked for identification as Exhibits 87 and also 1087, would you accept that?
A. Yes.
Q. Are there any changes that you need to make with respect to your Surrebuttal Testimony?
A. No.
Q. And if I asked you the questions that are contained in your Rebuttal and Surrebuttal Testimony, would your answers be the same today?
A. Yes, they would.

Q. Fine. Thank you.

MR. SWEARENGEN: With that, your Honor, I would offer into evidence Exhibits 86, 1086, 87, 1087 and tender the witness for cross-examination.

JUDGE JONES: Are there any objections to the exhibits?

MS. O'NEILL: No objection.

MR. MEYER: No objection.

JUDGE JONES: Exhibit 86, Exhibit 87, 1086 and 1087 are admitted into the record.

(Exhibit Nos. 86, 87, 1086 and 1087 were received into evidence.)

JUDGE JONES: Will there be cross-examination from the Office of Public Counsel?

MS. O'NEILL: No questions.

JUDGE JONES: Any cross-examination from the Staff of the Commission?

MR. MEYER: Yes, your Honor.

CROSS-EXAMINATION BY MR. MEYER:

Q. Good morning, Mr. Reed.

A. Good morning, Mr. Meyer.

Q. I'd like to -- I'd like to draw your attention to page 23 of your Rebuttal Testimony, please.

A. I have that.

Q. Lines 3 through 5, it's point one under a list of issues that you believed were drawing attention at this time among investors, I believe. Could you read point one for the court, please?

A. Item 1 at line 6 actually is Unpredictable earnings that lead to negative earnings surprises.

Q. Uh-oh.

A. Do we have different pagination?

Q. Page 23, line 3 of Rebuttal.

A. We may have different pagination.

Q. Uh-oh.

A. A strong balance sheet, is that what you have?

Q. The first thing at the top I have is, The number of rate proceedings.

MR. SWEARENGEN: May I approach the witness?

JUDGE JONES: Yes, you may.

THE WITNESS: I have that line.

BY MR. MEYER:

Q. Okay. We're on the same page now?

A. I believe so.

Q. Okay. And line 3 of that point 1?

A. It says, The allowed returns in new cases. Many utilities are expected to come in for their first rate proceeding in three or four years and analysts will be watching how the new allowed returns compare to previously authorized levels.

Q. Do you have a sense of what investors might be expecting regarding authorized ROEs in today's economic environment in light of that?

A. I would say that there's a wide range of expectations depending on the state, the utility involved, the risks of that company. Right now most analysts are looking at the historic trend in allowed returns on equity and they see that in 2003 those numbers were still in the 11 percent range on average. And they're expecting that that trend is essentially going to continue.

Q. Would you agree that some utilities might have benefited during the recent past from rate moratoria in a deregulatory environment?

A. In terms of -- yes, I would say so. They've benefited in the ability to earn a level of return that perhaps is above their authorized return on equity. And that's a positive that certainly affects many utilities. It hasn't been true for Aquila, but other companies have been able to earn above their authorized levels.

MR. MEYER: I'd like to have an exhibit marked and approach the witness, please.

JUDGE JONES: Okay. This will be Exhibit 183.

(Exhibit No. 183 was marked for identification.)

BY MR. MEYER:

Q. And are you familiar with the Standard and Poor's research services?

A. Yes.

Q. Okay. Would this type of analysis be something that you would typically see in the area of doing this type of research?

A. Yes.

Q. I draw your attention to the second paragraph under the heading Repair Job on the first page of this document. And specifically -- and specifically I believe it's the third sentence that begins, More justification on limiting ROEs.

A. I see the paragraph.

Q. Okay. Beginning with the sentence, More justification on limiting ROEs, could you read the next -- that sentence and the following I believe two sentences?

A. I'm sorry. You'd like me to read from, Beginning --

Q. Beginning with more justification on limiting ROEs, which I think is the fourth sentence in that paragraph.

A. More justification on limiting ROEs will come from eliminating double taxation on dividends. A recent example of this downward pressure is the pending settlement of Public Service Electric and Gas Company's distribution rates and recovery of deferred restructuring costs, in which a 9.75 percent ROE has been agreed to.

Q. And actually if I could go back a sentence that begins, One obvious danger?

A. One obvious danger, ironically, is a very low interest rate environment that may drive authorized ROEs down.

Q. Would you agree that these concepts that the S&P analyst has referenced here are valid concepts?

A. They're risks that the market's aware of, yes.

Q. So you would agree, for example, low interest rate environment might make a lower ROE a more attractive option?

A. No. Not at all. That's not a more attractive option.

Q. Less attractive option. I misstated that.

Would you agree that it's important to take into account the real world of economic environment of cost of capital in conducting analysis is this area?

A. Yes.

Q. I'd like to draw your attention to your Rebuttal Testimony, page 4, line 17 to 19.

A. Yes, I have that.

Q. And could you read the sentence that begins at that line 17, please?

A. This signal would be sent at a time when demands emanating from financial markets for stronger balance sheets, lower operating risks and more balanced regulatory regimes have never been stronger.

Q. And when you say the word "signal," could you explain what you mean when you say "signal"?

A. Certainly. The analysis conducted by both equity analysts and debt analysts, credit analysts indicate that they're tightening their standards as to what their perception of risk is and what they consider to be adequate returns. That is the signal through their published research, they're signaling a tightening of those standards.

Q. Okay. Do you believe that the Commission is responsible for assisting Aquila in repairing its balance sheet difficulties?

A. No. I think the Commission's responsibility rests with the rates of St. Joe Light & Power and MPS. And certainly it's responsible for helping those two companies to preserve and maintain their financial integrity, but not Aquila, Incorporated.

Q. I'd like to refer you to your Rebuttal Testimony at page 17.

A. I have that.

Q. And over the course of that page you have a few references to Staff-recommended equity ratios in the last few MPS cases. Would that be a correct representation of some of the information on that page?

A. Yes.

Q. Okay. Are you aware of what the basis of Staff's recommendations was for those equity ratios, what type of capital structure specifically?

A. The only information I have here is what the equity ratio was.

Q. Okay. May I draw your attention to page 2 of 2 of JJR-1 to your -- which is the schedule attached to your Surrebuttal Testimony. I believe there's a line on that, perhaps the fifth line down for Aquila, Inc.

A. Yes.

Q. Does that line reflect what the Aquila equity ratio was as of 2001?

A. It shows what it was as of year-end 2001 as published by Value Line I believe is the source here.

Q. Okay. That was actually my next question. And what does that equity ratio reflect in there? What is that equity ratio that is reflected there?

A. 56.1 percent.

Q. And now could I draw your attention, if you have it, to David Murray -- witness David Murray's Rebuttal Schedule 1 that was attached to his Rebuttal Testimony?

A. You said David Murray Rebuttal Schedule --

Q. I believe it's the Rebuttal Schedule 1. The exhibit number I do not know.

A. Okay. I have Revised Schedule 21. I'm not sure --

Q. I think it might have been the next page after that.

A. Yes. I have that.

Q. Okay. And if you can tell, does that page appear to reflect a number -- a common equity ratio for Aquila as of 2001?

A. Yes.

Q. And what is that percentage?

A. It would appear that the figure there is 44.17 percent.

Q. And if you know, are you aware of Mr. Murray's source for his percentage?

A. The Aquila annual reports.

Q. And generally, do you know what financial information Staff relies upon for its capital structure recommendation?

A.. As to between Value Line and annual reports, is that your question?

Q. Yes.

A. No. I know the source here was annual reports.

Q. Can you reconcile the discrepancy between Staff's numbers and the one that is reflected on JJR-1, which I believe you said came from Value Line?

A. Right. My recollection is that Value Line, first of all, eliminates short-term debt as being not a source of permanent capital. Apart from that, I haven't tried to do a mathematical reconciliation.

Q. Can I draw your attention to Mr. Murray's Schedule 1 attached to his testimony? And if you could, do you have a sense of the average equity ratio that is there?

A. I'm sorry. Could you -- Schedule 1 attach--

Q. It's Schedule 1 to Mr. Murray's Rebuttal Testimony.

MR. SWEARENGEN: David Murray?

BY MR. MEYER:

Q. David Murray. I guess Commissioner Murray's not here.

And on Schedule 1 of that what the average equity ratio was there, if you can make that out?

A. This is the page that we were just on?

Q. Correct.

A. 38.41 percent was the average that he shows over that period through 2001.

Q. And then could I draw you to -- your attention to page 6, lines 19 through 21 of your Surrebuttal

Testimony?

A. Could you just give me the reference?

Q. It's page 6, lines 19 through 21.

A. And could you give me the wording that you're talking about?

Q. I'm sorry. Yes. It begins with, The 2002 loss alone reduced Aquila's consolidated equity ratio. It's right before a question in bold, How do you respond?

A. Yes. I have that.

Q. And that sentence at line 19 that begins, The 2002 loss alone, it implies at that point that the equity ratio in 2001 was 44.2 percent. Is that your implication?

A. Per the annual report, that's correct.

Q. Okay. And are you aware of Mr. David Murray's recommendation in this area?

A. What recommendation?

Q. Percentage.

A. Yes.

Q. Okay. And would you agree that that would be 35.31 percent?

A. Yes.

Q. Okay. Would you say that the 35.31 percent or the recommendation that you've made is closer to the average equity ratio?

A. As I understand your question --

Q. I think I'm misstating that. Would you say that the 35.31 percent that Mr. Murray has recommended is closer to the average or is the 44.2 percent referenced in your testimony closer to the average equity ratio?

A. The average for Aquila, Inc. over the 10 or more years that Mr. Murray looks at? Is that your question? His -- the 38.5 percent.

Q. The number that's contained in Schedule 1 --

A. Yes.

Q. -- of Mr. Murray's testimony?

A. Yes. First of all, I'm not recommend recommending 44.2. My point here in this testimony is to simply say 11 percentage points of the difference is attributable to a simple accounting change on Aquila, Inc.'s balance sheet. I would agree that the 35.3 percent is closer to the historic average for Aquila, Inc. but, of course, we're not setting the rates here for Aquila, Inc.

MR. MEYER: I have no further questions and would move that Exhibit 183 be admitted.

JUDGE JONES: Any objection to Exhibit 183?

MR. SWEARENGEN: No objection.

MS. O'NEILL: No objection.

JUDGE JONES: Exhibit 183 is admitted into the record.

(Exhibit No. 183 was received into evidence.)

JUDGE JONES: Mr. Swearengen, do you have redirect examination?

MR. SWEARENGEN: Yes, I have a couple.

REDIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Mr. Reed, just as a follow-up to that last line of questions, you indicated I believe that the equity ratio for the company's corporate capital structure as of December 31, 2001 when compared with the equity ratio and the capital structure at the time of the last rate case approximately two years prior reflected, I believe in your words, an 11 percentage point drop; is that true?

A. Yes.

Q. And you said -- I believe you said that you thought that was attributable to an accounting change?

A. That's correct.

Q. What did you mean by that?

A. It's not attributable to a change in the financing as to how assets were financed. It's attributable to their decision to take a write off on their balance sheet for failed investments or investments that no longer had their acquisition value remaining in telecom international and merchant activities.

So they simply made an accounting adjustment to the 2003 balance sheet which removed $2.1 billion of equity value. It doesn't reflect how the assets were financed.

Q. Now, when you say "they," you're talking about Aquila, Inc., the corporation. Correct?

A. That's correct.

Q. And when you say it doesn't reflect how the utility assets are valued, are you talking about in this case the Missouri utility assets?

A. That's correct. It doesn't reflect how the Missouri assets were financed. It doesn't even reflect how the Aquila, Inc. assets were financed. It reflects that original financing, which was closer to 50/50, 44.2 percent adjusted for the write off and the equity.

Q. In response to an earlier question, I think you indicated that, in your view, this Commission had no responsibility to Aquila, Inc., the corporation, the parent corporation; is that true?

A. Not directly. Their responsibility is to the Missouri regulated operations.

Q. And when you say that, do you mean the Missouri regulated operations as stand-alone entities?

A. Yes. That's the way that regulatory policy says we should be setting the rates for these two businesses without regard to the unregulated or other diversified activities of their affiliates.

Q. You were also asked a question about the prospective range of expectations that investors may have concerning returns on equity, returns on equity that regulatory bodies may award in future cases involving electric utilities and gas utilities. Do you recall that?

A. Yes.

Q. And let me ask you this question. All other things being equal, is it true that a company with a lower equity ratio would expect a higher authorized return on equity?

A. Yes.

Q. And why is that?

A. Because the lower the equity ratio, the greater the degree of financial leverage and, therefore, financial risk in the business. That risk should be compensated for in the form of a higher return on equity.

Q. Generally speaking, would it be true that a company with a lower equity ratio would experience a higher cost of debt?

A. Yes.

Q. And why is that the case?

A. For the same reason, that the coverage ratios on the interest expense tend to be lower. The risk of the company not being able to make its debt service obligations is greater and, therefore, the cost of debt includes a risk premium, making the total cost higher.

Q. Then turn, if you would, please, to what we've marked as Exhibit 186, the Standard and Poor's document.

JUDGE JONES: That was 183.

BY MR. SWEARENGEN:

Q. Excuse me. Exhibit 183.

A. Yes, I have it.

Q. Published June 19th, 2003.

Do you have that in front of you?

A. I do.

Q. Down under the title Repair Job in the second full paragraph, there is a reference to, A recent example of this downward pressure is the pending settlement of the Public Service Electric and Gas Company's distribution rates and recovery of deferred restructuring costs in which a 9.75 percent ROE have been agreed to.

Do you see that language?

A. Yes.

Q. When they speak in terms of deferred restructuring costs, what is your understanding of the meaning of those terms?

A. Stranded costs that arose out of the restructuring of the service of Public Service Electric and Gas.

Q. Would the restructuring in that instance refer to spinning off generation assets?

A. Yes. Among other things.

Q. And would that make the company then less risky?

A. Yes. Typically the prevailing view in equity markets right now is that companies that have evolved into distribution-only businesses are less risky than companies that remain vertically integrated.

Q. Does that have any relevance to what we're talking about here today with respect to Aquila's MPS and L&P operations that are subject to this Commission's jurisdiction?

A. What it suggests is that the appropriate cost of equity for these businesses which remain vertically integrated would be higher.

Q. Thank you.

MR. SWEARENGEN: That's all I have.

JUDGE JONES: Thank you. You may --

MR. SWEARENGEN: We do offer the exhibits if they have not been received.

JUDGE JONES: They've been received.

MR. SWEARENGEN: Thank you, Judge.

JUDGE JONES: At this point we should take a break until let's say 10:30 unless you all -- if you all can keep going, we'll just break 10 minutes and come right back. So let's do that. Let's break until 20 after 10:00 and we'll come back with Aquila's next witness.

MR. SWEARENGEN: Thank you.

(A recess was taken.)

JUDGE JONES: Okay. We're back on the record with Case No. ER-2004-0034, and I believe Aquila's second witness is finished testifying. Do you have a third witness?

MR. SWEARENGEN: I do. Susan Abbott, I would call her at this time.

JUDGE JONES: Ms. Abbott, would you step forward?

(Witness sworn.)

JUDGE JONES: Thank you. You may be seated.

THE WITNESS: Thank you.

JUDGE JONES: Mr. Swearengen.

MR. SWEARENGEN: Thank you.

SUSAN ABBOTT testified as follows:

DIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Would you state your name for the record, please?

A. Yes. My name is Susan D. Abbott.

Q. And by whom are you employed and in what capacity?

A. I am currently employed as a managing director with New Harbor, Incorporated in New York.

Q. And what is the business of that company, just briefly?

A. The company is a financial advisory firm to the electric utility industry.

Q. Thank you.

Have you caused to be prepared for purposes of this proceeding certain Rebuttal and Surrebuttal Testimony in question and answer form?

A. Yes, sir.

Q. And do you have copies of that testimony with you this morning?

A. Yes, sir, I do.

Q. Are there any changes you need to make with respect to your Rebuttal Testimony, which has been marked for purposes of identification as Exhibit 84 and also Exhibit 1084?

A. No.

Q. With respect to your Surrebuttal Testimony, which has been marked as Exhibit 85 and also 1085, are there any changes that you wish to make to that testimony at this time?

A. No, sir, there are not.

Q. Thank you.

MR. SWEARENGEN: With that, your Honor, I would offer into evidence Exhibits 84, 1084, 85, 1085 and tender the witness.

JUDGE JONES: Are there any objections?

MS. O'NEILL: No objection.

MR. MEYER: No objection.

JUDGE JONES: Exhibits 84, 85, 1084 and 1085 are admitted into the record.

(Exhibit Nos. 84, 85, 1084 and 1085 were Received into evidence.)

JUDGE JONES: Will there be cross-examination from the Office of Public Counsel?

MS. O'NEILL: No questions, your Honor.

JUDGE JONES: Any questions from the Staff of the Commission?

MR. MEYER: Yes. Thank you.

CROSS-EXAMINATION BY MR. MEYER:

Q. Good morning.

A. Good morning.

Q. Ms. Abbott, do you know if Moody's gives opinions of stand-alone credit quality as a division of a company upon that company's request -- I'm sorry, of a division of a company upon that company's request?

A. No, they don't.

Q. Are you familiar with something called the Rating Assessment Service --

A. Yes.

Q. -- by Moody's?
A. Very much.
Q. Is that something you dealt with while you were employed at Moody's?
A. Certainly did.
Q. Could you explain the nature of that service?
A. Yes. Essentially a company would come to Moody's and request to have a particular question answered, which would be, If we did the following, what would be the rating result. And Moody's would do their analysis and come back with, If everything that you said exactly happens that way, then this would be the result.
Q. So it's sort of like a response to a hypothetical question?
A. Yes.
Q. Okay. Are you aware that -- if a utility could request that service to assess credit quality of divisions of that utility as though they were stand-alone entities? Is that the type of a hypothetical question that could be answered?
A. They could, but for the most part it was more practical, real world questions that would be answered such as, If I decide to make an acquisition and this is how much I would pay and these are the conditions under which I would do it, what would that do to my credit rating.

Q. To your knowledge then, are you aware of whether Aquila would have requested an analysis such as what a stand-alone division of their entity might be?

A. They never did while I was there and I am not aware that they have since.

Q. If Aquila would have done that, would Moody's have disclosed those results to anyone other than Aquila?

A. No.

Q. And so those records are basically kept confidential?

A. They're kept confidential. The company is allowed to do with the information what they wish, but Moody's is not going to reveal that to anybody else.

Q. Are you aware there are comments given by credit agencies regarding credit worthiness of utilities?

A. Yes.

Q. That's a very broad question.

A. Yes.

MR. MEYER: I'd like to have an exhibit marked, please. And may I approach the witness?

JUDGE JONES: Yes, you may. This will be Exhibit 184.

(Exhibit No. 184 was marked for identification.)

BY MR. MEYER:

Q. Specifically on what's been marked for identification as Exhibit 184, could I draw your attention to the fourth paragraph -- I'm sorry, the third full paragraph on that?

A. On the first page?

Q. On the first page.

A. Yes.

Q. And take into account that this is a discussion of both Aquila and Allegheny Energy. Could you read that third paragraph?

A. Certainly. Still, both issuers' longstanding utility operations are of meaningful scale and scope. The management teams espouse the mantra of a back-to-basics strategy, and the regulated utility represents the core business operations for these entities. It is noteworthy that the regulated utility businesses possess characteristics that would merit an investment-grade business profile on a stand-alone basis.

Q. So would you agree that the analyst in this case has indicated that there is some ability to determine whether or not if a diversified entity's subdivisions were taken on a stand-alone basis, in this particular case they could be considered investment grade?

A. I would put a little finer characterization to that because what Tobias is actually saying is that there are characteristics that the company's possess which could lead one to conclude that they are investment grade, but he is not stating outright that they are investment grade.

Q. And I guess let me back up for a moment. I'm quite certain you're familiar with the Standard and Poor's Ratings Direct Service; is that correct?

A. Yes. Absolutely.

Q. Okay. Are you aware of what the financial ratio was that Dr. Murry calculated to test the reasonableness of his recommendation?

A. Which one are you referring to? Are you referring to the equity ratio or --

Q. Let me look at your testimony to see where I'm going with that.

In your Rebuttal Testimony on page 10 regarding the -- I think it's line 19 reference to the pre-tax interest coverage ratio.

A. Yes. In my -- on page 10 of my testimony, line 19?

Q. Right.

A. That starts with, Flow is a percentage of outstanding debt?

Q. Right. Are you aware whether Dr. Murray calculated that?

A. I am not aware of whether he did or not.

Q. Okay. Do you know if Dr. Murray attempted to calculate any specific ratios to determine the credit quality of divisions on a stand-alone basis assuming his recommendation was accepted?

A. I am not aware of whether he did or not.

Q. Are you aware whether in Missouri the Commission routinely attempts to assess the effects of the rate case on the company's credit quality in a sort of generic sense?

A. I cannot say that I am aware of the testing of the results.

Q. In your Surrebuttal Testimony on page 1, lines 14 through 16 --

A. Yes.

Q. -- you have a reference to standards used by S&P?

A. Yes.

Q. And just to clarify, are those standards that you reference the same guidelines that would be related to Schedule SDA-1 that was attached to your Rebuttal Testimony?

A. I believe so. Let me just check to make sure that was what it was titled.

Yes, those are.

MR. MEYER: And I'd like to have an exhibit marked and approach the witness, please.

JUDGE JONES: Okay. This will be Exhibit 185.
(Exhibit No. 185 was marked for identification.)
BY MR. MEYER:
Q. And, again, it's another Standard and Poor's Ratings Direct document. Is that something that you recognize?
A. Yes.
Q. Okay. I'll give you a moment to look at this document, but the context is -- would you agree that these are the -- this would comprise the guidelines, the discussion of the guidelines that relate to the S&P financial targets that were attached?
A. Yes. They seem to be the same as the schedule I've submitted.
Q. Okay. Thank you.
And is this actually the -- would you agree that the guidelines here are, in fact, the same guidelines that are attached to -- I'm sorry, not the guidelines, the substantive information, the numbers here are the same numbers in this exhibit as are attached?
A. Yes. Given I've had five seconds to look at it.
Q. Certainly. Certainly. You would accept --
A. I spot checked the concept.

Q. Thank you.
A. Uh-huh.
Q. And may I direct your attention to the last paragraph of text on the first page of that document?
A. Of the Standard and Poor's report?
Q. Correct.
A. Yes.
Q. Could you read that last paragraph?
A. Starting with, Consistent with?
Q. Yes, please.
A. Consistent with Standard and Poor's rating methodology, the four published financial targets will be used with other quantitative measures, business risk analysis and comparative analysis of peer groupings to determine credit ratings. The new targets are designed to assist utilities, utility affiliates and the investment community in assessing the relative financial strength of issuers.
Q. And I note on page 3 of your Surrebuttal you discuss this concept. Would you agree with that?
A. Yes.
Q. And do you agree with the concept?
A. Absolutely.
Q. In the targets in both this document and also in Schedule SDA-1, a company with a business profile of 5

and a pre-tax interest of 5 would reflect double A status. Would that be --

A. That is correct.

Q. Okay. S&P does indicate, and you've agreed, there are other factors that would need to be considered beyond those targets; is that correct?

A. Many, many other factors.

Q. So would you agree that it's possible that a company may not fall precisely within a particular set of parameters but still be rated a specific rating that doesn't actually match those numbers?

A. Yes. That does happen.

Q. That does happen.

Has Aquila, to your knowledge, always had a debt capital ratio between 47 and 55 over the past five years?

A. No.

Q. Do you know what they were rated during that period?

A. They -- yes, actually I do. They have been rated various things over that period of time. Let me see. The last five years? Where do you want to start 1999, 1998?

Q. I guess this is 2004. '99.

A. They were B double A3 in 1999, 2000 and 2001. That's equivalent to a triple B minus. At S&P I believe they carry the same ratings. In 2002 they were downgraded to BA2. And they are currently C double A1.

Q. Thank you.

MR. MEYER: I have one more exhibit, if I may approach the witness and have it be marked.

JUDGE JONES: Yes.

(Exhibit No. 186 was marked for identification.)

BY MR. MEYER:

Q. I'll give you a moment to take a look at it.

A. Uh-huh.

MR. MEYER: And this is Exhibit 18--

JUDGE JONES: 186.

BY MR. MEYER:

Q. And I guess I'll ask you this, are you familiar with the CreditStats service?

A. I --

Q. Or let me --

A. I have seen things like this before. I'm not real familiar with this.

Q. Okay. Would you agree with me that the second company that appears to be reflected here is indicated as Aquila, Inc.?

A. Yes, it is.

Q. Okay. And that it appears to cover the years

1998 through 2002?

A. Yes, it does.

Q. Okay. I think you've just addressed that period indicating the credit ratings of Aquila during most of that period. I guess I do need to back up then, if you know what their credit rating was in 1998?

A. B double A3.

Q. Would that fall outside the S&P benchmarks, taking into account the numbers that are included in this document?

A. In -- well, some of them -- some of them will --

Q. And I realize it's a very broad question.

A. The question becomes which stats are more important than others. And in Aquila's case, or in anybody's case, FFO, funds flow from operations, interest coverage of all of these stats, I would say, carries slightly more weight than others for a credit analysis.

Because what -- what investors or lenders to these companies are interested in is whether they're going to get their principal and interest on a timely basis, and cash flow becomes paramount to that analysis. And in this case the cash flow number in 1998 would qualify for investment grade. FFO to interest coverage is 4.1.

Q. So would you say that would be within or without the --

A. It is within -- it is within the Standard and Poor's investment grade range.

Q. And what about for 1999?

A. Just barely.

Q. Okay. And what about for 2000?

A. Yes. It's within the range.

Q. And 2001?

A. It's within the range.

Q. And 2002?

A. It's within the range.

Q. Okay. What about the debt ratio during that same five-year span?

A. The total debt to capital?

Q. Correct.

A. It starts to fall out of that range -- okay. It is within the range -- it's just within the range in '98. And then it goes above the range in the following years, meaning that it drops out of the triple B range into a double B range.

Q. So, again, you would say this amounts to all in which particular column that you would be looking at as to whether or not the company would be in or outside of the range in any given year in the five-year span?

A. I'm sorry. Could you repeat that?

Q. Does it depend upon which column that you're looking at as to whether or not that number would be placing Aquila, Inc. in the range or outside of the range of the S&P on any given year during this five-year span?

A. Yes. If you look at total debt to capitalization and, for instance, the one to the left, which is funds flow to average total debt, those can't -- one can be out of the range and another one in the range. And this is why you can't use just one statistic to determine whether a company has creditworthiness because you get these variations. And it becomes an analysis that requires a wide variety of statistics and circumstances to view in order to come up with the proper answer.

Q. Thank you very much.

MR. MEYER: That's all I have. And I would move for the admission of the previous three marked exhibits.

JUDGE JONES: Are there any objections to Exhibits 184, 185 and 186?

MR. SWEARENGEN: The company has no objection.

MS. O'NEILL: No objection.

JUDGE JONES: Exhibits 184, 185 and 186 are admitted into the record.

(Exhibit Nos. 184, 185 and 186 were received into evidence.)

JUDGE JONES: Will there be redirect from Aquila?

MR. SWEARENGEN: Just a couple, your Honor.

REDIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Ms. Abbott, do you have Exhibit 186 in front of you, the document that Staff counsel offered into evidence?

A. I'm forgetting which one that was.

Q. It's entitled CreditStats: Electric and Gas Combination Utilities Integrated.

A. Yes. This chart.

Q. And what is your understanding of what a combination utility is?

A. It is a company that has regulated electric and regulated gas operations.

Q. Looking at that document in the second column entitled Sales --

A. Yes.

Q. -- would it be your understanding that that number would reflect revenues from both the sale of electricity and natural gas?

A. Yes, sir.

Q. And are the revenues associated with the sale of natural gas usually substantial?

A. No. Not necessarily.

Q. Okay. What would that depend on?
A. It -- well, it depends on the breadth of the gas business to -- in terms of the territory that it covers.
Q. For any particular company?
A. For any particular company.
Q. So you can't look at that document and make a determination how much of the sales revenues there reflects either electric or natural gas?
A. No, no. Not just with this one statistic.
Q. In your judgment, would regulated natural gas operations be riskier than regulated electric operations?
A. No. Actually, they tend to be slightly less risky.
Q. Gas operations tend to be less risky?
A. Yes. Less risky than electric operations.
MR. SWEARENGEN: That's all I have. Thank you.
JUDGE JONES: Thank you, Ms. Abbott. You may step down.
THE WITNESS: Thank you.
MR. SWEARENGEN: That's all we have, your Honor. I would ask that our witnesses who are from out of town be excused.
JUDGE JONES: They are excused.
MR. SWEARENGEN: Thank you.

JUDGE JONES: Now we'll have Staff's witness.

MR. MEYER: Staff would call David Murray, please.

(Witness sworn.)

JUDGE JONES: Thank you. You may be seated.

DAVID MURRAY testified as follows:

DIRECT EXAMINATION BY MR. MEYER:

Q. Mr. Murray, I believe you've previously prepared and Staff has submitted testimony that has been marked as Exhibits 88 Direct Testimony and 1088 also Direct Testimony; is that correct?

A. Yes.

Q. And documents previously marked as Exhibits 89 Rebuttal Testimony and 1089, Rebuttal Testimony; is that correct?

A. I believe that's correct.

Q. And Exhibits 90 and 1090 and also I believe Exhibits 1090-HC and 90-HC that have been marked previously that you prepared; is that correct?

A. I believe that's correct.

Q. And do you have any changes or corrections that you would like to make to those at this time?

A. No, I don't.

MR. MEYER: Understanding that all other foundational questions have been waived, I would offer those exhibits at this time.

JUDGE JONES: Is that 88, 89, 90?

MR. MEYER: And associated HC for 90.

JUDGE JONES: And is there also 1088, 1089, 1090?

MR. MEYER: Yes.

JUDGE JONES: Are there any objections?

MR. SWEARENGEN: Company has none.

MS. O'NEILL: No objection.

JUDGE JONES: Exhibits 87, 88, 89 -- I'm sorry 88, 89, and 90 and 1088, 1089 and 1090 are admitted into the record.

(Exhibit Nos. 88, 89, 90, 1088, 1089 and 1090 were received into evidence.)

MR. MEYER: I will tender the witness for cross examination.

JUDGE JONES: Is there cross-examination from the Office of Public Counsel?

MS. O'NEILL: No questions, your Honor.

JUDGE JONES: And any questions from Aquila?

MR. SWEARENGEN: I have a few, Judge.

JUDGE JONES: Please proceed.

CROSS-EXAMINATION BY MR. SWEARENGEN:

Q. Good morning, Mr. Murray.

A. Morning.

Q. How are you today?
A. Pretty good. How are you doing?
Q. Fine. Thank you.
Let me just try with you to frame up the issue in this case, if I can. Is it fair to say that one part of this cost of capital issue is how much equity should be considered in a capital structure for rate-making purposes?
A. Capital structure is an issue.
Q. Okay. And how much equity --
A. Is a part of that capital structure, that's correct.
Q. -- is part of that capital structure?
And then another piece of that, along the lines of the equity side, is how much should that equity cost, how much return on common equity should be authorized; is that fair?
A. That's correct.
Q. And you, for the Staff, have used Aquila -- the Aquila, Inc. corporate capital structure as of December 31, 2002; is that not correct?
A. That's correct. As the test year.
Q. That's the test year of capital structure of the parent corporation, Aquila, Inc.?
A. That's correct.
Q. And what is the equity ratio of that capital

structure?

A. The equity ratio for purpose of rate making as of test year December 31st, 2002 for Aquila, Inc. is 35.31 percent.

Q. And that's the equity ratio you think the Commission should adopt in this case for rate-making purposes?

A. That's correct.

Q. And what is your understanding of what the company thinks the equity ratio should be?

A. They base it -- they base their equity ratio on what they term allocated capital structure, which comprises of what they claim is 47.5 percent equity ratio.

Q. Now, is it fair to say that you have done a discounted cash flow or DCF analysis of a group of companies to determine what you think the authorized return on equity ought to be as a result of this case?

A. Yes.

Q. And that's a range -- you've calculated a range of 8.64 to 9.64 percent; is that true?

A. That's correct.

Q. And what's the midpoint, 9.1?

A. 9.14, that's correct.

Q. And what is your understanding of the company's position as to the appropriate return on equity in this case?

A. The company's position is the 12 to 12.5, which I believe is a midpoint of 12.25.

Q. Thank you.

Would you agree that equity is the highest cost of capital, generally speaking?

A. Generally speaking in the capital structure, that's correct.

Q. And so the more equity that is determined to be in the capital structure for rate-making purposes, the greater the revenue requirement?

A. Well, it depends on, like I said, the capital -- if the capital structure is optimal, you could have actually less equity in a capital structure and -- and it -- assuming that business risk is held constant, you could have a high rate of return if you have a very leveraged company then one that is -- you know, is at the optimal capital structure. So it's the ultimate rate of return that determines the revenue requirement is my point.

Q. Well, if equity is the highest cost of capital, if you have more equity in that capital structure, the revenue requirement associated with that would be greater, would it not?

A. Like I said, the rate of return is the ultimate number. If you have more equity in the capital structure, assuming all risk is held constant such as business risk, then that return on equity, because there would be less financial risk, would be -- you know, could be lower and also the cost of the debt could be lower.

So, therefore, it's -- it's -- your overall rate of return, it's really hard to determine exactly what is the optimal point where you'll have the lowest cost of capital. So it -- you could have a high cost of capital at 100 percent debt level that's higher than if you had some equity in your capital structure.

Q. Let's bring it back then to this case and the recommendations of the parties here. You're arguing for a 35 percent equity ratio and the company's arguing for a 47 percent equity ratio. Given that difference, in your mind, isn't there a significant revenue requirement difference between the two proposals?

A. I believe so.

Q. And what would that be? Can you quantify that?

A. I don't -- I think the two issues combined in the last reconcilement I saw was 20 million, but that's with capital structure and return on equity.

Q. So together, capital structure and return on equity results in about a $20 million difference, in your judgment?

A. That's based on some accounting records that I've been told about as far as the reconcilement.

Q. Would you agree that all other things being equal, a lower equity ratio should be accompanied by a higher cost of equity, all other things being equal?

A. All other being equal such as business risk, that's correct.

Q. And a lower equity ratio should be accompanied by a higher cost of debt as a general proposition. Is that a fair statement?

A. Assuming you hold everything constant, it's the same company and the same business risk, same -- which includes -- business risk includes all sorts of risk such as regulatory --

Q. All other things being equal.

A. Everything being equal, that would be a logical -- that's financial theory.

Q. Thank you.

And for a given firm, would you agree the cost of equity should always be higher than cost of debt because equity returns are subordinated to interest payments?

A. I agree with that.

Q. Do you have your Direct Testimony there in front of you?

A. Yes, I do.

Q. If you'd turn to page 5 and there I believe -- are you there?

A. Yes, I am.

Q. Beginning on line 33 you set out part of the decision in what is commonly referred to as the Hope Natural Gas case; is that true?

A. Yes.

Q. And part of that Hope decision discusses the rate-making process; is that true?

A. Yes.

Q. And that's the process that we're in before the Commission in connection with this case. Would you agree?

A. Yes.

Q. And in connection with that, would you agree that, as you've indicated at line 33 of your testimony, that the United States Supreme Court held in that case that the return to the equity owner should be commensurate with returns on investments and other enterprises having corresponding risks?

A. I believe that's what was stated in that case in 1944, that's correct.

Q. And then as you note on line 35, that decision goes on to state, That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and attract capital?

A. That's correct.

Q. And over at the top of page 6 of your Direct Testimony at lines 1 and 2, you indicate by I think paraphrasing the Hope case that the Hope case restates the concept of comparable returns to include those achieved by any other enterprises having corresponding risks. Correct?

A. That's correct.

Q. Then over on page 7 of your Direct Testimony, referring to lines 3 through 5, you state, The courts today still believe that a fair return on common equity should be similar to the return for a business with similar risks.

A. Yes.

Q. But not as high as a highly profitable or speculative venture. Correct?

A. Yes.

Q. And I assume that continues to be your testimony today as it was in your Direct Testimony that was filed earlier in this case?

A. That's my testimony. I just wanted to clarify that there has been a transition in rate of return analysis where rate of return witnesses recommend the cost of capital -- cost of common equity capital.

When making recommendations, I think

Dr. Murray earlier had indicated that the DCF model is his primary model and that is a cost of capital model. And so -- and actually this is quite consistent with the cost of service principle of rate of return rate base regulation where the objective of the rate of return analysis is to determine what the -- you know, the cost of capital is to the utility.

Q. Right. I'll ask you about that in a minute. I'm just focusing on what the Supreme Court has said about that.

My question is, would you agree that what the courts have said with respect to a fair return is the standard that this Commission should follow?

A. Like I said, there are other things that have to be taken into consideration. We are looking at cost of capital. Like I said, there's been that transition.

Yes, there's a court case there, but as far as I am aware, there's been no challenge on using a cost of capital analysis which is the primary analysis used by many commissions in this country to determine what is a fair recommended rate of return, not a comparable earnings analysis, which this Staff has not done since I've been here.

Q. Okay. Let me make sure I understand then. Are you saying that what the court has said in the Hope case and the related cases do not have to be followed by this Commission in determining what the fair rate of return is?

A. I'm not a lawyer. I just know that what has occurred has been a transition to a cost of capital analysis.

Q. So you would think then that perhaps maybe the Commission isn't following what the court has said. Would that be your testimony?

A. I would say if you look at page 4 of my Direct Testimony under the Bluefield there's references to returns generally being made at the same time, part of the country as, you know, another company return achieved by other companies, and then item three where it says, Return -- a return sufficient to assure confidence in the financial soundness of the utility, item three being one of the significant items.

And then within the Hope case, as you pointed out, that a return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and attract capital. I feel that, you know, the Commission needs to adhere to that and a cost of capital recommendation that is reasonable will allow that.

Q. Okay. Thank you.

I take it you wrote that portion of your testimony starting with your discussion of the Bluefield case on page 4 over through I guess page 7 we just talked about?

A. Yes.

Q. I think what you just said in response to two questions ago, that you think what the Commission is doing does comport to those cases?

A. Yes, I do.

Q. Okay. And would you agree then that the standard for a fair return, which has been cited in your testimony and has been cited by the courts and regulatory bodies, speaks in terms of returns being earned by companies of comparable risk?

A. That may be one of the standards that is considered.

Q. You have some doubt about that? You say it may be?

A. I just cited that there were three items, and one of those is the financial soundness and ability to attract capital. There are several items that are mentioned. That's both in the Hope and Bluefield case.

Q. Look over at page 5 of your Direct Testimony, if you would. And down in line -- beginning on line 33 where you quote the Hope case.

A. Yes.

Q. And does it not say that, By that standard, the return to the equity owners should be commensurate with returns on investments and other enterprises having corresponding risks?

A. Yes. And then it says, That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and attract capital.

Q. Fine. Thank you.

Would you agree that risk is extremely important to what we are doing here today?

A. Yes.

Q. Is it possible for you to determine through publications what returns utilities are actually earning? Is that possible to determine?

A. There is -- obviously Mr. John Reed referred to Regulatory Research Associates. I, myself, do not regularly look at that -- you know, that information.

Whenever I do my analysis to recommend a cost of capital, I'm looking at economic models, cost of capital models which are the discounted cash flow model, the capital asset pricing model and the risk premium model.

But if I were so inclined to want to review that, such as seeing an S&P report -- basically when I was reviewing some comments from S&P to find out what type of allowed ROEs are being -- are being ruled on in other states commissions I can -- you know, I can come across that obviously.

Q. Okay. That wasn't really my question. My question wasn't what was being allowed. My question was, can you determine in some instances what companies are actually earning?

A. I can review Value Line information, but those -- you have to take that with a grain of salt because obviously with the companies that are followed by Value Line, they're just like much -- you know, any other utility company out there. They have other operations within -- within their consolidated operations that are not just utility -- a regulated utility.

Q. Well, let me ask you this. If I'm an investor and I want to invest in a utility company and I want to know what return that company is earning, is there some way for me to find that out?

A. If you're investing in a consolidated utility and you're going to invest in a stock that comprises all the operations of that utility, yes, you can use Value Line to determine what the earned ROE was in any given past year for the last 15 years maybe.

Q. What about Empire District Electric Company? How would you characterize that company?

A. It's predominantly a regulated electric distribution utility and -- well, integrated utility, I'm sorry. But they do have -- you know, they get involved in some nonregulated investments as well.

Q. And can you go to some publication or some source and find out what they're actually earning?

A. Are you referring to Empire and the consolidated operations or are you referring to Empire Missouri jurisdictional utility operations?

Q. I'm talking about Empire.

A. Consolidated operations, like I said, Value Line -- you could refer to Value Line and find out exactly what they're earning.

Q. And would you believe that information to be accurate?

A. For consolidated operations, I would.

Q. Would that be true with any other figures that Value Line might publish for any other utility companies?

A. They're usually accurate. Sometimes they're revised a year or two later because of certain accounting changes.

Q. You mentioned authorized returns. Is there some way for you to determine or verify what regulatory agencies are authorizing for utility companies?

A. Mr. John Reed, he cited Regulatory Research

Associates. I believe that to be the -- you know, one of the main research organizations out there that, quote, allowed ROEs in various jurisdictions.

Q. Is there another way to determine that information other than referring to that source?

A. I believe C.A. Turner Utility Reports may have some allowed ROE indications, but I don't believe they have the dates of those allowed ROEs. So that information, especially if it's going back you know 10 years from now, would be of limited use because that obviously reflects a different economic and capital market environment than we have now.

Q. Can you access in some fashion, electronically or otherwise, the decisions issued by other state agencies, for example, the Kansas Corporation Commission?

A. If I was inclined to -- to look at their website, I'm sure I could.

Q. Have you ever done that?

A. Maybe in context of the last Aquila case to see what the witness Mr. John Dunn was doing in the Westar Energy Case I looked at their website. But as far as looking at their allowed ROEs, I don't know that I gave that much consideration.

Q. Have you ever looked at any decisions of other Public Utility Commissions or Public Service Commissions and read those decisions where they discussed the authorized returns that they were allowing for the companies under their jurisdiction?

A. No.

Q. You never have?

A. No. I -- there's many things that go on -- I have -- I have enough stuff to do here as far as doing my economic analysis using the DCF model and the capital asset pricing model. As far as what goes on in the specifics of cases throughout this country, I would be working 24/7 to be able to keep up with that.

Q. Turning to page 1 of your Direct Testimony, you state there that you're currently employed as a financial analyst for the Missouri Public Service Commission?

A. Yes.

Q. And is that your present position today?

A. Actually, I've been reclassified. I'm an auditor.

Q. And what does that mean?

A. It just means I have a different title.

Q. Okay. Your job functions are still the same?

A. I'm identified as a financial analyst, just to let you know.

Q. And am I correct that you're the only Staff witness who's testifying in this case with respect to cost of capital issues?

A. Yes.

Q. Over at page 2 of your Direct Testimony at line 16 you state, My testimony is presented to recommend to the Commission a fair and reasonable rate of return for Aquila, Inc., d/b/a Aquila Networks MPS and Aquila Networks L&P. Correct?

A. Correct.

Q. Then there's a following question on that page which is, Have you prepared any schedules to your analysis of the cost of capital for MPS and L&P? And your answer is, Yes; is that correct?

A. That's correct.

Q. And MPS and L&P are the Missouri operating divisions of Aquila; is that true?

A. That's correct.

Q. And would you agree with me that those operating divisions have hard assets in the ground here in Missouri?

A. Yes.

Q. And what would those assets consist of, to your knowledge?

A. Generation and distribution facilities, transmission facilities.

Q. Anything else that just comes to find?
A. Those are the main assets that I know are associated with the regulated electric utility. They may have some obviously natural gas distribution as well and storage maybe.
Q. And would you agree that those assets have been financed in some fashion?
A. Yes.
Q. And that would be with some amount of debt and some amount of equity?
A. Yes.
Q. And would you agree that those assets that you have described generally are the assets that are subject to this Commission's jurisdiction?
A. That's correct.
Q. I think you mentioned this earlier in response to one of my questions. Turning to the bottom of page 5 you mention that the -- what the Hope case stands for, in your opinion, and you noted that these returns that are authorized by regulatory agencies should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital. Correct?
A. That's correct.
Q. Given that, would you agree with me that one

of your responsibilities as the Staff's chief financial witness in this case is to make sure that the Staff's recommendation in this proceeding did not impair the financial health of Aquila's MPS and L&P operations?

A. My duty is to recommend a fair and reasonable rate of return for MoPub and St. Joe operations, which a fair and reasonable rate of return would not impair the financial health of MPS and L&P.

Q. So your answer would be yes, that you would consider that to be one of your responsibilities?

A. Yes.

Q. And in connection with that, would you agree with me that as the Staff's chief financial witness in this case, you can't make your recommendation in a vacuum?

A. No.

Q. You don't agree with that?

A. Repeat the question. I'm sorry.

Q. Would you agree with me that as the Staff's chief financial witness, you can't simply make a cost of capital recommendation in a vacuum?

A. That's true, I can't make it in a vacuum. There's many things you have to look at, economic market, capital market environment, correct.

Q. And would one of the things you would have to look at would be the ramifications of your recommendation with respect to the financial integrity of Aquila's operating divisions. Wouldn't you agree with that?

A. Yes. I would test the reasonableness of my recommendation, that's correct.

Q. You would test it with respect to the financial integrity of the operating divisions?

A. When you refer to "financial integrity," I assume you've referring to my pre-tax interest coverage calculation that is --

Q. Well, let me ask you this. What is your definition of financial integrity?

A. Financial integrity would -- we would like to see utility companies with a triple B investment grade credit rating. Of course, that's not possible with some companies because of the fact that they're associated with other operations.

Q. If you would, please, turn back to page 5 of your testimony.

A. Yes.

Q. At the bottom, The return should be sufficient to assure confidence in the financial integrity of the enterprise.

And in this case the enterprise is MPS and L&P. Correct?

A. That's correct.

Q. So as to maintain its credit and to attract capital.
Do you agree with that?
A. Yes.
Q. Okay. And, therefore, do I understand you to say that you would test your recommendation in this case against L&P and MPS's ability to maintain this credit and attract capital?
A. Unfortunately, this is -- I'm just going to get into what is difficult about when you're evaluating or trying to determine what -- you know, what rate of return is going to attract -- be able to attract capital, maintain the credit rating of MoPub and St. Joe.
Q. Well, let me ask you this. Can you answer that question yes or no and then give an explanation? Can you do that?
A. Repeat the question, please.
Q. Well, the question is, you've come up with a recommendation and you said you've tested that against something. And my question is, have you tested that, in accordance with the Hope case, against it should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and attract capital? Have you tested your recommendation with that standard in mind?

A. Yes.

Q. Okay. Let me ask you, earlier you indicated that you agreed that the legal precedent for a fair rate of return speaks in terms of returns being earned by companies of comparable risk. And you said that risk was important in this process; is that true?

A. Yes.

Q. And is it your belief that you've tried to apply that legal principle in this case in your testimony?

A. I took all the considerations that were indicated in the Hope and Bluefield case as far as things that should be weighed to determine what is reasonable.

Q. In connection with that, you have proceeded to select a group of six companies which you believe to be of comparable risk to Aquila; is that true?

A. Comparable to MoPub and St. Joe, that's correct.

Q. And those companies are set out in your testimony in various schedules; is that true?

A. That's correct.

Q. And what are those companies? Can you just rattle off the names for us, please?

A. Cleco, DPL, DQE Hawaiian Electric, IDACORP, NSTAR.

Q. And, once again, would it be your testimony that your goal here is to be consistent with the Hope case and find a group of other enterprises having corresponding risks to Aquila's MPS and L&P operations?

A. That's correct.

Q. Now, with respect to risk, would you agree with me that what we're talking about basically are two types of risk, one being business risk and the other financial risk?

A. That's correct.

Q. And would you agree that business risk is the risk which reflects items that could impact the business operations of a company?

A. All sorts of items, that's correct.

Q. Can you give us some examples for electric utilities?

A. Regulatory economic management, which competition doesn't play as much a part with a regulated utility, but just certain environmental factors, etc.

Q. Weather is that --

A. Weather exactly.

Q. -- a business risk?

How about rate of economic growth in the service area? Is that a business risk?

A. That's a risk. That's part of economic risk.

Q. Whether or not the company would have nuclear generation in its generation mix, would that be a business risk?

A. That's correct.

Q. And then would you agree there's another type of risk called financial risk?

A. Yes.

Q. And I think looking at your Surrebuttal Testimony at pages 7 and 8, if you could turn to that, please.

A. Yes.

Q. There in your Surrebuttal Testimony at the bottom you talk about financial risk and you offer a definition of -- or a generally accepted definition of financial risk; is that true?

A. That's correct.

Q. And that definition appears at the top of page 8?

A. Yes.

Q. And according to you, that generally accepted definition of financial risk is the ability of a company to meet its debt obligations; is that true?

A. That's true.

Q. What is the source of your generally accepted definition of financial risk as you have defined it there on page 8?

A. General knowledge.

Q. General knowledge?

A. I mean, I've went to college and had a finance curriculum, I've been working here for some time. I couldn't tell you exactly if I -- I didn't have a specific textbook where I came up with this definition, if that's what you're asking.

Q. That was going to be my next question. Did you have a textbook in college that had that definition of financial risk in it that you recall?

A. It may not have had this specific wording. Obviously that would be plagiarism.

Q. Looking again at your definition, the ability of a company to meet its debt obligations, isn't that really interest coverage?

A. Yes. Cash coverage of their debt service.

Q. And so it's really not an accepted definition of financial risk?

A. No. It's one of the things that the credit agencies look at as far as determining -- as far as your -- you could have a large amount of debt in a capital structure at a very -- at a lower interest rate and the ability of the company to meet that debt service is going to be determined by, you know, the cash flow coverage.

And I know that S&P, when they discuss

financial risk indicators, these are the exact ratios they're talking about. It's the coverage of the interest payments that they -- otherwise, if they can't cover it, you know, they're at risk of a default.

Q. Have you ever heard anyone say that a definition of financial risk is a measure of a degree of debt leverage in a company's capital structure?

A. I'd say that's the textbook definition.

Q. You have textbooks at college that had that definition in them?

A. And I think there's other textbooks I've seen that have different definitions. Just as there are many different regulatory textbooks that have different ideas on them.

Q. I think you hit on this earlier talking about risk and you may have thrown it in the category of business risk, but in your mind is there such a thing as regulatory risk?

A. Yes.

Q. And what is that?

A. Just the risk of outcome of proceedings once a rate case starts. Obviously investors are very concerned, as with Aquila in this case, Aquila's investors, as to the outcome of the proceeding as far as, you know, the decisions that are going to be made.

Q. And all of these risks that we've talked about here this morning, would you agree that they should be considered in the selection of comparable or proxy companies for a cost of capital analysis?

A. Yes.

Q. And these are items that are critically important, are they not, to a cost of capital analysis?

A. Risk is important, yes.

Q. Out of curiosity, I know you talk about your definition of financial risk in your Surrebuttal Testimony on pages 7 and 8. Anywhere in your Direct or Rebuttal Testimony did you discuss your definitions of business risk or financial risk, do you recall?

A. Do you want me to review that right now? Because I don't recall offhand.

Q. You don't recall offhand?

A. There's a lot of testimony here obviously.

Q. I'm not going to ask you to do that, but maybe while we're on a break you could just glance through that and we can come back to that later.

A. Sure.

Q. Turn, if you would, please, to page 26 of your Direct Testimony.

A. Excuse me. I'm taking a note here. Okay. Sorry.

Q. Yeah. That's fine. Page 26 of your Direct Testimony, please.

A. Yes.

Q. I would refer you there to line 8 where you indicate that your Schedule 11 to your Direct Testimony presents a list of market traded electric utility companies --

A. Yes.

Q. -- monitored by Value Line?

And how many companies were on that list, just approximately, do you know?

A. Quite a few. Anywhere from --

Q. Order of magnitude.

A. It's a -- I mean, if you take a look at Schedule 11, obviously I don't have time to count up all the rows, but there's probably 50 to 80, somewhere in there.

Q. And it's from that list that you selected your six proxy companies. Is that a fair statement?

A. That's correct.

Q. And then starting on line 9 you state, The criteria that I used to select the comparable companies are as follows. And you list eight items there; is that true?

A. That's correct.

Q. Now, looking at the first criteria that you use to select your proxy companies, stock publicly traded, would you agree with me that this criteria really has nothing to do with risk as you have defined risk?

A. Well, if a stock's not publicly traded, it may have liquidity risk issues. If it's not publicly traded, then there's not a market -- a recognized market where that stock could be traded, so liquidity risk would be an issue.

Q. What kind of risk is liquidity risk? Is that a business or a financial risk?

A. It's just -- I'm using an analogy. Before ebay, it might have been hard to sell some fairly unique items, but now that that market's been created, people that have unique interests, there's a market there now to buy and sell, so -- that they normally wouldn't be able to sell that and they may have had to offer a hire premium in order to be able to sell something that there really wasn't a market. So if a stock's not publicly traded, obviously you won't have somewhere to go to just offer that -- that stock.

Q. And there's a risk that you can assign to that?

A. Well, a general -- a general conceptual risk, yes.

Q. And then refer to item No. 2, Information printed in Value Line. That's your second criteria?

A. Yes.

Q. Would you agree that that has nothing to do with risk, whether or not information is published in Value Line?

A. Well, obviously investors -- if they're trying to get information on investments that they want to -- that they're considering investing in, it's important to have as much information as possible.

And with Value Line being an independent research service, if -- you know, if they have that information available to them by a recognized research service, that may minimize the risk of them, say, having to make a private equity investment in a company that's not followed by Value Line where they have to rely specifically on a company.

Q. Well, I thought you indicated earlier that a financial risk -- and you said the textbook definition was the amount of leverage in the capital structure; is that true?

A. Yes. But I think you just said general risk and I --

Q. All we're talking -- we're talking about business and financial risk. And my question is, do you define financial risk to mean the amount of leverage in the capital structure; is that true?

A. Yes.

Q. Now, what does whether or not information is printed in Value Line have to do with the amount of leverage in the capital structure?

A. It has nothing to do with the amount of leverage.

Q. Okay. And look at your criteria No. 5, Ten years of data available. Would you agree with me that that has nothing to do with business or financial risk, whether or not 10 years of data is available?

A. Okay. Let's just clarify. When you're referring to business and financial risk, obviously you're referring to the risk of the company. Does not necessarily mean that this is the risk the investor may be taking by investing in a stock when 10 years of data is not available.

Q. I'm talking about the definitions that you gave us earlier. You said what business risk was and you defined that and you gave us some examples and you said what financial risk was, the amount of leverage in the capital structure.

So my question is, with those definitions in mind, what does the fact that whether or not 10 years of data is available have to do with either of those risks?

A. Well, if you have 10 years of data to evaluate the trends in capital structure within any given company, you can evaluate the financial risk over time.

Q. But what does the fact of whether or not that data is available have to do with the actual business or financial risk of the company?

A. Well, if the data is not available, you don't have any trends to look at as far as what type of financial risk that the company, you know, typically incurred as far as its leverage.

Q. You don't have anything to look at, but what does that fact have to do with the actual business or financial risk of the company?

A. As far as whether that's available has nothing to do with the company specifically.

Q. Okay. And look at No. 8, No Missouri operations. Would you agree with me that whether or not a particular company has utility operations in Missouri has nothing to do with business or financial risk?

A. Obviously every jurisdiction has its own regulatory risk as you referred to, so there could be some risk factors there.

Q. There could be some regulatory risk?

A. Exactly.

Q. But not business or financial risk?

A. No, regulatory is part of business risk.

Q. Would it be fair to say that these items I've focused on, Items 1, 2, 5 and 8, those criteria really don't relate to risk but if they do, it's only in a very remote sense and you just simply used those to help narrow down your sample of companies?

A. If you're going to just pick out those specific items, I'll agree with that.

Q. Turn to your Rebuttal Testimony, if you would, please, page 25.

A. Yes.

Q. There on lines 12 and 13 of page 25 of your Rebuttal Testimony you say, Because smaller utilities operate in a regulated environment just as large utilities do, making an adjustment for firm size is not appropriate?

A. Yes.

Q. And then at the bottom I think of page 24 and the top of page 25 you cite a study that you believe supports that proposition; is that true?

A. That's correct.

Q. Do you know whether or not this Commission has ever made an upward adjustment in rate of return to reflect and recognize the small size of a utility company?

A. I don't believe they have, but -- not as far as my personal experience.

Q. Okay. If they had, would you think that the Commission had made a mistake?

A. That would not have been my recommendation. The Commission obviously weighs the evidence of any case.

Q. That's fair. I understand.

In any event, that wouldn't have been your recommendation and you would testify today that an adjustment for size, in your judgment's, not appropriate; is that true?

A. That's correct.

Q. Then turning back to your Direct Testimony again, please, at page 26 where you listed your criteria there your third criteria states, Total capitalization less than 5 billion; is that true?

A. That's correct.

Q. And that's a criteria related to size. Would you agree?

A. Yes, it is.

Q. But you also testified that an adjustment for size should not be considered; is that true?

A. Yes.

Q. So wouldn't you agree that that criteria, No. 3, really isn't a valid selection metric for measuring risk?

A. No. I wouldn't say that's necessarily the case. Obviously, you know, size is something that analysts think -- think about. But as far as what I'm rebutting is whether or not a specific size premium adjustment should be made especially when it's a division of a larger utility.

I don't think there's anything wrong with trying to limit the size of -- for purpose of selecting your comparable companies initially, but as far as -- you know, if you don't choose comparable companies, if you just choose to eliminate the -- you know, the size requirement, then you want to make a size adjustment, my point is you -- if you want to avoid that, make sure you use a -- you know, use a selection criteria that takes that into consideration if there is a chance.

My point is there's nothing conclusive on a size premium adjustment -- excuse me, a size premium adjustment being made.

Q. If size is a valid selection metric -- which is what you're saying, isn't it?

A. I'm saying it's a metric that I used and it just -- it brings -- it eliminates -- it tries to eliminate that possible argument coming from the company because I know it's used every time.

Q. What is that?

A. That a size premium adjustment should be made. So it just heads off that possibility.

Q. And what companies have made that?

A. Just about every company that comes in here, I believe.

Q. And do you know how has the Commission reacted to that? Do you know?

A. I think I just indicated I didn't know whether they made a size premium adjustment.

Q. And if your knowledge on that subject was incorrect and, in fact, there is a case or cases where the Commission has made an upward adjustment and return because of the small size of a company, would that change your view on this topic?

A. No.

Q. What companies did you eliminate through the use of your third criteria, the size criteria?

A. Okay. We're going to have a lengthy list here.

Q. How many were there? Are they set out in your testimony?

A. Yeah. They're set out on Schedule 11.

Q. And how can I identify those looking at your Schedule 11?

A. Look at column 3, total capitalization less than 5 billion. And then every -- every company where the answer is no was eliminated.

Q. So if size doesn't matter, then those should all be put back in; is that true?

A. I'm saying size can be -- I'm arguing against any size premium adjustment. I'm not indicating that it's not something that should be considered when you're narrowing down your comparable companies.

Q. Well, we're not talking here about the return on equity or premium adjustment though. We're talking about your selection of comparable companies here. You ended up with 6 companies out of maybe 80 you indicated, and I'm trying to figure out how you utilized the Hope standard of risk in selecting those 6 companies.

And your item No. 3, total capitalization less than $5 billion, appears to be inconsistent with later testimony that suggests no adjustment should be made for size.

A. I don't agree it's inconsistent. I -- once again, I'm trying to come up with comparable companies and head off -- basically I realize companies make this argument for a size premium adjustment, you know, over and over. As far as quantifying this specific adjustment, I don't agree with that. And if you want to try to head that off, which I did, you put in a total capitalization less than a certain amount to try to head off that argument.

Q. Let's go in that direction. Let's assume that argument has some validity and this Commission may make such an adjustment and allow a return to a small company. Shouldn't those companies be put back in the pool?

A. No. Because, once again, I would not agree with the size premium adjustment.

Q. Okay. And if the Commission has found otherwise, your opinion would differ from what the Commission has found; is that true?

A. Sure.

Q. Okay. Take a look at your No. 4 criteria there on page 26, Greater than 70 percent of revenues received from electric utility operations.

A. Yes.

Q. And I think you indicated that the application of that criteria eliminated 20 additional companies?

A. Yes.

Q. Were any of those companies what we would refer to as combination companies?

A. You refer to combination. Can you define what you mean by --

Q. Well, what's your understanding of a combination company?

A. I think there was a definition given earlier that a combination company would be a electric and natural gas company. I'm just wanting to make sure you're not referring to diversified company, which diversified companies get into much of the nonregulated energy market trading, etc., etc.

Q. Would you except as a definition of a combination company one that was in both regulated natural gas and regulated electric operations?

A. That may be a portion of their operations, that's correct.

Q. Is Ameren a combination company, for example?

A. Ameren has natural gas and electric operations, that's correct.

Q. And how about Aquila?

A. Aquila has natural gas, electric operations.

Q. Would the fact that the combination company might not have more than 70 percent of its revenues from electric utility operations simply reflect the sale of its -- of natural gas by its natural gas distribution operations?

A. I don't know. I relied on C.A. Turner Utility Reports for this. I don't know what they look at as far as to determine their percent of revenues -- electric revenues as far as the specific details.

Q. Well, let me ask you just -- let's talk about AmerenUE, for example. Do you know whether or not they get more than 70 percent of their revenues from electric operations?

A. AmerenUE, I believe they do. Obviously that's the largest part of their operations.

Q. Let's assume that they got 65 percent of their revenues from electric operations and the remainder 35 percent from natural gas operations. Applying your criteria No. 4, you would eliminate them, is that true, because they don't have more than 70 percent -- 70 percent or greater?

A. Assuming that's the case, that's correct.

Q. Yeah. Just assuming that with me.

A. That would be Ameren Corps, the consolidated Ameren Corporation.

Q. Just pick X company.

A. Any company, yes.

Q. It doesn't matter what company it is. If 65 percent of its revenue is from regulated electric operations, 35 percent of natural gas regulated operations, you would eliminate them; isn't that true?

A. And let's clarify. With C.A. Turner it does, in --

Q. Well, forget about C.A. Turner. Just the hypothetical question, some company, any company, The Jim Swearengen Utility.

A. Well, I still need to clarify. Just electric operations, in general, not regulated electric operations. It's very hard to find any -- you know, any type of source out there, unfortunately, that really breaks down the regulated electric and nonregulated electric. It's a very real problem.

Q. I understand that. What I'm trying to get your rationale here for that 70 percent cut-off point. And my question to you is, 65 percent come from regulated electric operations, 35 from regulated gas. Just assume that to be the case. You would eliminate that company?

A. Exactly.

Q. That's right.

And let me ask you this. Just because 35 percent of that company's revenues came from regulated gas operations, that would not necessarily reflect a higher operating risk for that company, would it?

A. When you refer to "operating," are you referring to business risk?

Q. Sure.

A. I mean, with any given company it's not necessarily going to -- as far as the percent of revenues, there are all sorts of things that come into play that are going to determine the overall risk level of a company such as management and what have you.

This is just something to -- in order to try to achieve electric utilities, which is what MoPub and St. Joe are. And that's what's -- the subject of this case, I should say, is what MoPub and St. Joe are because obviously they have gas operations and steam operations, but the subject of this case is their electric operations.

Q. Is it your view that gas operations are more risky than electric operations?

A. I think there is a general view that gas operations used to be riskier than electric operations, but obviously with deregulation and many electric utility companies being involved with nonregulated activities, there's probably been some shift in that. And -- and that's something that may change that.

Q. So you wouldn't subscribe to the belief that gas operations are necessarily more risky than electric operations?

A. I'm saying it's very hard to tell at this point in time.

Q. Would you agree that as a general proposition, there's little difference in risk between a regulated electric utility and a regulated gas distribution utility?

A. No. Because with vertically integrated regulated electric utility, you have generation and purchased power. Obviously with natural gas you have distribution and they have to purchase that gas. So, no, I wouldn't say they're the same risk. And that's why I -- with the gas case I selected natural gas utility companies.

Q. Would you say there's little difference in that risk?

A. I haven't quantified that.

Q. So you don't know?

A. I don't know.

Q. Would you agree with me that your criteria No. 4 is not really a measure of risk?

A. No. I'd say it is -- it's a very big measure of risk. The predominant criteria when choosing comparable companies is to make sure that those comparable companies are in the same general type of business operations, which is a very big reflection of risk, which is the business risk the company operates in.

Q. The same type of business operations?

A. Yes. I say that's -- that's probably the number one in selecting comparable companies.

Q. And I think you indicated that Aquila is a combination company; is that right?

A. Yes.

Q. And that perhaps some of the companies that you eliminated by applying your criteria No. 4 is a direct result of the fact that those are combination companies and derive significant revenues from their natural gas operations; is that true?

A. But we're looking at the electric operations of MoPub and St. Joe. I'm trying to evaluate the electric operations of MoPub and St. Joe, not the gas operations. That was evaluated in a gas case.

Q. I understand that. But are you not, through your selection criteria, attempting to find companies of comparable risk?

A. Of comparable risks to electric operations, correct.

Q. And what does the greater than 70 percent of revenues received from electric utility operations have to do with risk given the fact that you testified you didn't think there was a difference between the risk for an electric utility and the risk for a natural gas company?

A. Let me clarify. I didn't say I didn't think there was a difference between the risk of natural gas and electric utility. I said as far as quantifying that, I do not know at this point in time, especially because of the fact that electric utilities have become involved in nonregulated activities.

Q. But you're convinced there is a difference in risk?

A. I'm sure there is some difference and it depends on the comparable groups you pick out.

Q. What is more risky, a natural gas company or an electric company? Just that -- a pure natural gas company and a pure electric utility company, just assume that hypothetically. Which one is -- all other things being equal, which one is riskier?

A. Can you please define pure gas?

Q. That's all they're in, just a pure play regulated electric utility company.

A. Vertically integrated?

Q. Yeah. They don't do anything else.

A. They generate --

Q. Right.

A. -- electricity?

Q. Sure.

A. Nuclear generation?

Q. You make the assumption.

A. There are a lot of assumptions. You pointed out already there's a lot of different business risks that may come into play for an electric utility versus a natural gas utility.

In -- the general understanding before a lot of electric companies got into nonregulated activities was that electric utilities were less risky than natural gas utilities. However, with electric utilities veering off into many nonregulated activities and still being classified as electric utility companies, I would venture to say that, you know, you cannot make that general classification. And -- and I'm not trying to make that general classification here in this case.

Q. Let me ask you, you mentioned no nuclear operations. That's item No. 6 in your selection criteria?

A. Yes.

Q. And item No. 7, At least investment grade credit rating?

A. Yes. That's very important.

Q. And why is that important?

A. Because that entails all business and financial risk.

Q. If you just focused on those two items, six and seven, as screening criteria, would you agree that your sample group would be much larger than the six companies that you selected?

A. I don't know. I didn't do that analysis.

Q. You didn't do what analysis?

A. To determine if my sample group would be larger if I just used those.

Q. Do you have any idea at all?

A. No. I didn't look at that.

Q. So are you then saying that you did not eliminate from your sample group any companies based on items 1 through 5 and item 8?

A. Oh, I eliminated those, but there's many companies there that I -- obviously when the lines become blank, I didn't even bother to look at whether or not it's an investment grade credit rating or if there's nuclear operations. So it's really hard for me to tell.

Q. If you eliminated companies by applying criteria 1 through 5 and 8, wouldn't it stand to reason that if you didn't apply those criterias, those companies would have not been eliminated?

A. You would think so.

Q. But you don't have any idea how many that --

A. No. I have no idea.

Q. Now, one of your proxy companies is DPL, Inc.; is that true?

A. That's correct.

Q. And what is DPL, Inc.?

A. Dayton Power & Light.

Q. And where is it located?

A. Ohio.

Q. And what kind of business is it in?

A. It's obviously an electric utility.

Q. You say it's located in Ohio. Do you know what --

A. I mean, that's -- I think of Dayton Power & Light. Obviously my geography's not great, but yeah, that's my general understanding.

MR. SWEARENGEN: Could we take a brief recess?

Maybe we want to break for lunch and come back early.

JUDGE JONES: Why do you need to take a recess now?

MR. SWEARENGEN: I just need to check some materials and maybe I can shorten this.

JUDGE JONES: Does anyone have any objection to that?

Well, let's go ahead and break for lunch then. It's a quarter till noon and why don't we come back at one o'clock.

MR. SWEARENGEN: Thank you.

JUDGE JONES: Actually go ahead and make it 15 after 1:00 so we can catch the stragglers. We're adjourned until 1:15.

(A recess was taken.)

JUDGE JONES: We're back on the record with Case No. ER-2004-0034 and we're continuing with the cross-examination of Staff's witness David Murray.

Mr. Swearengen, you may proceed.

MR. SWEARENGEN: Thank you, Judge.

BY MR. SWEARENGEN:

Q. Before lunch, Mr. Murray, we were talking about the proxy companies that you had selected which are set out in various schedules attached to your testimony. And I asked you about Dayton -- or DPL and I believe you were describing what DPL is. What was your answer?

A. It's a holding company for Dayton Power & Light, which is their main electric utility for DPL, which I think you asked where they are located and I indicated in -- I said that was in Dayton, it was Dayton, Ohio.

Q. Dayton, Ohio. And it's a regulated subsidiary of DPL, Inc. Is that your understanding?

A. Yes.

Q. And have you read any of the financial literature in connection with DPL?

A. The information I may have read on DPL is from Value Line and maybe some Standard and Poor's credit rating research reports.

Q. Are you aware then that on December 10 of 2003 Standard and Poor's rating services announced that it had lowered DPL's corporate credit rating, including the credit rating of its regulated subsidiary from triple B to double B?

A. I believe that was pointed out actually in Dr. Murry's testimony.

Q. And were you aware of that fact when you put together your testimony in this proceeding?

A. No, I was not.

Q. Would you agree that by lowering the credit rating from triple B to double B, that DPL is no longer investment grade?

A. I would agree with that.

Q. And, therefore, as a result, DPL would not meet your criteria No. 7, At least an investment grade rating?

A. If I were to update my study, that's correct.

Q. So based on that, would you agree with me that DPL should be removed from your proxy group by your own definition?

A. If I updated the study, I would agree with that. But, no, since when I did the study they were investment grade, they met that criteria at that time.

Q. And when did you do that study?

A. Probably shortly before -- I believe a lot of the -- a lot of the research, Value Line reports that I used were dated October 3rd, 2003, testimony was filed December 9th. So within that time frame. I'm sure it was whenever I was looking at that. Maybe -- to be honest with you, as far as specific dates that I was preparing the study, I can't tell you.

Q. Let me ask you this. You're not disputing the fact that the credit rating has been lowered from triple B to double B for that company?

A. No.

Q. And you would agree that it, therefore, would not meet one of your screening criteria; is that true?

A. If the study was updated, that's correct.

Q. And your testimony here on the stand, would you consider that to be an update to your study?

A. No. I'm standing by the testimony that was -- that's been filed. We're discussing some of the things that may have occurred since my testimony was filed, but I haven't changed my recommended return on equity nor has any other witness in this case.

Q. I'm not asking you about that. I'm asking you about your selection of that particular company as one of the six companies in your proxy group. And I think -- where do you set out the criteria that you used to select the companies for your proxy group? Where do I find that?

A. Schedule 11, I believe.

Q. Is it anywhere in your Direct Testimony?

A. Oh, as far as the Direct Testimony? I believe we talked about that earlier when we were talking about risk.

Q. What page is that on?

A. I'll have to -- page 26.

Q. Page 26. And if I look there and I look at criteria No. 7, it says, At least investment grade rating?

A. Yes.

Q. And you used that criteria to eliminate six additional companies from the pool of companies that you were looking at that; is that true?

A. At that time, that's correct.

Q. And now you're saying that you recognize or you will admit or concede that DPL does not meet that criteria; is that true?

A. Yes.

Q. But, nonetheless, it's your testimony that in representing to this Commission what they ought to do in terms of appropriate capital structure and return for this company, based on your own testimony, they ought to use the results of a company that no longer meet your criteria. Is that what you're saying?

A. The analysis I did at the time contemplated a triple B credit rating, so the data I was looking at at the time reflected that triple B credit rating. I have not bothered to look at any additional information as far as the financial information for -- for the discounted cash flow analysis of DPL since they've been downgraded.

Q. So the fact that that company no longer meets your own criteria doesn't concern you at all?

A. I wouldn't say it doesn't concern me, but it doesn't change my recommendation.

Q. And why is that?

A. Because I evaluated all of my comparable companies when I arrived at my recommendation of the 9.6-- excuse me, 8.64 to 9.64. And all the -- I mean, there were more than -- there are more than just -- there's more than just one company in that comparable group.

Q. Let me ask you this. All other things being equal, if you were to do this study today, all other things being equal except DPL is no longer investment grade credit rating, wouldn't you agree that you would eliminate them from your proxy group?

A. I would eliminate them, but I'm not saying that my recommendation would change.

Q. Okay. And that being the case, you'd be left in your proxy group with just five companies, all other things being equal; is that true?

A. Well, who knows what might happen with some of the other companies.

Q. No. I understand that. I said all other things being equal, nothing else changes, assuming all other facts being equal.

A. If you want to make that assumption, that would be the case.

Q. Okay. Now, DQE, Inc. is in your proxy group; is that correct?

A. That's correct.

Q. And what is that company?

A. It's a predominantly electric utility. I believe that they operate I believe mainly in the state of Pennsylvania, electric distribution. I know they had some other operations they just sold. Obviously we're familiar with the fact that they had AquaSource, they sold that to Philadelphia Suburban, but they're an electric utility.

Q. Have you reviewed any financial literature with respect to that company?

A. Value Line and Standard and Poor's information, once again.

Q. Are you aware of a Value Line report dated December 5, 2003, which indicates that potential investors should exercise caution before taking a stake here, meaning making an investment in this company?

A. I didn't review the December Value Line sheet.

MR. SWEARENGEN: May I approach the witness, your Honor?

JUDGE JONES: Yes, you may.

BY MR. SWEARENGEN:

Q. Mr. Murray, I just handed you a document, a Value Line document. Can you tell the Commission what that is, please?

A. Yes. It's a Value Line -- what they refer to as tariff sheet for Dukane Light. For whatever reason, they've changed it to Dukane Light. It used to be DQE on my tariff sheet. And it's a report issued by Value Line as of December 5th, 2003 with financial information and some written analysis.

Q. Now, the statement that I indicated was contained in that document appears at the very end of it; is that not true?

A. Yes. It reads that through 2008, I believe -- it's hard to read, I think it is a fax copy -- potential investors should exercise caution before taking a stake here, which would actually drive the dividend yield up.

Q. And why would it drive the dividend yield up?

A. If there's commentary from analysts within the investment community to use caution when investing in stock, then obviously the stock price of that company may depreciate because there's a caution.

It's just -- obviously the -- as we know, there's very few sell orders put out there by Wall Street analysts, but as far as some more independent analysts, if they're telling investors to exercise some caution, they may, you know, choose to, you know, either decrease their position or may choose not to buy the stock. And when that price goes down, the dividend yield would go up. And the cost of -- therefore, the cost of capital to that company goes up.

Q. Is that because it's becoming riskier?

A. Obviously they believe there's some risk; otherwise, they wouldn't say use some caution.

Q. Have you done any detailed study of this company at all?

A. Just what's in my schedules and my general knowledge through Value Line, Standard and Poor's.

Q. Are you aware then that DQE is trying to divest itself of past investments and financial energy services as well as telecommunications operations?

A. Yes. They're divesting about three units. We're very familiar with AquaSource because they operate in the state of Missouri.

Q. And are you aware that the company has an ongoing Internal Revenue Service investigation involving its tax returns for the period 1994 through 1997?

A. I believe I saw something to that extent. I believe it was in the S&P report.

Q. And isn't it true that the company cut its dividend by 25 percent in 2003?

A. I'll take your word for the percentage, but I do know they cut their dividend.

Q. Am I correct in understanding your testimony and schedules that you use DQE's 25.5 percent equity ratio, which was its equity ratio at the end of 2002, in the calculation of your proxy equity ratio average of

36.8 percent?

A. That's correct.

Q. Would you agree that all other things being equal, the financial risk for that company, for DQE, exceeds that of the other companies in your proxy group?

A. All other things being equal, correct.

Q. So then, in summary, assuming that your proxy group has some validity, one of those companies, DPL, fails to meet one of your own criteria No. 7, At least investment grade credit rating. Correct?

A. Not at the time.

Q. It does as we speak here today though, does it not?

A. If I were to update the study, you would be correct.

Q. And a second company, DQE, would it be fair to say that company has so much uncertainty surrounding it that -- especially given its low equity ratio, that it was forced to reduce its dividend in 2003 and there's a warning from Value Line to investors about investing in that company?

A. Yes. I took all those things into consideration when I came up with my overall recommendation in this case.

Q. Let me ask you this. If you eliminated those two companies from your group of six proxy companies, would you agree then that the average equity ratio of your proxy group would be raised from 36.8 percent to about 43 percent?

A. I'll take your word for the average.

Q. Then do you have any reason to dispute that?

A. No. I don't have --

Q. Is that a difficult calculation to make?

A. Well, I'd have to average four --

Q. How long would it take you to do that?

A. I could do it right now.

Q. Okay.

A. What was the number you indicated?

Q. 43 percent.

A. 42.6 to be exact, but you're right.

Q. Okay. Thank you.

Now, before lunch we had a discussion about financial integrity. Do you recall that discussion?

A. Yes.

Q. And you indicated that based on the United States Supreme Court Hope decision, the return that this Commission authorizes should be sufficient to assure a confidence in the financial integrity of MPS and L&P; is that true?

A. Yes.

Q. So to maintain the credit of those entities

and to attract capital; is that true?
A. Yes.
Q. And that's still your testimony this afternoon?
A. That's correct.
Q. Thanks.
Turn to page 31 of your Direct Testimony, if you would.
A. Yes.
Q. There at the bottom of page 31, beginning on line 18 and continuing over on the top of page 32, you discuss the calculation on the pre-tax interest coverage ratio; is that correct?
A. Yes.
Q. First of all, what is a pre-tax interest coverage ratio?
A. It's just earnings before interest and taxes divided by interest. Just done -- trying to give an idea what the coverage of the interest expense might be.
Q. On page 32 at line 6 and 7 you say, This range of pre-tax interest coverage ratios falls between the lower quartile and median quartile for a triple B related electric utility. Correct?
A. Yes. And actually, I'm sorry, I didn't make this correction, but it shouldn't indicate median quartile.

It should just indicate median.

Q. So I should strike quartile?

A. Yes. I apologize.

Q. And I think you testified earlier that a triple B rating is the minimum rating for an electric utility to be considered investment grade?

A. That's correct.

Q. And then you go on from that point and discuss on page 32 and later a rate of return for Aquila's MPS and L&P operations; is that true?

A. Yes.

Q. And, once again, let me ask you to make sure that we're clear. Would you agree in order for a return to assure confidence in the financial integrity of the enterprise, which is the words the Supreme Court uses but in this case that would be MPS and L&P, would it be your intention that your recommendation in this case will result in MPS and L&P as stand-alone entities existing at an investment grade level?

A. I'm -- I never tried to give the impression that I knew exactly what their credit rating would be on a stand-alone basis, because that's a very hard thing to determine. I -- my recommended rate of return is fair and reasonable.

Now, if -- if the -- if that were to want to be determined, I am aware that S&P and Moody's both have services that the company could pursue. I think Moody's refers to it as rating assessment service. S&P refers to it as a rating evaluation service.

That indicates that if you -- if they were wanting -- if a company was wanting to try to assess the creditworthiness of a stand-alone company or stand-alone entity which could be a division, the company could pursue such a -- such an endeavor with Moody's and S&P.

And that would give -- that would be the only true way to give an independent and full-fledged, detailed analysis of what MoPub and St. Joe would be rated on a stand-alone basis. You can't just look at the quantitative ratios that's published by S&P for their targets because obviously, as we pointed out earlier, a lot of times those ratios are not falling within those targets.

And I'm aware from my conversations with Standard and Poor's and Moody's, that they compare the actual ratios that occur to companies -- other companies in the same industry, their actual ratios.

And that's why the financial medians are important to look at because they look at those in conjunction with those -- with those benchmarks. And -- but I am aware that Moody's and Standard and Poor's has indicated that they wouldn't be, you know, surprised if --

with this current environment where there are companies that have a lot of nonregulated activities and that there's proceedings going on in commissions where there's a dispute as to what the credit rating might be if the division were stand-alone, you know, that they -- you know, that they would possibly entertain the possibility of a company -- the commission would have to work with the company, but the company could request such an analysis to be done, which would be about as detailed and objective as you can get in determining what the -- what the integrity of the company would be.

Q. Well, you're the chief financial witness testifying in this case for the Staff of the Public Service Commission; isn't that true?

A. Yes.

Q. And I think you said this morning that you agreed -- and, once again, taking you back to the Hope case, that the return that this Commission authorizes -- and they're going to look at your recommendation in doing that -- should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital?

A. Yes.

Q. And given that standard, what have you done to test whether or not your recommendation in this case, if adopted by the Commission, will, in fact, meet that standard annunciated by the United States Supreme Court?

A. I believe it's detailed throughout all my testimony. I mean, one of the first calculations I performed was a pre-tax interest coverage calculation. And I recognized -- to be quite honest with you, at the time I debated whether or not to even use this pre-tax interest coverage calculation or put it in my testimony --

Q. Well, let me --

A. -- because of the concern that the debt cost for -- that are included in this pre-tax interest coverage calculation may be higher than what a utility could have received if they had a capital structure similar to Aquila's on a consolidated basis and they didn't have the exposure to the nonregulated operations.

Q. Let me back you up just a second. When you sat down to write your testimony in this proceeding -- and you said that this was your testimony, you wrote it and you put it in this language from the United States Supreme Court decision, and you've acknowledged that, you've indicated that you think this Commission needs to follow that -- was it your intention that your recommendation that you're presenting to the Commission will result in MPS and L&P as stand-alone entities existing at an investment grade level?

A. I -- once again, I never have come out and said that they would be an investment grade credit rating. I --

Q. That wasn't my question. My question was, was it your intent that your recommendation would result in MPS and L&P as stand-alone entities existing at an investment grade level?

A. No, that was never my intent to try to evaluate that.

Q. Thank you.

Now, you agree with me, do you not, that the Commission has jurisdiction over Aquila's regulated operations in Missouri; is that right?

A. Yes.

Q. And we talked about those being hard assets in the ground?

A. Yes.

Q. And you said you had some knowledge with those; is that true?

A. Yes.

Q. Would you agree that to the extent possible, the Commission should exclude the effects of Aquila's other investments and other business undertakings in determining a return in this case for these two operating divisions?

A. Exclude from what? I'm sorry. You'll have to give me some clarification, please.

Q. Do you believe that the Commission, to the extent possible, should exclude the effects of Aquila's other undertakings, other investments, nonregulated operations and what have you, in determining a return in this case for the MPS and L&P operating divisions?

A. I believe the Commission should adopt a capital structure that reflects how UtiliCorp has historically been financed, which --

Q. That wasn't my question.

A. -- was not including the nonregulated operations.

Q. Now, that wasn't my question. My question was, do you think that the Commission should exclude the effects of Aquila's other investments and other business undertakings in determining a return in this case for the operating divisions?

A. Sure.

Q. If you turn to your Surrebuttal Testimony, please, page 21, and you have the question there on line 4, Aren't you trying to determine what the cost of capital would be for MPS and L&P if they weren't part of Aquila?

A. Yes.

Q. Answer, Yes.

And that's consistent with what you've just said?

A. Yes, it is.

Q. Okay. Now, if you'd turn to your Rebuttal Testimony, please, and turn to page 4.

A. Yes.

Q. There at lines 12 through 14 in response to a question you state, It is important to match the capital structure components with their embedded costs as of the same date because they are closely related; otherwise, there is a mismatch of the cost and the capital structure components.

Is that your testimony?

A. Yes, it is.

Q. And is that still your testimony today?

A. Yes, it is.

Q. And would you agree with me that Aquila, the corporation, has assets located in many states?

A. Yes. Seven to be exact, I believe.

Q. And would you agree that Aquila, the corporation, has nonregulated businesses?

A. There are some that they're winding down, that's correct, and I think one remaining international operation.

Q. Notwithstanding those facts, that it has businesses in other states and it has nonregulated operations, you are suggesting to the Commission that it utilize the corporation -- the corporate capital structure for rate-making purposes in this case; isn't that true?

A. That's correct.

Q. Let me ask you this, Mr. Murray, what have you done to identify the capital structure for MPS that provides utility service to the MPS customers?

A. MPS and L&P don't have a capital structure so there's nothing to do to identify that. It's a -- it's been called an allocated capital structure by the company, which was based on a hypothetical study done in 1988.

And since that time, there's been the representation given that there's some -- an actual tangible capital structure there when even Aquila's own witness, Mr. John Reed, indicates that divisional capital structures are not discernible. It's not a reflection of reality.

Q. So the answer to the question is you haven't done anything to identify the capital structure for MPS that provides service to the MPS ratepayers; isn't that true?

A. Because capital structure doesn't exist.

Q. So you haven't done anything to attempt to identify it?

A. Exactly.

Q. And if I ask you the same question about the L&P operations, would your answer be the same?

A. Yes.

Q. And I think you indicated you have some knowledge of Aquila's assigned capital process?

A. Yes, I do.

Q. And has that not been the subject of some prior Commission decisions?

A. Probably since 1988, I believe so, that's correct.

Q. Do you know whether or not the Staff, the Commission Staff, has ever audited or attempted to verify that the capital which Aquila has assigned to MPS was, in fact, used or not used to build the assets that provide utility service to those customers, the MPS customers?

A. Can you please define audit or verify?

Q. Well, you can use your own definition of that. Have you done anything to substantiate that?

A. The numbers just don't add up as far as my -- you know, my review. And based on comments made by Aquila personnel in the most recent collateralization case, that more equity is allocated to the nonregulated and less equity is allocated to the regulated, it's only natural and logical to understand that if that's the case, that the equity ratios that are allocated to the regulated would be less than the consolidated capital structure.

So I have tried to verify -- you know, I've tried to understand the process and the process just doesn't add up. It's fuzzy to me.

Q. What have you done to verify that the capital which Aquila has assigned to MPS was, in fact, used or not used to build the assets to provide utility service to MPS customers?

A. The only thing I'm aware of as far as -- and you have investments that are incurring in these properties I'm sure for quite some time. But I'm aware that in 1980 there was an equity ratio ruled on in that case of 27.5 percent equity.

Q. Well, that wasn't my question. My question was -- you said you tried to verify this. And my question is, what did you do to try to verify that the capital which Aquila has assigned to MPS was, in fact, used or not used to build the assets that provide service to the MPS customers?

A. Well, I've looked at the fact that it's been -- it's been presented that this -- is the allocated capital structure is the actual capital structure that -- that supports the assets of MoPub and St. Joe.

Q. I'm not asking you what's been presented. I'm asking you what you have done to verify that.

A. I've reviewed what's been presented and I don't agree with it.

Q. And you don't agree with it?

A. No.

Q. And what have you reviewed?

A. I've reviewed the business allocation procedure, I've reviewed the testimony that contradicts itself from the company itself. And, like I said, the numbers don't just add up from a financial theory standpoint. It doesn't make sense. Now, have I written a report on this other than testimony? No.

Q. Well, that was going to be my next question. So since you don't think it makes any sense, do you know whether or not the Staff has ever recommended changes to Aquila's allocation method so that the cost of capital of MPS would more accurately reflect the cost of providing service to Missouri ratepayers?

A. No. Because we recommend the consolidated capital structure. There wouldn't really be a purpose for us to do that.

Q. Isn't it a fact that in Case ER-93-337 this Commission adopted the assigned capital structure for rate-making purposes?

A. That's correct. And there's two cases where they adopted the consolidated that were fully litigated, a '97 case and the 1990 case.

Q. Are you saying that the ER-93-337 wasn't fully litigated?

A. That's been my understanding all along.

Q. Has somebody told you that?

A. That's -- I believe so.

Q. Who told you that?

A. It's been subject to testimony for quite some time.

Q. Who told you that that case wasn't fully litigated?

A. I believe it was when I was reviewing the previous Staff consultant's testimony, Stephen Hill in the 1997 case. And Bob Schallenberg indicated that -- whenever I was discussing something with him about it, that there was a hang-up on one specific issue that --

Q. Are either of those people lawyers, Bob Schallenberg or Stephen Hill? Who's Stephen Hill?

A. Last time -- he's a consultant the Staff has hired. Last time we hired him was back in '97, which was a MoPub case.

Q. You hired him in '97 and he told you the '93 case wasn't fully litigated?

A. Yeah. That was indicated in his testimony. I didn't see anything to dispute that.

Q. Have you read the decisions in the 93-337 case?

A. Not the full decisions.

Q. How many decisions are there, do you know?

A. I don't know.

Q. And so when you say you haven't read the full decisions, what have you read? What parts of the decisions have you read?

A. The rate of return report and order. I've seen that portion of it.

Q. Have you read the portion of the orders that pertain to capital structure?

A. That includes the rate of return capital structure.

MR. SWEARENGEN: Could I approach the witness?

JUDGE JONES: Yes, you may.

BY MR. SWEARENGEN:

Q. I'm going to hand you a portion of a Report and Order in ER-90-337 that concerns rate of return, capital structure. You say you're familiar with that. Could you read into the record the material that I've bracketed here on page 17?

A. Sure. In comparing Public Counsel's proposed capital structure and MoPub's proposal, the Commission finds that MoPub's divisional capital structure is the most appropriate. MoPub's divisional capital structure is testable, understandable, based on public facts and material, has been in continuous operation for more than five years and has been subjected to substantial regulatory review.

MoPub's capital structure is reproducible in that all the material assumptions and data involved in its formation are either published, distributed to regulatory authorities or otherwise publicly available.

Also, MoPub's booked capital structure is reasonable due to its continuity. Modifications are made only to reflect year-to-year historical development. It is not as subject to manipulation as Public Counsel's hypothetical capital structure.

Furthermore, Public Counsel's hypothetical capital structure cannot reflect the history of activity within a utility nor the particular risk of that utility as does MoPub's booked capital structure. Thus, the Commission finds that the use of Public Counsel's proposed capital structure is not appropriate in this case.

Q. Now, you said you read that decision previously; is that true?

A. Yes.

MR. SWEARENGEN: May I approach the witness again, please?

JUDGE JONES: Yes.

BY MR. SWEARENGEN:

Q. What's the date of that decision? Do you know offhand?

A. June 18th, 1993.

Q. Okay. Thank you.

Now, I'm going to hand you another decision in that same case dated April 4, 1997, almost four years later, same case, and ask you to read the bracketed material beginning on page 38 concerning return on equity, capital structure. Start there and read over to the end of that capital structure paragraph, please.

A. Okay. This is Report and Order on remand in Case No. ER-93-337 issued April 4th, 1997.

Here's the reading: Because MoPub must raise capital through UtiliCorp, the use of UtiliCorp's consolidated capital structure may be a valid approach. However, this is not the best approach for this case because UtiliCorp's comprised of both operating utility divisions and unregulated subsidiaries and its capital structure -- excuse me, its capital structure reflects that mix.

Use of MoPub's assigned capital structure will help insulate it to some extent from UtiliCorp's unregulated subsidiaries. And the assigned structure is actually analogous to the capital structures of comparable electric utilities.

Q. Is that the end of that discussion?

A. No. I have one more paragraph.

Q. Thank you.

A. Although the capital structures proposed by MoPub and Public Counsel -- excuse me, Public Counsel are substantially the same, the Commission determines that use of MoPub's assigned capital structure is warranted.

This structure was assigned to MoPub several years prior to this case based upon a comprehensive system of capital structure allocation by UtiliCorp in conformity with Securities Exchange Commission requirements and generally accepted accounting principles. Use of it will allow year-to-year continuity and permit easier period-to-period comparisons.

Finally, the Commission determines that in this case it will not impose a different capital structure on a utility where the management of the company has chosen an appropriate capital structure.

That's it.

Q. Now, once again, what's the date of that decision?

A. Date of that is it was issued on April 4th, '97; effective date April 15th, 1997.

Q. Thank you.

Now, how many years have you been with the Commission?

A. Going on four years in June.

Q. And you're aware, I assume, of cases that took place prior to that time, including this one that we just discussed?

A. I'm aware of those cases.

Q. Are you aware of any rate case before this Commission that lasted over four years?

A. I don't know the details behind that case so I -- as far as if that rate case lasted that long?

Q. Well, you just said the first order was issued --

A. It was remanded. I'm not an attorney --

Q. I understand that.

A. -- so you're asking me questions that --

Q. Would you agree with me the first order was issued in June of 1993? I think we've established that. And the last one you read from was in April '97?

A. It was remanded, yes.

Q. And you still think that case wasn't fully litigated. Is that your testimony?

A. That's in my testimony.

Q. That's based on something somebody named Stephen Hill told you?

A. I believe that's his name, and I believe that's correct.

Q. Okay. Back to your recommendation for a capital structure in this case, make sure I've got the numbers right. Is it 35.31 percent common? Is that what you're proposing?

A. That's correct.

Q. And you've got a little piece of short-term debt, .38 percent; is that correct?

A. That's correct.

Q. And 64.31 percent long-term debt?

A. That sounds correct.

Q. Okay. Are you familiar with the term "investment grade bond"?

A. Yes, I am.

Q. And would you agree with me that for purposes of this case, Aquila has agreed that the cost of debt should be set at a level not to exceed the Standard and Poor rate for a triple B rated bond?

A. I'm aware of that commitment.

Q. And is that the lowest investment grade bond, a triple -- a Standard and Poor triple B bond?

A. A triple B minus actually is the lowest.

Q. And does Aquila currently have that rating --

A. No.

Q. -- a triple B rating?

Would you agree that if the bond rating of a company declines, you would expect that company's cost to borrow to increase?

A. Yes.

Q. And would you agree that the Standard and Poor's guideline for a triple B utility of average risk is 45 percent debt and 55 percent common equity?

A. Are you referring to the guidelines --

Q. Yes.

A. -- from this?

I want to say it was 47 to 55 not 45 to 55, but I could verify that.

The financial target for a business position of five for a triple B rated company is 47 to 55.

Q. And what's a business position five? What's that mean?

A. Basically you have business profiles from 1 to 10, 1 being the least risky, 10 being the most risky. Whenever you have a business profile that indicates less risk, the financial ratios, metrics do not have to be as solid, if you will, if that -- as far as the financial health in order to have, say, the same credit rating as a company with a business profile of five.

They have some more business risk so they need to have, say, for instance, more equity in their capital structure to -- to compensate for that additional risk in order to have the same credit rating.

And a company with a business profile of 1, 2

3 -- I don't see many with a 1, but 2 and 3 usually are water companies. A 4 is probably a fully regulated electric utility. You get to 5 and 6 and you're looking at vertically integrated regulated utilities with some -- some nonregulated.

Aquila when -- the nonregulated Aquila merchant operation business profile I believe was a 7, so when you get into energy marketing and trading, wholesale power, tolling agreements, etc., you're looking in the 7, 8 range. And that's how that -- how that's measured.

Q. Okay. Thank you.

You did say though that the -- back to the S&P guidelines for a triple B utility of average risk, the common equity ratio, the guideline is 55 percent?

A. Yes. The benchmark is 47 to 55.

Q. 47 to 55 on common; is that right?

A. No. This is total debt to total capital.

Q. Okay. There's a range. Is that what you're saying?

A. Yes. For triple B. This is not an exact science by any means. And these targets, you know, a lot of times aren't even met to achieve a certain credit rating.

Q. Your comparable companies, what document would I look at in your testimony that would show me the common equity ratios of your comparable companies?

A. Actually, I think we were just referring to them. Something about 25 percent for DPL and DQE. That is Schedule 20 in column 1.

Q. Schedule 20 to your Direct Testimony?

A. Direct Testimony, column 1.

Q. Schedule 20, column 1. And how many of those companies fall into this Standard and Poor's guideline range that you were just talking about?

A. It's interesting, there's only one. And actually that company is an A-rated company. You actually have NSTAR, which is an A-rated company, that has 37.8 percent common equity total capital. So I'm sure that falls even further outside the range that are normally required for -- or I wouldn't say required, but that's the target for an A-rated utility with, say, a business position of five.

So that just illustrates more that this is more of an art than it is a science in assessing the creditworthiness because these benchmarks tend not to be met by some of these companies.

Q. You've got two in there that we talked about earlier that I think you agreed probably don't belong in your group. And that's DPL, Inc. and DQE; is that true?

A. I don't think we agreed that they don't belong in my group, but those -- you know, those -- they had triple

B credit rating at the time and, once again, those fell out of the guidelines that are indicated by Standard and Poor's in their financial targets.

Q. How much is DPL, Inc. out of the guideline?

A. Over 20 percent.

Q. And how about DQE? How much is it out of the guideline?

A. Over 20 percent.

Q. Would you agree that the lower the interest coverage, the greater the financial risk?

A. Holding all things equal, yes.

Q. And holding all things equal, would you agree that the greater the financial risk, the higher the cost of the common stock?

A. Yes.

Q. Is it true that a higher interest coverage indicates greater security to the investor and suggests to the investor that he will receive his anticipated interest payments?

A. Holding business risk equal once again, yes.

Q. Do you still have Schedule 20 there in front of you?

A. Yes, I do.

Q. And what does column 3 show?

A. Column 3 shows pre-tax interest coverage ratios for my comparable companies.

Q. And the average is 2.65 times; is that true?

A. That's correct.

Q. And then if you turn to the next schedule, I believe, Schedule 21 --

A. Yes.

Q. -- do you show there what your recommended proposed interest coverage will be for Aquila?

A. Yes. With many assumptions, I have calculated it a pre-tax interest coverage ratio there.

Q. Is that in the third column on that page under the 9.64 percentage?

A. Well, there's actually a range. If you go down to item 8, it shows the pre-tax -- with many assumptions, it shows the pre-tax interest coverage ratio of 2.11 for 8.64, 2.17 for 9.14, 2.23 for 9.64.

Q. And those interest coverage figures that you just read into the record correspond to the range of your proposed return on equity in this case, 8.64 to 9.64; is that right?

A. That's correct.

Q. So on the high end of your recommended ROE range, the 9.64, the proposed interest coverage is only 2.23 times; is that right?

A. That's correct. And I did -- as I explained in my testimony, I still have many reservations from drawing too much of an inference from -- from this test of reasonableness because of the fact that Aquila's credit ratings are a result of its consolidated operations; therefore, the credit quality of the debt that is assigned to MoPub and St. Joe is a function of the nonregulated operations of Aquila and also Aquila's leveraged capital structure, which is all I'm trying to reflect in my recommendation here.

Since the debt costs are what they are and what they're -- what they're assigned to MoPub and St. Joe, it's only natural to go ahead and use the capital structure that is a function of that credit rating and the costs associated with it.

Q. With your recommended capital structure, did you calculate what return on common stock equity would have produced a pre-tax coverage equal to the average of your comparable companies, which you said was 2.65 times?

A. No. That doesn't drive my recommendation.

Q. Did you make that calculation?

A. No.

Q. Is that a hard calculation to make?

A. I've never made it. I don't know, you know, if -- probably have to do some algebra.

Q. You can't do it on the witness stand this afternoon?

A. I could do it for you later. I really don't feel like doing it right here.

Q. Let me ask you this. Would 14.16 percent return on common stock equity sound like a number that might make that turn out to be 2.65 times?

A. You'd have to show me the calculations.

Q. Okay. Could you make that calculation while we're on recess?

A. If you have the calculations, I mean, I can review your calculation because I wouldn't want to confuse our methodologies here.

Q. You didn't do this calculation, did you?

A. No. I said it's not something -- pre-tax interest coverage -- a desired pre-tax interest coverage ratio calculation is not driving my recommendation. It's the other way around.

I come up with a recommendation, I use pre-tax interest coverage ratio to test the reasonableness. As far as I know, it's never been a matter of pre-tax interest -- a desired pre-tax interest coverage ratio driving what a recommendation should be.

Q. And you said you did it to test the reasonableness, and that's the essence of my question. Did you calculate what return on common stock equity would have produced a pre-tax coverage equal to the average of your comparable companies, which you said was 2.65 times?

A. No.

Q. And don't you think you should have done that to test the reasonableness of it?

A. No.

Q. Why not?

A. Because I looked at -- I evaluated the current interest rate environment, I looked at the growth rates in my DCF model, I looked at the dividend yields in my DCF model, I evaluated all six of my comparable companies. And I realized that some of those comparable companies had some problems and I took that into consideration when I made my recommendation. I calculat--

Q. How did you take that into consideration when you made your recommendation, the fact that some of your comparable companies had problems?

A. If you want to take a look with me, I'll explain it to you.

Q. Yeah. I'd love to. First of all, what companies are you talking about that have problems?

A. Well, there's obviously volatile growth rates because it's the nature of the industry right now, unfortunately.

Q. Which companies in your comparable companies had problems?

A. Well, let -- as soon as I turn to it, I can just start going through some of this with you.

Q. Okay.

A. Okay. If you turn to Schedule 14.

Q. And that's to your Direct Testimony?

A. Yes.

Q. Okay. Which of your comparable companies listed there -- and you have all six of them -- are having problems?

A. And when I say "problems," I'm referring to the fact that their growth rates are differing as far as historical and projected. You've already pointed out some things about DPL and DQE with their negative growth rates and historical growth rates.

And one of the things that happens when a company has a negative historical growth rate, a lot of times their near term projected growth rate will be higher than what is actually sustainable.

I actually discussed this in the last Empire rate case when they had an anomalous year -- because of the fact that Value Line has a projected earnings per share five years out -- three to five years out, that they expect them to return back to a normal level, but because they had an anomalous year, their base year to use to calculate that projected compound growth rate is going to be lower than it normally would be so an analyst has to take this into consideration.

Q. You're talking about the Empire District Electric Company?

A. I'm explaining what has to be taken into consideration.

Q. Well, are you talking about the Empire District Electric Company?

A. I'm using it as an example to explain what has to be taken into consideration when you look at growth rates.

Q. That's not one of your comparable companies though?

A. No. I'm using an example to explain here --

Q. That's fine.

A. -- as to why you have to take these things into consideration.

Q. I just wanted to make sure that that wasn't being substituted here. Go ahead.

A. No, it's just an example. I'm just trying to help explain.

So if -- when you look at the growth rates within -- you know, within my comparable groups there, you look at some of the average historical and projected. For

DPL and DQE, as you pointed out, you know, there are some issues there, but I'm not going to exclude them. I have confidence enough in myself to be able to sort through this information and come up with a reasonable recommendation.

And for the average historical and projected growth of DPL and DQE, you're right, the average historical growth and projected growth is 1.5 for DPL, for DQE it's negative 1.01.

Well, if you look at a company like Cleco and Hawaiian Electric, which is one of more captive electric utilities just because of the nature of the fact that it's on an island, they have very little growth.

And that's -- that's not -- that's not surprising to me because the growth for a electric utility is a lot of times based on what they call organic growth, which is growth and demand for electricity, which, you know, may not be growing as high as at one time because of energy efficiency issues, could be growth in customers within -- within their jurisdiction. So I gave some weight to that. I also gave some weight to NSTAR because NSTAR looks like it had historical and projected growth rates that were, you know, fairly -- you know, fairly similar.

So I looked at all that and took that in consideration. And -- and as you can see, my proposed range of growth was, you know, 10 basis points below my highest average historical and projected, which was NSTAR. 3.1 gives some weight do Hawaiian Electric. And then if you go to Schedule 16 there, you'll see that as far as my column 5, my -- the high end of my recommendation is actually higher than the overall results that I came up for any of my companies, which was 9.48 for Cleco. The high end of my range is 9.64.

So, once again, I'm looking at NSTAR, I -- I looked at some of these results and decided, you know, I need to analyze this, just like Dr. Murry calculated several DCF calculations with just the dividend growth. And he was coming up with absurd results, 6, 7 percent. I mean, you can make these calculations and you can look at them. It doesn't mean you're going to necessarily go with that recommendation.

Q. I want to take you back to your statement you made earlier that some of these companies have problems and you never really defined what you meant by problems, but you referenced specifically DPL, Inc. and DQE, Inc. Are any of the other companies in your proxy group -- any of the remaining four companies problem companies from your standpoint?

A. No. And when I say "problems," I'm saying that there was some things I looked at as far as their growth rates. I had to recognize that there was some things going on there with the negative historical and -- and the -- you know, the positive forward-looking growth and weighing my decision on what -- what is reasonable to recommend in this case.

Q. So when you said problems, other than DQE and DPL, Inc. you didn't really mean that the companies had problems?

A. I just meant that it presented problems with my analysis, that I had to --

Q. Okay.

A. -- if I can say, I had to use a little judgment here.

Q. Let me ask you this. Would you agree that if there is an increase in the rate of inflation, it is likely that the Federal Reserve will increase the level of interest rates?

A. Well, that depends to be -- if the economy starts to pick up and the Federal Reserve will, you know, eventually act. They've made some unprecedented announcements that they do not intend to raise their federal funds rate for any -- any time soon.

Q. What if there's an increase in the rate of inflation? What do you think the Federal Reserve will do?

A. Your guess is as good as mine on that. I mean, that's -- analysts are trying to figure that out all the time. I don't know.

Q. What normally happens if there's an increase in the rate of inflation with respect to what the Federal Reserve does in terms of the level of interest rates?

A. Well, if it's a sustainable amount of inflation, they may raise the fed funds rate, but they have to weigh a lot of factors -- more factors than I can even try to get into here. And I don't know.

Q. If you turn to your Direct Testimony, Schedule 6, there you list several economic forecasts; isn't that true?

A. Yes.

Q. And what does the Value Line Investment Survey indicate that the inflation rate was in 2003?

A. 1.9.

Q. And what does it say the inflation rate will be in 2004?

A. 2.

Q. 2 percent?

A. 2 percent. Sorry.

Q. And what does it say the inflation rate will be in 2005?

A. 2.1 percent.

Q. And would that indicate to you that analysts expect inflation to increase?

A. Yes. And that would be reflected in my DCF model.

Q. It will be reflected in your DCF model or is reflected in your --

A. It is.

Q. Okay. And how did you account for that in your DCF analysis?

A. I'm trying to measure investor expectations. And obviously investors review all this financial information when determining whether or not a specific security is attractive just as whenever dividends -- whenever double taxation of dividends was decided to, you know, start ratcheting that down to a point where it was down towards a capital gains level, utilities stock prices went up, they take that in consideration.

Take in consideration the fact that they cannot get as an attractive return on fixed interest rate investments because the level of interest rates are lower and that results in -- in investors being attracted towards equities.

Q. Now, you did a CAPM analysis as well; is that true?

A. Yes.

Q. Did you account for this expectation of increasing interest rates in the future in your CAPM analysis?

A. The -- the yield on the 30 -- and this is going to be a roundabout answer, you're going to have to excuse me. The yield on a 30-year --

Q. We haven't had any of those today, have we?

A. The yield on a 30-year treasury, the interest to yield to maturity for that security, that is an indicator of investors' expectations on what they think interest rates will do. So that does take into consideration inflation. It's not easy to come up with just -- this is not something that's -- like I said, it's more of an art than it is science.

Q. Are bonds less risky investments than the common stocks of the same company?

A. Yes.

Q. Are you familiar with the textbook Principles of Public Utility Rates by James Bonbright?

A. I believe Dr. Murry cited that. I just -- I'm familiar with his quotation.

Q. Have you ever looked at that book yourself?

A. No.

Q. There's a statement I think that Dr. Murry indicated that appears on page 308 of that textbook to this effect, Some analysts and commissions base their overall estimate on what they regard as a typical objective or ideal capital structure without regard to the actual capitalization of the company under review.

Are you familiar with that concept?

A. If you can refer me, I want to take a, you know, look specifically at his quote.

Q. I may be able to do that.

MR. SWEARENGEN: Could we have just a minute here?

JUDGE JONES: Yes.

MR. SWEARENGEN: Do you want to take a short recess?

JUDGE JONES: Is it going to take long for you to find what you need?

MR. SWEARENGEN: I've got it.

JUDGE JONES: You've got it, so we don't need to take a recess.

MR. SWEARENGEN: I thought maybe the reporter was getting tired.

May I approach the witness?

JUDGE JONES: Yes, you may.

MR. SWEARENGEN: I've got a copy.

BY MR. SWEARENGEN:

Q. For the record, Mr. Murray, I've handed you what I believe to be that portion of the text that we were just discussing that contains that statement.

A. Yes.
Q. My question is, do you agree with that statement?
A. You're referring to the statement, Some analysts and commissions base their overall estimate on what they regard as a typical objective or ideal capital structure?
That's the statement that you're referring to specifically --
Q. Yes, sir.
A. -- that's highlighted?
I agree with that statement. I agree that there's many opinions on that as well as far as what's typical, what's objective, what's ideal.
Q. One thing -- and are you familiar with any analysts that have said that or adopted that principle?
A. Not to my knowledge. As far as anybody specifically, no.
Q. But you would agree with it, nonetheless?
A. I'd agree that there are many things that you can do to evaluate whether or not a capital structure is, you know, typical or objective.
Q. You agree with the concept regardless of who said it --
A. Yes.

Q. -- is that a fair statement?

A. Yes.

Q. And if I said it, you would agree with it. Is that a fair statement?

A. Well --

Q. The reason I ask that, is that it says, Some commissions base their overall estimates on what they regard as typical objective or ideal capital structure. And I thought you said this morning that you've never read any decisions of other state commissions on that topic, so that's why I ask that question.

A. Okay.

Q. Do you agree that there's a school of thought that adheres to the principle that the cost of capital and rate-making should be based on what is reasonable and prudent for a regulated utility?

A. Can you show me what you're referencing, once again?

Q. I can show you my outline of my questions and that's all. I have no text to refer you to. I'm just asking you as a general proposition, do you agree or disagree with that? You accepted the other statement with me saying it. I wanted to see if you'd accept this one.

A. Can you repeat it one more time, please?

Q. Do you agree that there is a school of thought that adheres to the principle that the cost of capital in rate-making should be based on what is reasonable and prudent for a regulated utility?

A. I'm not sure what the basis of -- I'm trying to get some clarification here as far as the cost of capital for a reasonable and prudent utility. If we're talking about cost of capital, I agree.

Q. Okay. Thank you.

And did you calculate a cost of common stock equity for Aquila, Incorporated or for the Missouri regulated electric operations MPS and L&P?

A. MPS and L&P.

Q. Your capital structure, however, is the Aquila corporate capital structure; is that true?

A. That's MPS and L&P's capital structure.

Q. It's the Aquila corporate capital structure; isn't that true?

A. That's where the numbers came from, but it's MPS and L&P capital structure.

Q. So your testimony now is that MPS and L&P have a capital structure?

A. Yes. The actual consolidated capital structure of Aquila.

Q. If you turn to your Rebuttal Testimony, please, on page 8 starting on line 30. Do you have that in front of you?

A. Yes, I do.

Q. You make the statement, It is inappropriate to utilize Aquila's allocated capital structure for rate-making purposes in this case because, quite simply, Aquila does not have the equity to allocate to its divisions to maintain its target equity ratios.

Is that your testimony?

A. That's my testimony.

Q. Would you agree with me that large corporations, conglomerates, what have you, oftentimes allocate capital costs to various divisions in order to make capital budgeting decisions?

A. I'm familiar with the fact that there may be some discount rates that are determined. As far as the accounting capital cost, I'm not -- I can't speak to that.

Q. You don't know. Does Aquila allocate the capital costs of utility assets to the relevant operating utility divisions? Is that your understanding of what Aquila does?

A. I know they have assigned -- they have assign debt cost, and I guess that's the basis behind their allocated capital structure system.

Q. Let me ask you this. You read into the record a while ago excerpts from the Commission's decisions in

ER-93-37 that went into some detail about that, did you not?

A. Yes.

Q. Have you ever read any of the record or transcript of proceedings or the testimony that was filed in that case, ER-93-37?

A. I think I stated before I read just the part of the Report and Order that dealt with the rate of return and -- and capital structure.

Q. And did the Commission not in that case endorse the approach to the divisional capital structure that Aquila was supporting in that case?

A. In that case.

Q. They did. Right?

A. In that case.

Q. Let me ask you this. Is an allocation of capital to the operating division that uses the asset likely to be a closer estimate of the capital of that division then the sum of the capital for all of the divisions together?

A. Can you repeat the question, please?

Q. Sure. Is an allocation of capital to the operating division that uses the asset likely to be a closer estimate of the capital of that division then the sum of the capital for all of the divisions together?

A. I would say that the -- the capital is assigned or allocated to all the divisions of the consolidated operation of Aquila would -- would obviously have to add up to the consolidated equity ratio.

Q. Say that again.

A. Because of the fact -- especially considering the fact that Aquila is reverting back to a regulated -- domestic regulated utility. Their consolidated capital structure is going to be much more -- you know, it's going to be aligned with their regulated utilities because obviously if you have -- let's see, I think they have seven states that they operate in.

If there's seven divisions and they're maintaining that they're allocating 47.5 percent equity to those seven divisions and their consolidated equity ratio is 35 percent that shows on the annual report, you asked me if I've ever done any auditing of this, but the numbers just wouldn't add up.

Q. Let me ask you a question about that. I think earlier you said that Aquila has unregulated operations; isn't that true?

A. That they're winding down, that's correct.

Q. Yeah. And isn't all of that reflected on their financial statements and on the capital structure that you're proposing for use in this case?

A. Yes. But Mister -- I believe it's Mr. Empson indicated in the collateralization case that they actually allocate more equity to nonregulated. So it only stands to reason that the equity ratio that actually if the allocation process was done correctly, would be less than the consolidated because they're having to put more equity towards their nonregulated operations.

Q. Well, let's take you back to my question. Wouldn't you agree that an allocation of capital to the operating division that uses the asset be a closer estimate of the capital of that division than simply adding up the capital of all the divisions together?

A. No.

Q. You disagree with that?

A. Disagree.

Q. If one could demonstrate that the divisional capital structure is a more accurate estimate of the capital used to support the utility services of the division, would you use it as the capital structure for rate-making for that utility?

A. Repeat the question, please.

Q. If one could demonstrate that the divisional capital structure is a more accurate estimate of the capital used to support the utility services of the division, would you use it as the capital structure for rate-making for that utility?

A. That's a question I don't think that could ever be proved. I don't think anybody can prove that there's a capital structure that is actually supporting the division other than the consolidated capital structure of the utility.

Q. Well, didn't the Commission back in ER-93-37 conclude just the opposite?

A. Well, they concluded just the op-- what I'm referring to in the 1990 and 1997 case.

Q. Let's talk about 93-37 and those decisions that you read into the record. Don't you think there was something to support the Commission's decision in that regard?

A. The Commission weighed its evidence in that case.

Q. And do you think the facts they relied on were made up?

A. I'm saying it doesn't add up for me at this point in time. I do not see how this capital structure system has any support or evidence. And I've not seen any support or evidence submitted by the company to -- to convince me that this is the actual capital structure that supports the assets of MoPub and St. Joe.

Q. Well, what information would show you or convince you that the divisional capital structures of MPS and L&P were closer estimates of the actual capital used to serve those customers than the capital structure of Aquila, Inc.?

A. Spin them off as a subsidiary and have them issue their own debt.

Q. That's an event. I asked you what information would show you.

A. There isn't any information that would convince me.

Q. Okay. Okay. But there apparently was back in 1993; isn't that true?

A. I wasn't here in 1993.

Q. So you don't know?

A. The Commission weighed the evidence at the time. I was not the witness in 1993.

Q. Do you know who was?

A. Actually, I do not. May have been Jay Moore. I believe he was here at that time.

Q. Who's Jay Moore?

A. He used to be manager of the financial analysis department, but I don't know for sure.

Q. If Aquila allocated the nonregulated losses to nonregulated operations, would there be plenty of equity capital to finance MPS?

A. I'm sorry. Repeat the question again.

Q. If Aquila allocated the nonregulated losses to nonregulated operations, would there be plenty of equity capital to finance MPS?

A. At what level? When you say plenty of equity to finance MPS, at what level are you referring to?

Q. At any level.

A. They would have whatever equity -- when you say plenty of equity, obviously when I'm recommending a 35 percent equity ratio, individuals do not think that's plenty of equity. You know, there -- they have had to take write-downs to their equity ratio.

Q. What about at a 45 or 47 percent equity ratio?

A. I don't believe it's available to be allocated.

Q. If they allocated their nonregulated losses to nonregulated operations, you don't think that would be possible?

A. I haven't seen anything where they're separating the nonregulated losses and for that matter the nonregulated debt from the equity that was there before they -- Aquila's equity ratio started to decrease dramatically. I've not seen any separation.

Q. If you turn to page 11 of your Rebuttal Testimony, please. Are you there?

A. Yes.

Q. The answer that begins on line 9, I would have proposed to use a hypothetical capital structure. I would not accept the allocated capital structure proposed by Aquila because, as I have demonstrated, it is a fictitious capital structure.

That's your testimony?

A. Yes, it is.

Q. And what do you mean by the term "fictitious capital structure"?

A. It's not there. It's not tangible. Aquila's own witness, Mr. Reed, has indicated that divisional capital structures are not discernible.

I'm being attacked here and I -- there's a witness on the -- you know, with Aquila that has testimony that indicates a divisional capital structure is not discernible, which hence, means it's non-identifiable, its non-tangible, it's fictitious.

If Aquila wants to represent they want to use a hypothetical capital structure, that's fine, but with -- with trying to give the impression that there's actually some equity there at these divisions when we know that it's not because their current financial situation, I just -- I think that that's something that is -- is false and fictitious.

Q. Is "fictitious capital structure" a term that I would find in a college level textbook?

A. If you looked hard enough, you might. It's not --

Q. Have you ever seen it?

A. It's not a generally recognized financial term.

Q. Have you ever seen it?

A. In my college financial text? I don't recall.

Q. Okay. How does a fictitious capital structure, however you define that, differ from a hypothetical capital structure?

A. Like I said, a hypothetical I think is the same as a fictitious capital structure. A hypothetical capital structure is used primarily just to come up with a discount rate.

There's no attempt, when you're using a hypothetical capital structure, to give the representation that that capital is -- that mix of capital is actually there. It's just to determine what the discount rate to use is for -- you know, as a net present value calculation for a project, whether it's a go or not.

Q. Has this Commission ever used a hypothetical capital structure for purposes of setting rates?

A. St. Joseph Light & Power, I believe.

Q. Really?

A. I believe it was proposed. I recall that it was proposed. I don't know if it was accepted or if that was settled.

Q. Proposed by who?

A. Proposed by Staff.

Q. Staff proposed a hypothetical capital structure in a case involving St. Joseph Light & Power Company?

A. I believe that was the case.

Q. What case was that?

A. Before they got acquired by Aquila. I don't recall the exact case number.

Q. Was that the right thing to do in that case?

A. I -- Staff was -- that was their determination at the time. I don't know if I would have made the same determination or not.

Q. And why did they make that determination that a hypothetical capital structure should be used?

A. For whatever reason, they felt like it wasn't reasonable.

Q. What wasn't reasonable?

A. The capital structure.

Q. You mean the actual capital structure of the company?

A. The actual consolidated capital structure.

Q. Consolidated capital structure. What do you mean by that with respect to St. Joe Light & Power consolidated capital structure?

A. Its actual capital structure that's on the books reported to the SEC.

Q. Have you read that case? Are you familiar with that case where the hypothetical capital structure was proposed by the Staff?

A. Not in detail.

Q. Okay. Well, what did the Commission decide in that case?

A. You know, I don't recall if they -- if they adopted that or not.

Q. If the purpose of all this is to determine an appropriate capital structure for rate-making purposes, what is the difference between a hypothetical capital structure and an allocated capital structure?

A. Well, I believe -- I believe there's some dispute on that. I think in the collateralization case there was, you know, some indication from the company that Staff was trying to make a distinction without a difference.

There is definitely a difference. A hypothetical capital structure is used when the capital structure is determined to be unreasonable, whether it's because it's not consistent with the company's historical capital structure or whether it's not consistent with comparable companies, what have you. There's a decision to use a hypothetical capital structure.

Q. Is it a real capital structure, a hypothetical?

A. No. Hypothetical is not a real capital structure.

Q. So is it a fictitious capital structure?

A. It's just used to come up with a discount rate. No, there's no -- there's no representation that that capital is actually there.

Q. So if it's not real, it's fictitious. Right?

A. Exactly.

Q. Okay.

A. I mean --

Q. Hypothetical capital structure would fit your definition of a fictitious capital structure; is that true?

A. Yes. But the allocated capital structure that -- that Aquila uses for MoPub and St. Joe is a capital structure that -- that they have been giving -- trying to give this Commission that it's the actual capital structure that is the actual capital that capitalizes MoPub and St. Joe. And I do not agree with that.

Q. What did the Commission say about that back in 1993?

A. I think we've read that, but they've also had opinions that contradict that in 1990 and 1997.

Q. Did they ever issue an opinion that said what they said in '93 wasn't right, or did they just simply issue an opinion saying for purposes of rate-making in this case, we're going to go with the corporate capital structure?

A. I think they kept it within that case.

Q. Yeah.

MR. SWEARENGEN: Do you want to take a short break, Judge?

JUDGE JONES: No.

MR. SWEARENGEN: Do you want to keep plugging ahead?

JUDGE JONES: At least until 3:00.

MR. SWEARENGEN: I'll go get some more questions then.

BY MR. SWEARENGEN:

Q. Now, you've been wanting to talk all day about the DCF process. Is that a fair statement?

A. I'll say I wasn't wanting to talk at all today. And that's an inside joke.

Q. Okay.

A. But if you'd like to, I will.

Q. Let me ask you this. You mentioned earlier you've done a DCF analysis in this case and a CAPM -- you've gone through the CAPM process; is that true?

A. Yes.
Q. And is it fair to say that those are both theoretical processes or attempts to measure the returns required by investors?
A. Yes.
Q. And would you agree that those processes are based generally on the price of those equities, their projected future cash flows and their volatility?
A. I'd say the discounted cash flow is -- specifically addresses the prices of the stocks, the dividends associated with those stocks, potential growth rates for capital appreciation going forward, the capital asset pricing model doesn't necessarily involve the price of the stock.
It involves the beta, which is the measure of the volatility of the stock as it relates to the market added to some -- some interest rate which is usually a risk-free treasury with the beta times the market return to come up with an estimate. So that's not directly related to the price of stock as far as the CAPM.
Q. Would you turn to Schedule 16 to your Direct Testimony?
A. Yes.
Q. Is it on that schedule, Mr. Murray, that you set out your DCF estimated cost of common equity for your

six comparable companies?

A. Yes.

Q. And you came up with an estimated cost of common equity range of 8.64 percent to 9.4-- excuse me, 9.64 percent; is that correct?

A. That's correct.

Q. And I think you said earlier that you applied that result to the Aquila corporate capital structure which existed at the end of 2002?

A. Applied it to the corporate common equity ratio or common equity amount, that's correct.

Q. Right. Have you ever heard the term "company-specific DCF analysis"?

A. Yes, I have.

Q. And what is your understanding of the meaning of that term?

A. If -- and this hasn't been the case for Aquila in at least the last couple cases, but if -- if we have a Missouri utility that has -- that pays a dividend, it is, you know, predominately in the industry that we're trying to determine a cost of equity for, we will use the market information for that company specifically in order to arrive at a recommendation for, you know, the cost of common equity for that specific company such as Empire.

Q. Okay. Now, and you've done that in the past for companies? You haven't done it in this case for Aquila, I think you said; is that right?

A. That's correct.

Q. For MPS and L&P; is that right? You haven't done it for MPS and L&P?

A. No. It's impossible.

Q. But you have done it in the past for companies such as Empire you suggested?

A. I believe Empire is the only case that I've been able to do a company-specific analysis.

Q. Let me ask you this question. And I hate to keep taking you back to the Hope case, but I think I'm going to maybe one more time. How does a company-specific DCF analysis in and of itself meet the requirement of the Hope case of looking at the returns of comparable companies?

A. Well, it gives an idea as to what the cost of the common equity is for the company. And the most important thing for an investor to be assured of is that they're going to be able -- if they make an investment in the company, that the return they require, which is the cost of common equity, needs to be achieved by that company in order for them to make that investment attractive or worthwhile.

And so that ties directly into the Hope case in the fact that this would assure confidence in the financial integrity of the enterprise so as to maintain credit and attract capital, because we are recommending the allowed return based on the cost of capital, which, like I said, that -- that level has to be met in order for investors to be attracted to the security.

Q. Now, that's the second part of the Hope test that we've talked about, maintaining -- or assuring confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital.

But the first part of the Hope test is what I was really referring you to. And that says, The return to the equity owner should be commensurate with the returns on investments and other enterprises having corresponding risks.

And so my question is, when you do what you define as a company-specific DCF analysis, how does that in and of itself meet the Hope case requirement?

A. Well, like I said, there's been, you know, I think different readings and as you pointed out before, I'm not an attorney, but there's -- there's been many -- there's been a transition from looking at the earnings back in the 19-- like I said, 1940's or what have you where these models may not even have been coming into play.

These are models that are a result of financial research, financial types of break-throughs on how to evaluate the cost of capital. Actually, the original intent behind the dividend growth model was in order to determine what is a reasonable stock price, not actually the rate of return for a utility -- for a utility in the rate of return arena, but I know that there are still some analysts that do comparable earnings analysis.

I think the last Missouri-American case I -- there was an analysts that did the comparable earnings analysis. But for the most part every -- every case I've worked on, we all -- rate of return witnesses use cost of capital models to determine what is a fair rate of return.

Q. I think I understand what you're saying, but my question is, as far as you know, the Hope case is still the law; isn't that true? I know you're not a lawyer and I'm not trying to put you on the spot in that regard, but when you read those words, the standard -- the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks, how do you square that with a company-specific DCF analysis where you don't even look at --

A. Well --

Q. -- other enterprises with corresponding risks?

A. Let me -- let me back up to -- let's talk about when I did a company-specific DCF analysis. Now, that's not the only analysis I did to come up with the