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Acquisition Premium
Witness: David P. Broadwater
Sponsoring Party: MoPSC Staff
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Case No.: EM-2000-369

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

DAVID P. BROADWATER

UTILICORP UNITED INC.

AND

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM-2000-369

Jefferson City, Missouri
June 2000

****Denotes Highly Confidential Information****

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1 Schedule 1, I have analyzed the cost of capital for numerous small water, sewer and
2 telephone utilities.

3 Q. Were you previously employed before you joined the Commission's Staff
4 (Staff)?

5 A. Yes, I was employed by Cullum & Brown, Inc. from July 1991 through
6 November 1993 in a sales and sales support capacity.

7 Q. What is your educational background?

8 A. In 1991, I earned a Bachelor of Science degree in Business Finance from
9 Northwest Missouri State University. In 1995, I earned a Master of Business
10 Administration degree with an emphasis in Finance from the University of Missouri at
11 Kansas City.

12 Q. Are you a member of any professional associations?

13 A. Yes. I am a member of the Society of Utility and Regulatory Financial
14 Analysts (SURFA), formerly the National Society of Rate of Return Analysts.

15 Q. Do you hold any professional designations?

16 A. Yes. On May 13, 1997, I was awarded the professional designation of
17 "Certified Rate of Return Analyst" (CRRRA) by the Society of Utility and Regulatory
18 Financial Analysts. This designation is based upon education, experience and the
19 successful completion of a comprehensive examination.

20 Q. What is the purpose of this testimony?

21 A. The purpose of my testimony is to: (1) respond to UtiliCorp United Inc.'s
22 (UtiliCorp) proposal to "freeze" the capital structure of The Empire District Electric
23 Company (Empire) for ratemaking purposes at Empire's normalized capital structure; and

1 (2) respond to UtiliCorp's proposal to recover 50% of the acquisition premium associated
2 with the purchase of Empire directly through rates.

3 Q. How does your testimony filed in this merger application compare to the
4 testimony you filed earlier concerning the same issues in the UtiliCorp/St. Joseph Light
5 & Power Company (St. Joseph) merger application, Case No EM-2000-292?

6 A. It is very similar to that testimony filed earlier in the UtiliCorp/ St. Joseph
7 merger case. However, I have addressed certain unique financial aspects of the
8 UtiliCorp/Empire transaction in this testimony that are not relevant to the UtiliCorp/St.
9 Joseph transaction.

10

11 **FROZEN CAPITAL STRUCTURE**

12 Q. Why does the Staff believe that UtiliCorp is proposing to use the current
13 normalized capital structure of Empire to set rates for Empire customers after the merger?

14 A. UtiliCorp's capital costs are less than what Empire capital costs have been
15 historically. This is one of several indirect ways in which UtiliCorp plans on recovering
16 50% of the acquisition premium for which they are not seeking direct recovery.

17 Q. What is Empire's current capital structure that UtiliCorp referred to in its
18 Regulatory Plan?

19 A. According to UtiliCorp's response to Staff Data Information Request No.
20 3823, UtiliCorp has corrected the direct testimony of Mr. John W. McKinney, on page
21 28, where he states that UtiliCorp is proposing the capital structure for Empire be
22 maintained at a normalized level of 47.5% long-term debt and 52.5% common equity. It
23 should read that UtiliCorp is proposing the capital structure of Empire be maintained at a

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1 normalized level of 52.5% long-term debt and 47.5% common equity. (The new
2 numbers in Mr. McKinney's testimony are now consistent with those contained in
3 Empire witness Robert B. Fancher's direct testimony at page four, which addresses
4 Empire's "normalized" capital structure). Empire's current capital structure is
5 approximately 40% common equity and 60% long-term debt (excluding short-term debt),
6 an explanation of why Empire's capital structure contains as much debt as it does will be
7 addressed later in my testimony. However, Empire's targeted capital structure is between
8 45% and 50% common equity and 50% and 55% long-term debt, while UtiliCorp's
9 current targeted capital structure is 40% common equity and 60% long-term debt.

10 Q. Is it true that, absent the merger, Empire's capital structure would not have
11 changed appreciably from the normalized level over the next five to ten years?

12 A. It is impossible to say what Empire's capital structure would be going
13 forward but, according to Empire's forecasts, the anticipated common equity ratio would
14 vary from ** _____ ** to ** _____ %** for the years 1998 through 2002 (Source: Due
15 Diligence material given to UtiliCorp by Empire made available to Staff at UtiliCorp's
16 Corporate Headquarters).

17 Although Mr. McKinney represents his proposed capital structure to be a
18 normalized capital structure, Empire's projections of what it believed its capital structure
19 would be going forward shows an average equity ratio of ** _____ ** versus Mr.
20 McKinney's normalized equity ratio of 47.5%.

21 Q. How will the Empire utility operations be financed going forward, and
22 what are the real capital costs that will be incurred in the operation of the Empire utility
23 operations?

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1 A. Empire's utility operations will be financed by UtiliCorp once the merger
2 is consummated. Empire will operate as a division of UtiliCorp after the merger is
3 consummated. As a result, Empire will not have any common stock outstanding, publicly
4 traded or otherwise. The actual capital costs of the merged entity will be UtiliCorp's
5 capital costs. UtiliCorp has repeatedly stated that it intends to keep its targeted capital
6 structure at approximately 40% common equity and 60% long-term debt. Therefore,
7 assuming that rates are set based on actual costs, the capital costs that should be included
8 in rates for the Empire Division, are UtiliCorp's capital costs, not Empire's pre-merger
9 normalized capital costs.

10 Q. How does UtiliCorp's capital structure practices differ from that of
11 Empire?

12 A. UtiliCorp's targeted capital structure contains 40% common equity and
13 60% long-term debt. UtiliCorp's forecasts show that its common equity ratio will vary
14 between ** ____ ** and ** ____ ** for time period 1999 through 2003, which is not that
15 different from Empire's projected capital structure of between ** ____ ** and ** ____ **
16 common equity for approximately the same time period. The real issue is that of the cost
17 of capital differences between the companies come from different attitudes that the
18 companies have regarding the use of debt and ultimately how those differences are
19 reflected in rates. Standard & Poor's *Global Utilities Rating Service Utility Credit*
20 *Report for UtiliCorp* January 2000 states the following regarding UtiliCorp:

21 **Capital Structure.** Management's aggressive attitude regarding
22 debt leverage and off-balance-sheet obligations appears in the
23 balance sheet ratios, where total debt to capital approaches 60%
24 and is projected to decrease only moderately in the future. Some
25 ebbing in the attitude toward leverage has been manifested at
26 times, but Standard & Poor's believes that management's historic

1 affinity for the use of leverage is still present and will limit credit
2 quality in the future.

3 The consensus is that UtiliCorp will fund its operations with approximately 40%
4 common equity on a going forward basis. In fact, below is an excerpt from the transcript
5 of the August 5, 1999 conference call with security analysts discussing second quarter
6 1999 earnings where UtiliCorp Chairman and CEO Richard C. Green, Jr., stated that
7 UtiliCorp is still very comfortable with a 40% common equity/60% debt capital structure.

8
9

10 Q: Okay. And presumably, have you determined at this point –
11 would these be financed as ones have similarly in the past as far as
12 the US capital markets?
13

14 RCG: Yes and let me talk a little bit broader about that because it
15 is our strong intent to be very effective and good at deploying our
16 capital and growing our business base and balance sheet.
17

18 And underneath that, what we're talking about is when we get to
19 the point of doing equity offerings those are equity offerings in
20 conjunction with accretive deals.
21

22 You'll remember that the offering we did last year was an
23 accretive stock offering.
24

25 And that when we do these transactions they're **based at least on a**
26 **60/40 equity/debt or debt/equity balance here.** [emphasis added]
27

28 So we have a lot of confidence that when you put together
29 accretive deals like we've been doing in the South Pacific that
30 that's just going to, you know, be positive the bottom line even
31 when we have to put out the equity to balance the - to shore up the
32 balance sheet.
33

34 Q: And you're still comfortable with that 60/40 split as the
35 business expands and is further dispersed around the world?
36

37 RCG: Yes. Yes we are. . . .

1 The approach to UtiliCorp's capital structure as illustrated above is significantly
2 different than Empire's. Standard & Poor's *Global Utilities Rating Service Utility Credit*
3 *Report for UtiliCorp* April 1999 states the following regarding Empire's capital structure:

4 **Capital Structure.** Historically, EDE [Empire] has used
5 conservative financing practices. Between 1993 and 1997, the
6 company's construction program was relatively stressful. Yet,
7 management has striven to maintain capital structure balance by
8 issuing large amounts of common equity over the past several
9 years. This conservative financing strategy is expected to continue
10 during the next several years. The company has no unsecured or
11 long-term floating-rate debt outstanding. EDE's average debt life
12 is 16.5 years. Asset quality is relatively high, with balance sheet
13 deferrals of regulatory assets consisting of unamortized loss on
14 reacquired debt (net of deferred income taxes) of \$11.3 million as
15 of Dec. 31 1998, or a reasonable 4.9% of common equity.

16 EDE's reported debt leverage stands at 48.4% and common equity
17 of 45.1% of total capitalization. When factoring in off-balance
18 sheet purchased-power commitments using a weighted average
19 risk factor of 45%, debt leverage rises to a liberal 53.2%. While
20 this level of debt is marginally acceptable for EDE's current
21 ratings, leverage will rise later this year if the company issues more
22 debt than equity to fund its new capacity addition and again in
23 2001 when adjusted for the capacity payments under the WR
24 [Western Resources] purchased power contract

25 EDE's 32.9 million preferred stock layer is all fixed-rate perpetual
26 and accounts for 6.5% of total capitalization. The company's
27 embedded cost of preferred stock was 7.59% in 1998.

28 This illustrates the vastly different approach that Empire and UtiliCorp take to
29 their capital structures. Although both Empire and UtiliCorp's capital structure have
30 been fairly debt heavy in the recent past, the motivation has been vastly different in each
31 case. Empire has been using both debt and equity to finance generation additions to meet
32 the needs of its growing service territory, while UtiliCorp's management has shown it
33 preference for financing with debt, mostly to fund its acquisitions.

1 It also should be noted that the financing Standard & Poor's referred to in its
2 discussion of Empire's capital structure was completed at the end of 1999. Empire
3 actually issued all unsecured debt for this financing because, at that time Empire and
4 UtiliCorp had already entered into a merger agreement and UtiliCorp did not want
5 Empire to issue new equity that it would have to later reacquire at a premium.

6 Q. What is the impact of the UtiliCorp/Empire merger on the combined
7 company's cost of capital?

8 A. The impact of this proposal is two-fold. First, Empire's normalized cost
9 of capital is higher than UtiliCorp's actual cost of capital so there will be an immediate
10 reduction in the capital cost to operate the Empire properties after the merger. This will
11 be a potentially significant source of merger savings from the perspective of Empire
12 customers. Secondly, there will be a reduction in UtiliCorp's risk with the addition of the
13 Empire and St. Joseph properties, further reducing UtiliCorp's cost of capital (UtiliCorp's
14 proposed acquisition of St. Joseph is now pending before the Commission in Case No.
15 EM-2000-292).

16 The first type of reduction in capital costs referenced above will create
17 approximately \$2.5 million per year for a total savings of approximately \$25 million over
18 the ten-year period UtiliCorp is proposing to freeze Empire's capital structure (See
19 Schedule 2). The Staff's analysis of the \$2.5 million per year in capital cost savings is
20 based upon UtiliCorp's authorized cost of capital from their most recent rate case (Case
21 No. ER-97-394, et al) and the capital structure UtiliCorp is proposing to be used to set
22 rates for the Empire customers. As an alternative, if the Staff would use the cost of
23 capital estimate that UtiliCorp is employing in this case to calculate capitalized merger

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1 savings (11.37% per the response to Staff Data Request No. 1), the annual savings shown
2 on Schedule 2 would rise to approximately \$5.1 million. The second type of reduction in
3 capital costs will come from the reduction in risk that the acquisition of Empire and St.
4 Joseph will create for UtiliCorp. The amount of savings from the reduction in risk that
5 will be generated from these acquisitions is not known. The Staff is confident, thought,
6 that the risk and corresponding capital costs of UtiliCorp will be reduced due to the
7 addition of these regulated operations. The certainty that is associated with cash flows of
8 regulated utility operations is greater than that of unregulated operations. Through these
9 acquisitions, the percentage of UtiliCorp's cash flows that come from regulated
10 operations will increase in relation to the total cash flows thus creating greater certainty
11 of the total cash flows of UtiliCorp. UtiliCorp has not acknowledged this benefit in its
12 direct testimony, but does acknowledge it in a written transcript of "UtiliCorp's Investor
13 Call, July 13, 1999 - \$250MM Senior Notes." UtiliCorp's CEO Richard C. Green
14 referred to the pending Empire and St. Joseph transactions as low risk; however, the
15 magnitude of the effect this transaction will have on UtiliCorp's cost of capital is not
16 known. It appears that the Staff and UtiliCorp both agree that the effect of the Empire
17 and St. Joseph transactions will be lower risk and lower capital costs to UtiliCorp, which
18 ordinarily would result in lower costs to the customers of Empire, St. Joseph and
19 UtiliCorp.

20 Q. Has the Commission previously heard the issue of "frozen capital
21 structure?"

22 A. No. This issue has not been presented to the Commission previously in
23 this manner, but a very similar version of this proposal was proposed by UtiliCorp in

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1 Case Nos. ER-97-394, ER-93-37 and ER-90-101, its last three general rate proceedings in
2 Missouri. In those cases, UtiliCorp was proposing a capital structure for its Missouri
3 Public Service (MPS or MoPub) division that had significantly more equity than was
4 being used to finance MoPub's assets. The Staff argued in Case No. ER-97-394 that the
5 allocated capital structure proposed by MoPub would have the effect of artificially
6 increasing the cost of capital to be paid by MoPub customers. More specifically, in the
7 Direct Testimony of Consultant Steven G. Hill, Staff stated the following:

8

9 . . . [O]verall capital costs based on the Company's allocated
10 capital structure will not equal the actual overall cost of capital
11 because the allocated capitalization is different than the capital
12 structure on which the Company's actual costs are based. For
13 example, UtiliCorp management has selected an allocated
14 ratemaking capital structure for MPS which has an equity ratio of
15 approximately 47%. Other electric utilities that have similar
16 capital structures have bond ratings which are several ratings
17 categories higher than the bond rating of MPS's parent, UtiliCorp.
18 The Companies included in Mr. Dunn's electric utility sample have
19 an average equity ratio of approximately 48% and an average
20 Standard & Poor's (S&P) bond rating of "A+." UtiliCorp has an
21 equity ratio closer to 40% and has a bond rating of "BBB."

22
23 The cost rates associated with the debt issued by UtiliCorp (and
24 subsequently allocated to MPS) are a function of UtiliCorp's
25 "BBB" bond rating, not of the allocated capital structure. Those
26 embedded debt cost rates are not the cost rates that would exist for
27 MPS if it had actually been capitalized in a manner similar to the
28 allocated capital structure. Therefore, in order to accurately
29 estimate MPS's actual overall capital costs those embedded debt
30 cost rates should be matched with the capital structure on which
31 the cost of that debt is predicated – the consolidated capital
32 structure of UtiliCorp.

33
34 It is important to remember that capital dollars are not color-coded.
35 Once they enter the corporate treasury accounts, dollars derived
36 from retained earnings, equity issuances, debt issuances or
37 investment tax credits are not differentiable from each other.
38 When those dollars are disbursed to subsidiary operations, they can

1 certainly be classified as being from a certain percentage of debt or
2 equity (as UtiliCorp has done in allocating capital to its
3 subsidiaries) but, in reality, it is not possible to distinguish the
4 source of those monies once they are deposited in the corporate
5 treasury. Therefore, the cost rate which is most appropriately
6 associated with those monies is the parent company's overall cost
7 of capital. (pp. 13-14)

8
9

10
11 . . . [W]ith the use of an allocated capital structure there exists the
12 potential for the overrecovery of capital costs. Overrecovery can
13 occur on the debt capital costs through the allocation of debt to the
14 regulated subsidiary which carry a cost rate higher than the overall
15 consolidated embedded cost of debt. For example, UtiliCorp
16 reported to its shareholders in "The 1996 Corporate Profile" a
17 statistical supplement which the parent characterizes as a
18 "companion piece to the UtiliCorp United 1996 Annual report to
19 shareholders," indicates that the consolidated embedded debt cost
20 at year-end 1996 was 8.14%. However, Schedule JCD-10
21 attached to the Direct Testimony of Company witness Dunn
22 indicates that the Company requests that its rates be set using an
23 embedded cost of 8.39%

24
25 Also, if rates are set for MPS using a capital structure which has a
26 higher percentage of equity capital than that actually utilized by the
27 parent, the parent company will have the opportunity to realize a
28 return on equity higher than that which is allowed in utility rates.
29 (pp. 15-16)

30 Q. How did the Commission rule on that issue in that case?

31 A. The Commission's Report And Order dated March 6, 1998, stated the
32 following:

33 Based on substantial evidence of record, the Commission finds that
34 the consolidated capital structure as proposed by the Staff
35 accurately reflects the correct capital structure of UtiliCorp itself,
36 and therefore MPS, during the actual test year.

37
38 The Commission adopts the Staff-proposed capital structure of
39 56.14 percent debt to 43.86 percent equity.

40 Q. How were the two previous cases decided?

1 A. In Case No. ER-93-37, the Commission ruled in UtiliCorp's favor, but in
2 Case No. ER-90-101, the Commission ruled in the Staff's favor and stated the following:

3 The Commission determines that the capital structure proposed by
4 Staff/Public Counsel, as modified hereinafter, should be adopted in
5 this case. In ratemaking, establishing the correct capital structure
6 is part of the process of setting the rate of return on the Company's
7 facilities. The goal of selecting a rate of return is to attract
8 sufficient capital for the company's needs in financing its facilities.
9 It is important that the rate of return established realistically reflect
10 the assessment of prospective investors in that company. The
11 Commission finds that it is more reasonable to use the consolidated
12 capital structure for MPS than it is to assign a hypothetical capital
13 structure to MPS. As noted by Staff/Public Counsel, MPS has no
14 capital structure of its own and its stock is not traded on the stock
15 market. Investors cannot invest in MPS but can invest in
16 UtiliCorp. It is the capital structure of UtiliCorp that prospective
17 investors will examine when contemplating the investment. It is
18 UtiliCorp which must attract capital for the use of its divisions and
19 subsidiaries including MPS.

20
21 The Commission determines that the use of a consolidated capital
22 structure in this instance will not, per se, expose MPS's ratepayers
23 to any adverse consequences arising from UtiliCorp's other
24 activities any more than the use of a hypothetical, assigned capital
25 structure will insulate them from these consequences. As stated by
26 Staff/Public Counsel's witness, the present capital structure of
27 UtiliCorp is not harmful to MPS's ratepayers. However, an
28 adjustment would need to be made in future rate cases should
29 UtiliCorp develop a capital structure that would subject MPS's
30 ratepayers to adverse consequences arising from UtiliCorp's other
31 activities.

32
33 The Commission further determines that it is not germane to
34 establishing of an appropriate rate of return that the consolidated
35 capital structure is unavailable to finance MPS's future
36 construction. As pointed out by Staff/Public Counsel's witness,
37 only new capital is available to MPS for new construction. Since
38 UtiliCorp raises the capital for MPS's use, it is UtiliCorp's capital
39 structure which is the more important in raising capital from
40 investors to finance MPS's construction program.

41
42 Q. Why is UtiliCorp seeking to fix Empire's capital structure for the next ten
43 years?

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1 A. UtiliCorp is attempting to guarantee the regulatory treatment of Empire
2 and its capital structure over the next ten years. This is an attempt by UtiliCorp to “lock
3 in” the capital structure for Empire outside the context of a rate proceeding. What
4 UtiliCorp is attempting to do with its proposal to freeze the capital structure for Empire is
5 to take away the Commission’s right to set the capital structure of Empire at an
6 appropriate level in future rate cases.

7 Q. Is this proposal similar to “single issue ratemaking?”

8 A. Yes. “Single issue ratemaking” is when (1) rates are set or (2) issues that
9 have a rate impact are heard, outside the context of a rate proceeding, without considering
10 all relevant factors. This proposal is an attempt by UtiliCorp to do exactly that.
11 UtiliCorp wants the Commission to determine an appropriate capital structure for Empire
12 at this time that will be used in at least two rate proceedings over the next ten years.
13 UtiliCorp’s proposal is an attempt to “lock in” the capital structure for rate purposes
14 without considering all the relevant factors that go into determining what an appropriate
15 capital structure would be at those times.

16 Q. From a more general perspective, would you discuss why companies enter
17 into mergers and acquisitions?

18 A. Yes. The value of a company or any asset is derived from the present
19 value of its future cash flows. Based on this concept, the following formula can be used
20 to establish the value of a company:

21 $V = FCF / (K - G)$

22 Where

23 V = Value of the company

24 FCF = Unleveraged free cash flow defined as

1 Q. Could you please summarize Staff's position on UtiliCorp's proposal to
2 freeze the capital structure of Empire at the pre-merger level for ratemaking purposes?

3 A. It is Staff's position that there are going to be capital cost savings created
4 from this merger in two different ways. First, the cost of capital required to operate the
5 Empire properties will be lower with UtiliCorp's current capital costs than they were with
6 Empire as a separate company. Secondly, there is the effect that this merger will have on
7 UtiliCorp's cost of capital. The merger of Empire, as well as the merger of St. Joseph
8 into UtiliCorp will have the effect of lowering UtiliCorp's overall risk profile; therefore,
9 the future cash flows should be more certain and less risky requiring a lower discount
10 rate. This discount rate at which future cash flows are discounted is the company's
11 overall cost of capital. In this case, UtiliCorp's cost of capital should be less after the
12 merger than it is prior to the merger, creating additional savings in the area of capital
13 costs. While UtiliCorp should have a reasonable opportunity to retain some portion of its
14 merger savings, including cost of capital savings, Empire customers should also reap
15 some benefits from these savings as well.

16 Therefore, it is the Staff's opinion that UtiliCorp's proposal to freeze Empire's
17 capital structure for ratemaking purposes at a pre-merger level is not necessary or
18 appropriate, as discussed in the Rebuttal Testimony of Staff witnesses Mark L.
19 Oligschlaeger and Cary G. Featherstone of the Accounting Department. The Staff's
20 position is to allow the company to retain a portion of merger savings through the use of
21 regulatory lag. Use of regulatory lag will allow UtiliCorp to retain for some period of
22 time cost of capital savings associated with the Empire merger. Allowing UtiliCorp to
23 retain merger savings in the cost of capital area through artificial restrictions and

1 movement from cost-based ratemaking (as is implicit in the “frozen capital structure”
2 proposal) should not be approved by the Commission.

3 **Empire’s Actual Capital Structure**
4

5 Q. Could you please describe Empire’s capital structure history?

6 A. Yes. From 1990 through 1998, Empire’s total debt to total capital ratio
7 has fluctuated between approximately 47% to 50%. Then, in 1999, Empire’s total debt to
8 total capital ratio jumped to approximately 60% (see Schedule 3)

9 Q. What caused this sharp increase?

10 A. Through most of the 1990’s, Empire has been adding capacity to meet the
11 demands related to the load growth in its service territory. Empire has financed its
12 growth in a conservative manner by issuing both debt and equity. In 1999, Empire
13 entered into the Merger Agreement with UtiliCorp and, as a result of the Merger
14 Agreement Empire retired all of its outstanding preferred stock. The repurchase of
15 preferred stock was coupled with the issuance of \$100 million in unsecured debt and no
16 new equity issuance. The result has been in increase in the total debt to total capital ratio
17 of approximately 10% in one year.

18 Q. Did the Commission approve Empire’s issuance of \$100 million in new
19 debt?

20 A. No. It is Empire’s position that since the new debt issuance is unsecured
21 that there is not any requirement for Empire to get Commission approval.

22 Q. Why did Empire change its conservative strategy by issuing only debt and
23 not a combination of debt and equity in its recent financing?

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1 A. Due to its pending merger with UtiliCorp, the decision was made in
2 accordance with the Merger Agreement that there would be no new equity issued except
3 in the normal course of business. Therefore, Empire had to issue debt only to finance the
4 construction of its new generating station.

5 Q. Is Empire the first utility in Missouri to issue unsecured debt in lieu of
6 secured debt?

7 A. No. There are several utilities that have gone to issuing unsecured debt.

8 Q. Why have companies gone to issuing unsecured debt?

9 A. It gives them flexibility. When a company issues first mortgage bonds or
10 secured debt, it is limited in what it can do with the property it has pledged as security,
11 where as unsecured debt does not limit a company nearly as much. Within the electric
12 industry, the idea of flexibility extends into to the area of deregulation. If in the process
13 of deregulation the company decides to divest or spin-off a portion of the company, then
14 the presence of secured debt may severely limit the company. Within this context, the
15 Staff has not traditionally been opposed to the issuance of unsecured debt as long as any
16 additional cost is not excessive.

17 Q. Why is there an additional cost to issue unsecured debt?

18 A. The flexibility that unsecured debt offers the issuers of the securities
19 translates to additional risk to the purchasers of the security. Therefore to attract
20 investors to purchase the security, the unsecured debt must be offered at a higher interest
21 rate. Another major factor that effects the cost of unsecured debt is the fact that holders
22 of secured debt (i.e. first mortgage bonds) are first in line to receive their principal in the
23 event of a liquidation. In the event that a utility issues unsecured debt as a policy and has

1 no secured debt outstanding, then the holders of unsecured debt are first in line in the
2 event of a liquidation. Even in this situation, unsecured debt holders would still require a
3 premium because there is nothing that would keep the company from changing its policy
4 and issuing secured debt which increases the flexibility for the issuer and increases the
5 risk for the investor.

6 Q. Assuming that the purpose of the law that requires utility companies to
7 gain Commission approval before they issue secured debt is to protect the utility
8 customers, does issuing unsecured debt protect utility customers?

9 A. No. Even though unsecured debt does not directly encumber the assets of
10 a utility, to the extent that a utility has assets in excess of its current balance of secured
11 debt, the unsecured debt investors have a claim to the utility's assets in the case of a
12 liquidation. Therefore, given that the market value of a utility's assets are greater than
13 the par value of the secured debt outstanding, then the unsecured debt holders have a
14 claim to the assets of a company. In the Staff's opinion, this essentially poses the same
15 concerns from a customer perspective as if the company would have issued secured debt.

16

17 **ACQUISITION PREMIUM**

18 Q. Is the Staff supporting UtiliCorp's proposal regarding the recovery of one-
19 half the acquisition premium directly through rates?

20 A. No. It is the Staff's position that this merger is ultimately about the
21 shareholders and maximizing shareholder value. This merger is not being done for the
22 customers of Empire, the employees of Empire or the communities that Empire operates
23 within. In the *Proxy Statement of The Empire District Electric Company*, Empire lists the

1 following six reasons why this transaction is a good deal. As can be seen by their
2 recitation below, they all involve shareholder benefit issues:

- 3 • The merger consideration offers you an attractive premium over
4 the trading price of our common stock prior to the announcement
5 of the merger;
- 6
7 • As a result of the merger, you will most likely benefit from
8 increased dividends;
- 9
10 • You will benefit by participating in the combined economic
11 growth of the service territories of UtiliCorp and Empire, and from
12 the inherent increase in scale, the market diversification and the
13 resulting increased financial stability and strength of the combined
14 entity;
- 15
16 • There will likely be cost savings from a reduction in operating and
17 maintenance expenses and other factors;
- 18
19 • The combined enterprise can more effectively participate in the
20 increasingly competitive market for the generation of power; and
21
22 • UtiliCorp has significant non-utility operations and, as a larger
23 financial entity following the merger, should be able to manage
24 and pursue further non-utility diversification activities more
25 efficiently and efficiently than Empire could as a stand-alone
26 entity.

27
28 In Empire witness Myron W. McKinney's direct testimony, he makes the claim
29 that this merger will provide opportunities for our customers, employees, and
30 shareholders that would not be available if Empire would remain an independent
31 company. However, this merger is not about customers or employees – it's about getting
32 the most value for the shareholder. The Empire Board of Directors is employed by
33 Empire's shareholders and it is their duty to maximize the value of the Company. That is
34 exactly what they have done here in negotiating this merger.

35 **Bond Indenture Change**

36
37 Q. What is Empire going to change about its bond indenture?

Rebuttal Testimony of
David P. Broadwater

1 A. There is a provision in its original indenture that states that in the event of
2 a merger, future dividends have to be paid out of current earnings. UtiliCorp and its legal
3 advisors objected to that provision and asked Empire if they could get it changed.
4 Empire did receive bondholder consent to eliminate that provision, but to obtain that
5 consent it cost Empire approximately ** _____ **.

6 Q. How did the need to change the bond indenture effect the merger
7 agreement?

8 A. The price per share of Empire was lowered by ** ____ ** per share.
9 Originally, UtiliCorp had agreed to purchase Empire for ** ____ ** per share. When
10 this issue arose Empire estimated that to obtain the necessary bondholder consent it
11 would cost between ** _____ **. Consequently, an equivalent amount was
12 taken out of the share price.

13 Q. Does that mean that UtiliCorp is only asking to recover the acquisition
14 premium up to \$29.50 per share and not ** ____ ** per share?

15 A. Not exactly. UtiliCorp is seeking recovery of half of the acquisition
16 premium through rates, which is the difference between the book value of Empire and the
17 agreed upon price of \$29.50. However, UtiliCorp is asking for recovery 100% of the
18 amount needed to change the bond indenture through an amortization as a transaction
19 cost. Therefore, UtiliCorp is asking for ratepayer reimbursement of more than half of
20 their ** ____ ** per share offer for Empire.

21 Q. Is it appropriate for customers to pay for this change in the bond
22 indenture?

1 A. No. This is money that is being spent for the benefit of UtiliCorp's
2 shareholder. It is intended to protect the dividend stream of UtiliCorp's shareholders
3 going forward. The bondholders consent does not in any way help the customers of
4 Empire or any of UtiliCorp's other operating divisions. This cost is strictly a shareholder
5 benefit issue, which should be paid by shareholders.

6
7 **The Empire District Electric Company Valuation**

8 Q. Theoretically, how are companies valued?

9 A. A company is just like any other asset that needs to be valued. The value
10 of an asset is based on the present value of future cash flows. When a company is being
11 valued, the future benefits are dollars available to investors. In the discussion of the
12 frozen capital structure issue, we discussed the following valuation formula:

13
$$V = FCF / (K - G)$$

14 This formula derives the value of a company from the cash flow that is available
15 to the shareholder. There is also the more conventional discounted cash flow model
16 which, when solving for price, is as follows:

17
$$P = D / (K - G)$$

18 Both of these formulas value a company based on the present value of future cash
19 flows. Once the value of a company has been estimated using some type of discounted
20 cash flow analysis, it is prudent to consider the results versus how a group of comparable
21 companies have been valued in the market. Also consideration is given to comparable
22 companies that have previously been involved in merger transactions. There are several
23 ratios that can be used for this process such as sales price to any of the following:

1 earnings, operating cash flow, book value, sales, EBITDA (earnings before interest,
2 taxes, depreciation and amortization) and/or EBIT (earnings before interest and taxes) as
3 well as what premium is being paid over and above market value as compared to the
4 unaffected market value per share. These are just some of the possible ratios that can be
5 used to ensure that the discounted cash flow price for the company in question is
6 reasonable.

7 Q. How did UtiliCorp determine a value for Empire?

8 A. UtiliCorp did not hire an investment banker to assist with the process of
9 evaluating Empire -- the process was done in-house. UtiliCorp reviewed the financials of
10 Empire, analyzed what the consolidated financials would look like if UtiliCorp would
11 purchase Empire, and UtiliCorp reviewed what the ratios would be as a result of paying a
12 variety of prices for Empire. They then compared the ratios to those of several recent
13 transactions within the electric industry. UtiliCorp did not do an independent analysis of
14 Empire's value. While what UtiliCorp did was good, it just did not go far enough.

15 It is critical that an analysis of the specific assets be done when a company is
16 valued. What UtiliCorp has done is make the assumption that each of the other
17 transactions they reviewed as part of their analysis were valued correctly and have
18 relevance to UtiliCorp's purchase of Empire. It is just like you are looking to buy a
19 specific house and in determining what you would be willing to pay for it. You look at
20 what other houses in the area have sold for and make your offer to buy based only on the
21 analysis of other homes. That analysis may lead to you getting a good house in a good
22 area at a good price, but it could just as easily lead you to overpaying for that house in the
23 good area if that house is not comparable to the other homes. A better approach to

1 determining what a home's value would be based upon characteristics that are specific to
2 that home and what they would be worth to you, and then compare that price to the price
3 at which others have sold.

4 What I believe UtiliCorp has done is assume that the market for electric utility
5 companies is a competitive market and quite simply it is not. It is true, by some
6 definition, the "market price" of Empire is \$29.50 per share, but that market price is not
7 the result of a competitive market. While Empire negotiated this deal exclusively with
8 UtiliCorp they did have several other utilities that they discussed merging with in the
9 past. Empire took UtiliCorp's offer because they believed that it was the best they could
10 do for their shareholders. A competitive market is defined by having many buyers and
11 sellers, all with perfect information, competing for a homogenous product. In the
12 mergers and acquisitions market, you have only a few players and the products are all
13 unique. UtiliCorp was one company that had an interest in Empire, but there very well
14 could have been others. On the other side of the transaction, Empire is the "product" and
15 there is not another company exactly like Empire. Therefore, the "market price," that has
16 been determined by the sale of Empire is not the result of real competition and should not
17 be assumed to be the "fair market value" of Empire. To take that idea to the next logical
18 step, the value of other companies as part of the precedent transactions analysis should
19 not be assumed to represent the market value of any specific electric company.

20 Q. What was the process used by Empire to determine its value?

21 A. Empire had retained the firm of Salomon Smith Barney (Salomon) to
22 assist the Board of Directors and the Company with various financial matters including
23 the potential sale of the Company. Salomon did an independent DCF analysis of Empire,

1 as well as a comparison to other electric companies and an analysis of other mergers in
2 the electric and gas utility industry. Salomon conducted a DCF analysis of the value of
3 Empire at two different points in time in association with this merger. The first was as of
4 February 6, 1999, and was done for the Board of Directors to assist them in negotiating
5 with UtiliCorp. The second was as of May 10, 1999, which was done just prior to the
6 announcement of the merger for the purpose of supporting Salomon's Fairness Opinion.
7 Salomon also looked at trading statistics for comparable electric companies, as well as
8 mergers in the electric utility industry from 1996 through the present.

9 In the DCF analysis conducted by Salomon, it determined the estimated cash
10 flows for Empire as well as a terminal value for the Company, then it discounted the cash
11 flows and the terminal value to determine the present value of Empire. Salomon
12 estimated the discount rate for Empire to be in the range of ** _____ ** to ** _____ **.

13 Q. What is the significance of the discount rate used to discount future cash
14 flows?

15 A. The discount rate used to value a company should be the pre-tax weighted
16 average cost of capital of the acquiring firm. When Empire was determining its value, it
17 would have been appropriate for Salomon to use Empire's cost of capital as the discount
18 rate in the analysis. A reasonable value for the pre-tax weighted average cost of capital
19 would be 13.10% based on the Staff's opinion of the rate of return reflected in Empire's
20 last settled rate case (No. ER-97-81).

21 Q. Did Salomon use Staff's pre-tax weighted average cost of capital from
22 Empire's last rate case for their May 10, 1999 presentation to Empire's Board of
23 Directors?

Rebuttal Testimony of
David P. Broadwater

1 A. No. That analysis was more than two years old and the economic
2 environment has changed significantly over that two year period. However, discount
3 rates in the range of ** ____** to ** ____** are extremely low, even when considering
4 the current economic environment. Using a simplified case where a company is financed
5 with 50% debt and 50% equity and taxes are not considered, a cost of capital of
6 ** ____** would result from a cost of debt of ** ____** and a cost of common equity of
7 ** ____**.

8 Q. Was Empire's Board of Directors' satisfied with Salomon's DCF
9 analysis?

10 A. Yes. Mr. Myron McKinney was asked about the discount rates Salomon
11 used in its DCF analysis he stated in his May 22, 2000 transcribed interview with the
12 Staff and the Office of Public Counsel that ** _____

13 _____
14 _____ ** (Transcript, page 87).

15 Q. What is the effect of using such a low discount rate?

16 A. The lower the discount rate the greater the present value of the future cash
17 flows and the greater the present value of the terminal value of the firm. These greater
18 present value figures translate into a greater value for Empire. By coupling that
19 understanding with the fact that Empire's Board of Directors goal is to maximize
20 Shareholder value, it is not difficult to see that there would be an incentive by Empire's
21 Board of Directors to keep the discount rate as low as reasonably possible.

22 Q. What were the assumptions and results of the discounted cash flow
23 analysis performed by Salomon on Empire's behalf?

Rebuttal Testimony of
David P. Broadwater

1 A. As stated above, Salomon used discount rates of ** _____ ** to ** _____ **.
2 With those variables and the cash flow projections done by Salomon, which were not
3 provided to the Staff, Salomon estimated Empire's value to be in the range of ** _____ **
4 to ** _____ ** per share.

5 Q. How would the savings that UtiliCorp believes it can generate effect the
6 DCF analysis conducted by Salomon?

7 A. The estimated savings that will be generated by the merger will increase
8 Empire's cash flow, thus making Empire worth more to UtiliCorp than it would
9 otherwise. The concept of having a rate case to 'lock in' higher rates and then implement
10 a five-year rate moratorium is another attempt by UtiliCorp to increase the cash flows of
11 Empire prior to the merger. This will also have the same effect of increasing the value of
12 Empire to UtiliCorp.

13 Q. How should the Commission value Empire for the purpose of determining
14 an appropriate acquisition premium?

15 A. The Commission needs to decide what the appropriate value of Empire is
16 if it plans on reflecting all, or a portion, of the acquisition premium in rates. Determining
17 the value of a utility company is nothing new for a utility commission. It is done in every
18 contested rate case in which cost of capital is an issue. The only difference is in this
19 analysis, the Commission needs to decide what the value of the Empire is and, in a rate
20 case, the value is a given and the appropriate discount rate is what is at question. In both
21 cases, the theoretical concept is identical. The only difference is the factor of the
22 equation that is being solved for.

1 The Staff believes the most appropriate value for Empire is the value that uses
2 UtiliCorp's cost of capital as the discount rate. The cash flows that Salomon used should
3 be augmented by the savings that UtiliCorp will realize through this merger as well as
4 any additional cash flow that will be generated due to the rate case Empire has planned
5 on filing this fall. The Staff had hoped to perform such an analysis for the Commission,
6 but Salomon stated that they did not have any work papers justifying their DCF analysis,
7 making it impossible for the Staff do such an analysis (Staff Data Information Request
8 No. 3821).

9 Q. Is recovery of the acquisition premium using this valuation the position
10 that the Staff is supporting in this case?

11 A. No. The Staff's position is that UtiliCorp should not receive any direct
12 recovery of the acquisition premium. The acquisition premium is a shareholder cost and
13 should not be allowed in rates. To further illustrate this point, let us look at an example
14 where a utility sells an asset at a premium to its book value. In this example, the Staff's
15 position would be that the gain goes to shareholders and is not included in rates as an
16 offset to rate base. The Staff's position concerning the acquisition premium is consistent
17 with the Commission's historical treatment of premiums on assets sales. If, and only if,
18 the Commission decides to change its policy and allow direct recovery of all or part of
19 the acquisition premium, does there come a need to determine what is the true value for
20 Empire. In that event, the Commission should direct Staff to conduct a discounted cash
21 flow analysis of Empire's cash flows using UtiliCorp's pre-tax cost of capital as the
22 discount rate.

1 Q. Has UtiliCorp historically been comfortable with the policy of this and
2 other state commissions regarding non-recovery in rates of acquisition premiums?

3 A. Yes. The policy of this Commission and most other state commissions
4 has been that acquisition premiums have not been allowed in rates. UtiliCorp is aware of
5 the historical treatment of acquisition premiums and, in fact, believes they do not
6 necessarily need to interfere with making a profit. In the early 1990's, Mr. Richard
7 Green made the following remarks to a group of security analysts at a conference in
8 St. Louis:

9 Where I'd like to go from here is into about 3 slides that focus on
10 some questions I've been asked about the company and why we're
11 able to do what we're able to do and still be very strong
12 financially. This first one here deals with the premiums that we
13 have paid for our acquisitions in comparing them to operating
14 income. As you can see, the premium is a significant amount. So
15 that people that understand you have to pay a premium to get an
16 acquisition, also can understand that the premium doesn't have to
17 be such that interferes with making a profit. I think this very
18 clearly illustrates that we've been able to buy our properties at a
19 price that we're still able to make good money at.

20
21 This, I think, is the most interesting of the three because it is an
22 attempt to explain to people how one can mitigate the premiums of
23 a price paid for a property and, therefore, take away a lot of, if any,
24 of the negative effects of doing an acquisition. You can see in the
25 red lines that is the UCU stock sale premiums. The premium over
26 book in which we have put our stock out on the market and the
27 other line is the premiums we've paid for the acquisitions. Of
28 course, adjusted for asset growth, that's simply saying that as
29 assets have been added to those acquisitions, they've added at
30 book value and, therefore, they average down the premium paid
31 over time. But, essentially, you can see that we're getting more for
32 our price of stock than we're paying for the properties we're
33 buying, so you're really mitigating a lot of that premium and that's
34 a function that's allowed us to be as aggressive as we have been in
35 the acquisition market, and as long as we keep those two curves
36 relatively close, I think we're going to still make a very profitable
37 and prudent acquisition.
38

1 What this excerpt illustrates is that UtiliCorp believes that acquisitions are
2 possible at a premium, and do not require any direct recovery of that premium as long as
3 the price is within reason for what is being purchased. At approximately the same time,
4 UtiliCorp published an Issue Report entitled *Mergers and Acquisitions in the Utility*
5 *Industry*. In that report, UtiliCorp states the following:

6 In the view of some analysts, growth that is achieved through
7 acquisition of regulated utility properties is an uneconomic way of
8 building value. Because the utility being purchased has an
9 earnings potential that is restricted to the book value of assets
10 allowed in rate base, they contend that it is difficult to justify the
11 expense of paying a premium over the book value of a utility's
12 assets. They further assert that because premiums are not
13 recovered through cost-of-service-based rates, the utility will not
14 perform as well as others in its peer group.

15 In UtiliCorp's view, the success of our growth strategy can
16 best be measured by the performance of our securities in the debt
17 and equity markets. The conclusion cited above can be proved by
18 an analysis of UtiliCorp's total return to investors in the five years
19 since it began its growth strategy.
20

21 The conclusion that can be reasonably drawn from the above comments is that
22 UtiliCorp believes that if it can purchase regulated utility companies at a fair price, there
23 is no need to directly recover the acquisition premium. To take that to the next logical
24 step and apply it to this case, UtiliCorp has no need to receive direct recovery of the
25 acquisition premium paid to Empire shareholders unless it has overpaid for the
26 properties.

27 Q. Does this conclude your rebuttal testimony?

28 A. Yes, it does.

DAVID BROADWATER

<u>COMPANY</u>	<u>CASE NO.</u>
Empire District Electric	ER-95-279
Laclede Gas Company	GR-96-193
Missouri Gas Energy	GR-96-285
Empire District Electric	ER-97-81
Empire District Electric	ER-97-82
Kansas City Power & Light	EO-97-84
Union Electric	EO-97-86
Missouri-American Water Company	WR-97-237
St. Louis County Water	WR-97-382
Laclede Gas Company	GR-98-374
Laclede Gas Company	GR-99-315
GTE Midwest /Spectra Communications	TM-2000-182
AmerenUE	EO-2000-205
Kansas City Power & Light	EO-2000-210
Atmos Energy Corp./Associated Natural Gas Company	GM-2000-312
UtiliCorp United Inc. and St. Joseph Light & Power Company Merger	EM-2000-292

**UtiliCorp United Inc's Cost of Capital Including
The Empire District Electric Company Normalized Capital Structure**

Capital Component	Capital Dollars	Percentage	Cost	Weighted Cost	Tax Factor	Pretax Cost
Common Equity	\$0	47.50%	10.75%	5.106%	1.6231	8.288%
Preferred Stock	\$0	0.00%	0.00%	0.000%	1.6231	0.000%
Long-term Debt	\$0	52.50%	8.18%	4.295%	1.0000	4.295%
Short-term Debt	\$0	0.00%	0.00%	0.000%	1.0000	0.000%
Total	\$0	100.00%		9.401%		12.583%

UtiliCorp United Inc's Cost of Capital

Capital Component	Capital Dollars	Percentage	Cost	Weighted Cost	Tax Factor	Pretax Cost
Common Equity	\$1,525,400,000	39.41%	10.75%	4.237%	1.6231	6.877%
Preferred Stock	\$100,000,000	2.58%	8.81%	0.228%	1.6231	0.369%
Long-term Debt	\$2,245,100,000	58.01%	8.18%	4.744%	1.0000	4.744%
Short-term Debt	\$0	0.00%	0.00%	0.000%	1.0000	0.000%
Total	\$3,870,500,000	100.00%		9.209%		11.990%

Cost of Capital Difference 0.592%

Empire's Rate Base \$423,250,645

Dollar Impact / Year \$2,506,682

Source: The Empire District Electric Company's Capital Structure was taken from UtiliCorp United's Direct Testimony

UtiliCorp United's Capital Structure was taken from UtiliCorp United's response to Data Information Request 3816

**The Empire District Electric Company
Historical Capital Structure**

	1990	1991	1992	1993	1994
Common Equity	\$148,847	\$156,910	\$163,293	\$167,861	\$173,780
Preferred Stock	\$7,902	\$8,102	\$7,902	\$7,902	\$32,902
Long-Term Debt	\$142,310	\$142,314	\$143,719	\$165,227	\$185,097
Short-Term Debt	\$6,000	\$6,000	\$15,000	\$15,000	\$16,000
Total	\$305,059	\$313,326	\$329,914	\$355,990	\$407,779

Common Equity	48.79%	50.08%	49.50%	47.15%	42.62%
Preferred Stock	2.59%	2.59%	2.40%	2.22%	8.07%
Long-Term Debt	46.65%	45.42%	43.56%	46.41%	45.39%
Short-Term Debt	1.97%	1.91%	4.55%	4.21%	3.92%
Total	100.00%	100.00%	100.00%	100.00%	100.00%

	1995	1996	1997	1998	1999
Common Equity	\$193,137	\$213,091	\$ 219,034	\$ 229,791	\$ 234,188
Preferred Stock	\$32,902	\$32,902	\$ 32,902	\$ 32,634	\$ -
Long-Term Debt	\$194,705	\$219,533	\$ 219,385	\$ 246,093	\$ 345,850
Short-Term Debt	\$14,000	\$7,500	\$ 28,000	\$ 14,500	\$ -
Total	\$434,744	\$473,026	\$ 499,320	\$ 523,018	\$ 580,038

Common Equity	44.43%	45.05%	43.87%	43.94%	40.37%
Preferred Stock	7.57%	6.96%	6.59%	6.24%	0.00%
Long-Term Debt	44.79%	46.41%	43.94%	47.05%	59.63%
Short-Term Debt	3.22%	1.59%	5.61%	2.77%	0.00%
Total	100.00%	100.00%	100.00%	100.00%	100.00%

Source: The Empire District Electric Company's Annual Report to Shareholders