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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

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Missouri Public Service Commission

SURREBUTTAL TESTIMONY

OF

DAVID MURRAY

AQUILA, INC. d/b/a AQUILA NETWORKS-MPS (Electric)

CASE NO. ER-2004-0034

Exhibit No. 1090 NP
Case No(s). ER-2004-0034
Date 3-1-04 Rptr TL

Jefferson City, Missouri
February 2004

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

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc.,	)	Case No. ER-2004-0034
d/b/a Aquila Networks-L&P and	)	
Aquila Networks-MPS to implement	)	
a general rate increase in electricity.	)	

AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

David Murray, of lawful age, on his oath states: that he has participated in the preparation of the following surrebuttal testimony as modified on February 27, 2004, in question and answer form, consisting of 47 pages to be presented in the above case; that the answers in the following surrebuttal testimony as modified on February 27, 2004, were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

David Murray
David Murray

Subscribed and sworn to before me this 26th day of February 2004.

D SUZIE MANKIN
Notary Public - Notary Seal
STATE OF MISSOURI
COLE COUNTY
MY COMMISSION EXP. JUNE 21,2004

D Suzie Mankin
Notary Public

TABLE OF CONTENTS OF

SURREBUTTAL TESTIMONY OF

DAVID MURRAY

AQUILA, INC.

d/b/a AQUILA NETWORKS-MPS (Electric)

CASE NO. ER-2004-0034

Response to Dr. Murry's Rebuttal Testimony 2

Response to Ms. Abbott's Rebuttal Testimony 32

Response to Mr. Reed's Rebuttal Testimony 37

Summary and Conclusions 46

SURREBUTTAL TESTIMONY

OF

DAVID MURRAY

AQUILA, INC.

d/b/a AQUILA NETWORKS-MPS (Electric)

CASE NO. ER-2004-0034

Q. Please state your name.

A. My name is David Murray.

Q. Are you the same David Murray who filed direct and rebuttal testimony in this proceeding for the Staff of the Missouri Public Service Commission (Staff)?

A. Yes, I am.

Q. In your direct testimony, did you recommend a fair and reasonable rate of return for the Missouri jurisdictional electric and steam utility rate base for Aquila, Inc. d/b/a Aquila Networks-MPS?

A. Yes, I did.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Dr. Donald A. Murry, Mr. John J. Reed and Ms. Susan D. Abbott. Dr. Murry sponsored rate-of-return direct and rebuttal testimony on behalf of Aquila, Inc. (Aquila). Mr. John J. Reed sponsored rate-of-return rebuttal testimony on behalf of Aquila, Inc. His testimony dealt with some specific issues regarding my rate-of-return recommendation, but he also discussed other issues about Staff's position in this rate case. He also discussed general concerns about the utility regulatory environment in Missouri. Ms. Susan D. Abbott sponsored rate-of-return rebuttal testimony on behalf of Aquila, Inc. She addressed her concerns with what she believes MPS's stand-alone credit rating would be assuming they issued their own debt.

Response to Dr. Murry's Rebuttal Testimony

Q. What is your general response to Dr. Murry's accusations that your recommended rate of return is going to "imperil the financial health" of MPS?

A. While I have recommended a just and reasonable rate of return in this proceeding for MPS, I recognize that there are other factors, such as Aquila's failed non-regulated investments, that can have a dramatic effect on MPS's financial health, such as MPS's increased cost of capital because of the deterioration in Aquila's creditworthiness.

Although MPS could be financially healthy utilities on a stand-alone basis, their connection to Aquila and its failed non-regulated investments does not allow this. Aquila is now in the process of restructuring itself back to a domestic, regulated utility. However, the regulated utilities will be burdened with the obligations associated with the residual non-regulated debt remaining on Aquila's balance sheet. This residual non-regulated debt reduces the Company's debt capacity that it may need for investments in its remaining regulated properties. This residual non-regulated debt will drive up the cost of the debt that Aquila is able to procure. MPS's situation can be compared to that of two individuals who have a joint credit account. One of the parties may be quite responsible and healthy financially, but the spending spree of the other individual ruins the otherwise responsible individual's credit rating. The responsible individual is now jointly responsible for the debt that the other individual charged to the account even though he didn't receive any benefit from the spending spree. However, his or her cost of funds is now higher than would otherwise be the case. MPS's situation is even more dire because it isn't part of a joint account. MPS do not issue their own debt. They depend on Aquila for their capital needs. The remaining Aquila non-regulated debt after it restructures is the responsibility of the regulated utilities, which includes MPS.

This Commission should have confidence that adopting my recommended rate of return will not ultimately imperil the financial health of MPS. Although the actual cost of capital for MPS is now higher because of Aquila's financial deterioration, Aquila represents that it is not attempting to pass along these higher costs to ratepayers, at least from the context that the rates will not be higher because of these costs. Staff is also not recommending that MPS ratepayers pay for Aquila's higher cost of capital as a result of its failed non-regulated investments. It is the fact that MPS were not and are not fully insulated from Aquila's other failed businesses that would result in these Missouri utilities being driven into bankruptcy with Aquila, if such an event should happen. This is the case because they are not bankruptcy-remote subsidiaries, they are operating divisions of Aquila.

Q. On page 2, lines 10 through 12 of his rebuttal testimony, Dr. Murry indicates that your use of Aquila's capital structure as of the test year is flawed, especially when considering that the Missouri electric affiliates' (MPS) capital structures are more accurate. Do you agree with this characterization?

A. No. The capital structure that is "allocated" to MPS is far from accurate. An examination of Aquila's current financial condition proves that this allocation system is purely fictitious and has no evidence to support it. The equity that Aquila claims is available to MPS are simply numbers on paper. These numbers don't represent the amount of equity that MPS truly have available for their operations. As I demonstrated in my rebuttal testimony, not only is it easily understood that Aquila does not have the common equity to "allocate" to its divisions at the ratios it proposes for ratemaking purposes in this case, but Mr. Rick Dobson, Chief Financial Officer (CFO) of Aquila, freely admits that Aquila does not have the common equity available to allocate at the desired levels. Consequently, the divisional capital structures that Aquila desires to use for MPS for ratemaking purposes in this case are inaccurate when considering the amount of equity that is available and should not be used for ratemaking purposes. Even when Aquila was in better financial condition, the capital structure that it supposedly "allocated" to its regulated divisions was not consistent with basic financial theory when comparing the allocated ratios to Aquila's consolidated capital structure. The capital ratios that are implied from Aquila's "allocated" capital structure are fictitious. There is no evidence to support that this proportion of capital is available to the Missouri operating divisions.

Q. On page 3, lines 8 through 10 of his rebuttal testimony, Dr. Murry indicates that Aquila's consolidated capital structure is not consistent with the capital structure that will support the assets of MPS during the period when the rates set in this proceeding are in effect. Do you agree?

A. No. If anything, the consolidated capital structure of Aquila in the future will be more closely linked to its regulated divisions because it is Aquila's stated intention to return to a regulated utility company because of its failed non-regulated investments. If I had chosen to update Aquila's capital structure through the update period of September 30, 2003, then my capital structure recommendation would be even more leveraged than the one I chose to recommend. This is because Aquila's book common equity has eroded as it has incurred further losses while exiting non-regulated investments. The September 30, 2003 updated capital structure represents the most current known capital structure that supports the assets of MPS. However, I am not recommending this capital structure because it is not consistent with how MPS have been capitalized in the past as indicated by Aquila's historical capital structures.

Q. Dr. Murry cites Bonbright, *et.al.*, in *Principles of Public Utility Rates*, page 309, on page 5, lines 9 through 16 of his rebuttal testimony, in order to support his contention that it is inappropriate to utilize the consolidated capital structure for ratemaking purposes in this case. Do you agree that this supports his contention?

A. No. The first part of this quotation indicates that "...if the existing capital structure is clearly unsound or is extravagantly conservative, the rule may need to be modified in the public interest." I have demonstrated in my direct and rebuttal testimony that Aquila's consolidated capital structure as of the test year is clearly sound. In fact, Aquila's consolidated capital structure as of the test year is consistent with the way it has historically been capitalized when it had investment grade credit ratings, meaning that Aquila itself has deemed this capital structure to be sound for financing its operations.

The second part of the quotation that discusses the risk differential between non-regulated and regulated activities implies that the consolidated capital structure would not be appropriate for the financing of a public utility if the utility is diversified. General financial theory indicates that if a company diversifies into riskier, non-regulated activities, then it will have to maintain better financial ratios in order to balance the additional business risk that the company faces from the non-regulated operations. This would imply that a company would have to maintain more equity on a consolidated basis in order to counter-balance its increased business risk. This is consistent with the way in which Standard & Poor's evaluates the creditworthiness of the utilities that it analyzes. Therefore, my use of Aquila's consolidated capital structure for ratemaking purposes is appropriate, if not conservative, because it has had to contain more equity because of its riskier, non-regulated operations in order to maintain its BBB credit rating.

Q. Do you have any evidence from Standard & Poor's that supports your position?

A. Yes. I introduced this research report in the last Aquila rate case, Case No. ER-2001-672. On October 19, 2001, Todd A. Shipman, CFA, of Standard & Poor's made the following comments regarding the affirmation of UtiliCorp's credit rating:

> The ratings on UtiliCorp reflect its average business position and gradually improving financial profile. The regulated utility operations are supported by sales and earnings stability derived from international geographic and economic diversity. The credit profile of UtiliCorp's unregulated operations is weaker than the company's core utility business, but UtiliCorp placed a public offering of a 19.9% ownership stake in its Aquila Inc. energy marketing and trading subsidiary in 2000 and intends to spin off the rest of Aquila to its shareholders by the end of 2001.

> The operations of UtiliCorp after the spin-off of Aquila [This was previously the non-regulated subsidiary name. UtiliCorp changed its name to Aquila when it decided to align and identify itself with its non-regulated operations.] will be dominated by a collection of relatively low-risk, regulated utility assets. However, the improvement in the company's business profile is likely to be offset by an increase in its financial risk so that the overall creditworthiness of UtiliCorp will not improve. To the extent that the plans for Aquila are not accomplished as currently envisioned by the company, Standard & Poor's expects UtiliCorp to adjust the level of financial risk to remain consistent with its business risk so that its creditworthiness is held constant.

Although this Standard & Poor's (S&P) research report was published before S&P began to downgrade Aquila (formerly UtiliCorp), it supports my position that in the past Aquila had to maintain more common equity, and therefore less debt, in order to offset the increased business risk associated with its non-regulated businesses to maintain its BBB credit rating.

Q. Why do you believe the S&P report is implying that Aquila would have had to maintain more common equity in the past in order to offset the increased business risk from the non-regulated businesses?

A. Because Mr. Shipman specifically states that if Aquila (previously UtiliCorp) had spun-off most of the non-regulated operations, the Company's business profile would have improved because it would now be dominated by regulated utility assets. However, Mr. Shipman expected that this improved business profile would likely "be offset by an increase in its financial risk so that the overall creditworthiness of UtiliCorp would not improve."

Q. What is the generally accepted definition of "financial risk?"

A. The ability of a company to meet its debt obligations. If the amount of debt in a company's capital structure increases, then this tends to increase the company's financial risk. The percentage of debt that a company has in its capital structure is often referred to as the amount of financial leverage the company utilizes.

Q. Why is it important to consider Aquila's business risk in the past in this proceeding?

A. Because I am primarily relying on Aquila's historical consolidated capital structures since 1990 to substantiate that Aquila's capital structure as of the test year is appropriate for ratemaking purposes in this case. The above comments from Mr. Shipman imply that Aquila could have utilized more debt leverage (higher percentage of debt in the capital structure) in the past and maintained a BBB credit rating, if the Company only had regulated utility operations. Therefore, my analysis of Aquila's historical capital structures to test the reasonableness of my recommended capital structure in this proceeding is conservative and appropriate.

Q. Dr. Murry indicates that Staff acknowledges the merits of using a hypothetical capital structure when it issued its report to the Commission in December 2002. Dr. Murry quotes part of this report on page 5, lines 24 through 29 of his rebuttal testimony. Did Staff know what Aquila's capital structure would be as of the test year, December 31, 2002 when it issued its report?

A. No. The Staff was trying to reassure the Commission that if there were unique circumstances in the next Aquila rate case, it could address them if the situation required it. If the circumstance required it, such as if the capital structure wasn't reasonable as of the test year, then the Staff may have recommended a hypothetical capital structure. However, now that the Staff has had the opportunity to review Aquila's test year capital structure, it is comfortable with recommending this capital structure. Based on its tests of reasonableness, namely being that the test year capital structure is consistent with how Aquila has been financed during the 12-year period from 1990 through 2001, this capital structure is not "clearly unsound" as explained in Bonbright's book *Principles of Public Utility Rates.*

Q. Dr. Murry cites from a Report and Order in Case No. ER-93-37 to support his position that Aquila's proposed allocated capital structure has been accepted by this Commission. Did he fail to mention any other cases in which this Commission adopted the use of Aquila's consolidated capital structure?

A. Yes. I cited these cases, Case Nos. ER-97-394 and Case No. ER-90-101, on page 11, lines 18 through 20 of my rebuttal testimony. These cases were fully-litigated before the Commission. I also freely admitted that the Commission did accept Aquila's allocated capital structure in the partially settled MPS rate case in 1993, Case No. ER-93-37, so the Commission would have all information at its disposal to make an informed decision as it relates to this case.

Q. On page 6, lines 20 through 27 of his rebuttal testimony, Dr. Murry indicates that operating divisions of Aquila, Inc. (MPS) have insulated Missouri ratepayers from the impacts of the costs of the non-regulated affiliates. Do you agree?

A. No. As I discussed previously, Standard & Poor's implied that Aquila could have enjoyed a better credit rating if it had less business risk, namely non-regulated businesses. This would have been the case as long as the financial risk, which includes financial leverage in the capital structure, was held constant. It is only logical to conclude that because Aquila's non-regulated businesses increased the business risk of the Company and the regulated utilities had and still have to rely on Aquila for their financing, that the cost of debt financing has been higher for the regulated utilities because of non-regulated activities.

Q. Did Aquila commit to not pass through to ratepayers any incremental costs of debt that are higher than BBB-rated debt?

A. Yes, but the comments from Mr. Shipman of Standard & Poor's implies that in the past, if Aquila had not had the non-regulated businesses in its portfolio, then it is possible, and even likely, that Aquila would have had a credit rating that was higher than BBB, if financial risk were held constant.

Q. Did Dr. Murry make a downward adjustment to his recommended embedded cost of long-term debt to take into consideration that Aquila would have had a better credit rating than BBB if it were only made up of regulated operations, holding financial risk constant?

A. No. Therefore, Dr. Murry's recommended cost of long-term debt contains impacts of Aquila's non-regulated investments. If a regulated utility were insulated from the other operations of its parent, then it would have to be a subsidiary with its own credit rating and recognized as being insulated by Standard & Poor's. A division of a parent company cannot be insulated. This was even acknowledged by Aquila during the transcribed interview on July 16, 2003 in Case No. EF-2003-0465, *In the Matter of the Application by Aquila, Inc. for the Authority to Assign, Transfer, Mortgage or Encumber its Franchise, Works or System.* I cited this interview in my rebuttal testimony. The following exchange occurred during that interview. I have included more than just

Aquila's admission that a division cannot be insulated in order to provide some context to the discussion.

> MR. BIBLE: This is Ron Bible. Are your regulated operations insulated or ring fenced from your non-regulated operations?
>
> MR. EMPSON: I think there's two answers to that question. First, from a regulatory perspective, when we set rates, they are, in our belief, ring fenced or insulated because we're basing the establishment of rates on what an investment grade utility would be with investment grade capital structure and debt costs.
>
> Second, on operational side, you heard from Glenn the focus that we have on the utility operations to make sure that we're maintaining the service quality that we believe is important for a utility. So we believe we have the tools in place to provide that insulation at this point in time.
>
> MR. BIBLE: Has any of the credit rating agencies acknowledged or declared that your regulated operations are insulated from your non-regulated operations?
>
> MR. DOBSON: Not to my knowledge. This is Rick Dobson.
>
> **MR. BIBLE: Can you in fact insulate or ring fence a division?** (emphasis added)
>
> **MR. DOBSON: Not to my knowledge, you can't.** (emphasis added)
>
> MR. EMPSON: Let me go back and make sure we understand. From a total financial perspective? Is that what you're referring to, Ron?
>
> MR. BIBLE: I'm not thinking of any particular -- I'm thinking in terms of, you know, what you're saying as far as you're insulated and ring fenced.
>
> MR. EMPSON: We're looking at that, as I tried to explain, anyway, from a rate making perspective, that we are providing that and, therefore, the

divisions are in effect being ring fenced. In my term ring fenced, meaning provided protection from the other operations, having not an impact on them during a rate making proceeding.

MR. BIBLE: But my previous question was have any of the credit rating agencies acknowledged or declared you to be insulated or ring fenced as far as your regulated and non-regulated?

MR. EMPSON: That is correct, but to us that's important from an Aquila, Inc. corporate perspective, but Aquila, Inc., corporate is effectively ring fencing utility operations by only charging them an investment grade rate.

MR. DOBSON: This is Rick Dobson. I don't believe I have ever asked the rating agencies that particular question from a rate making perspective. They look at it from a global, since there are no -- it's not set up as a public utility holding company from a legal structure, then they just look at it from a consolidated entity structure when they set rates. I'm sorry, when they set a rating.

MR. MURRAY: So you're acknowledging that credit ratings ring agencies do declare whether or not there is a particular utility if it's in, say, a subsidiary and a holding company structure, whether or not it's ring fenced or insulated?

MR. DOBSON: No. I'm just saying I've never asked them the particular question that you're talking about now with respect to do you consider our rates that we charge our ratepayers to be ring fenced or insulated. I've never asked them that question. I'm not sure they really care. They're only looking at if there was a legal ring fence, like a public utility holding company, they probably would separately rate them, but since there's not a legal ring fence, there's no separating. That's why Aquila is rated as a whole.

MR. MURRAY: So there is a difference between legal ring fencing and what you call ...

> MR. DOBSON: There is a difference between legal ring fencing and what Ron Empson is saying it.
>
> MR. BIBLE: Would you agree that applies to the term insulation also?
>
> MR. EMPSON: Legal insulation versus what we're talking about as a regulatory? Yes.
>
> MR. DOBSON: Yeah, that would apply there too.
>
> MR. BIBLE: So you acknowledge then that there are certain insulation and ring fencing used in the United States and by credit rating agencies versus what you're using?
>
> MR. DOBSON: I don't know. Maybe.
>
> MR. BIBLE: Okay.

In the above interaction, Aquila personnel tries to distinguish between what Aquila refers to as "ratemaking insulation" and "legal insulation." However, the message is clear that MPS, because of the fact they are divisions of the operating company Aquila, cannot not be "legally insulated" from the rest of Aquila's operations. On page 8, line 23 through page 9, line 2 from the discussion above, Mr. Empson indicates that in his mind MPS are insulated because Aquila is "basing the establishment of rates on what an investment grade utility would be with investment grade capital structure and debt costs."

Based on Dr. Murry's testimony that the debt costs of the Missouri operating divisions are capped at the debt costs of a BBB-rated utility, one can only presume that when Mr. Empson indicates that Aquila's definition of insulation means that they will only base rates on the costs associated with an investment grade utility and its corresponding capital structure, he means a BBB-rated utility.

Q. What was Aquila's credit rating for the period 1990 through 2001 shown on Schedule 1 attached to your rebuttal testimony?

A. BBB.

Q. What was Aquila's average common equity ratio for this period?

A. 38.41 percent.

Q. Is the common equity ratio of 47.5 percent requested by Aquila in this case consistent with Aquila's average common equity ratio when it had a BBB credit rating?

A. No.

Q. Is it possible, or even likely, that Aquila could have enjoyed a higher credit rating than BBB, which is the cost that Aquila wishes to charge utility ratepayers, if it had not had the business risk associated with its non-regulated investments, assuming constant financial risk?

A. Yes.

Q. Doesn't this mean that even from a ratemaking perspective that Aquila's operating divisions, MPS, are not insulated from Aquila's non-regulated investments?

A. Absolutely.

Q. What is the only truly recognized way to insulate a utility?

A. Through structural and regulatory measures that would be recognized by the credit rating agencies. For example, in the "Behind The Ratings: 'Ring-Fencing' A Subsidiary" article in the *Standard and Poor's CreditWeek,* October 27, 1999, Standard & Poor's provided the following as examples of insulating conditions:

STRUCTURAL INSULATION

-Partial ownership of a subsidiary by an outside party,

-Separate boards of directors for each entity (preferably with outside representation),

-Separate management,

-Separate country or jurisdiction,

-Separate name,

-Absence of cross-default covenants, and

-Separate financing activities.

REGULATORY INSULATION

-Restrictions on cash flow,

-Restrictions on debt as a percentage of capital,

-Restrictions on dividends,

-Debt rating targets established by a commission,

-Limitations on the amount of investment in nonutility businesses, and

-Limitations on the types of investments that a utility or holding company can make.

Because Standard & Poor's (S&P) service is to assess the credit quality of companies' debt issuances that subscribe to its service, it is only natural that the company would have to issue its own debt in order for this service to be of use. Therefore, a utility would have to be a separate subsidiary that issues its own debt in order for S&P to provide an assessment of the insulation, or lack thereof, of the utility subsidiary.

Consequently, creditors are only concerned about insulation of a utility if they are lending funds directly to a utility subsidiary.

Q. What is the average credit rating for utility companies that emphasize a more traditional regulated corporate structure?

A. According to a recent January 29, 2004 Standard & Poor's (S&P) research report, "U.S. Utilities' Ratings Decline Continued in 2003, But Pace Slows," S&P indicated that "companies that continue to emphasize a more traditional regulated structure, whether vertically integrated or not, should hang onto an 'A-' average."

Q. Why do you think it is important to point out this average credit rating?

A. Because, Aquila has indicated that because it is not going to charge MPS ratepayers more for its cost of capital than a BBB-rated utility and its corresponding capital structure and cost of debt, it is insulating ratepayers from increased costs associated with its failed non-regulated investments. If the average credit rating for traditional, regulated utilities is an A-, then it would appear that this would be a more appropriate credit rating to use for the cost of debt than a BBB credit rating. However, because I am recommending the test year capital structure that is consistent with Aquila's historical capital structure when it was rated BBB, I decided to utilize the BBB rating in my own recommendation.

Q. Did Aquila provide Staff with some logic in the July 16, 2003 interview as to why they chose to base the rate of return charged to ratepayers on a BBB credit rating?

A. Yes. The following exchange occurred:

> MR. BIBLE: How did you determine triple B is the appropriate credit rating to use to determine what you would charge that debt out at?

MR. EMPSON: We went back and looked at the last ten years of the Company were at triple B, when we were going through basically all the regulatory proceedings and things. We just looked at that was our historical amount when we were investment grade that we raised capital at, and that's what we're charging today.

MR. BIBLE: And over those last ten years, what did the Company look like? I mean, what kind of operations were you in?

MR. EMPSON: It's going to vary when you look at each year. If you go back ten years ago what we were might have been primarily a utility operation with relatively small amount of non-regulated going on, and it grew to a more dominant position of non-regulated.

MR. BIBLE: And now that you're going back to strictly regulated, you determined triple B is the appropriate credit rating to use?

MR. EMPSON: For this allocation process, yes, we did.

MR. BIBLE: So what you're saying is you went from predominantly regulated utilities with a triple B credit rating, went into a relatively large, non-regulated operation, and were still triple B, and now that you're going back to predominantly regulated operations, you determine you're going to remain triple B?

MR. EMPSON: That's what we've done at this point in time for what the charges are going to be; that is correct. We don't know what the actual rating will be when we reach our end state, but during this transition, we're using what we were at the time when we started the transition.

MR. BIBLE: So you moving predominantly into non-regulated operations had no impact on your credit rating?

MR. EMPSON: The information I saw is we stayed at triple B for an entire decade.

> MR. DOBSON: This is Rick Dobson. It did not have an impact until early 2002, and then by mid 2002, we were downgraded.
>
> MR. MURRAY: This is David Murray. Did your risk profile change? There is a risk profile of one to ten by Standard & Poors. Did you risk profile at that time?
>
> MR. DOBSON: I don't have the exact information on that. This is Rick Dobson again. But if you want to make a request, we can get that. I believe it did, but I can't say for sure. It did change.
>
> MR. MURRAY: Doesn't the Standard & Poors require stronger financials at higher risk profiles?
>
> MR. DOBSON: I'm sorry. Would you please repeat the question?
>
> MR. MURRAY: Just say Standard & Poors, let's go to an agency we refer to quite a bit. As the risk profile changes, do they require better financial type of ratios?
>
> MR. DOBSON: It does vary, but as the risk profile does change, they do require you to have, for instance, probably a bigger -- bigger either cash contingency or a bigger equity base or a whole variety of factors. Or a better coverage ratios, and until really mid 2002, we had those. So that's why we maintained our investment grade rating and issued securities under that type of credit spread.

Q. From the discussion above, what was Aquila's logic in using a BBB credit rating and associated capital structure and debt costs to determine what should be charged to Missouri ratepayers?

A. The historical credit rating of Aquila for the last ten years, which has been suppressed by its non-regulated operations.

Q. What capital structures did Standard & Poor's evaluate over the last ten years in order to determine that a BBB credit rating was appropriate for Aquila?

A. Aquila's consolidated capital structures.

Q. Were these the same capital structures that you evaluated and attached as Schedule 1 to your rebuttal testimony in order to determine that your recommended capital structure was reasonable and appropriate for ratemaking purposes in this proceeding?

A. Yes.

Q. If Aquila's consolidated capital structure would have been more like the allocated capital structure that Dr. Murry is proposing, then wouldn't it be logical to conclude that Aquila would have enjoyed a better credit rating even with its non-regulated investments included in the operations?

A. Yes.

Q. Isn't it logical to conclude that Aquila's credit rating would have been even better yet if Aquila's consolidated capital structure was the same as the allocated capital structure and it did not have the non-regulated operations in its business portfolio?

A. Yes.

Q. Do you know what the credit rating could have been?

A. No, but based on all of the information that I reviewed it would have been higher than the BBB that it had with the non-regulated operations and its historical capital structures.

Q. Did Dr. Murry adjust his embedded cost of long-term debt downward to take this into consideration?

A. No, but because Aquila's non-regulated operations put downward pressure on the Company's credit rating, he should have.

Q. On page 7, line 9, through page 8, line 9, Dr. Murry criticized your recommended cost of common equity to apply to MPS because it was not consistent with the 2003 estimated return on equity for your comparable companies. Should comparisons of actual or estimated returns on common equity as a test of reasonableness for determining a fair recommended return on equity in a rate case proceeding be used with caution?

A. Yes. One doesn't need to look any further than the Commission's recent complaint case against AmerenUE, Case No. EC-2002-1 to understand this concept. If Staff measured the reasonableness of its recommended return on equity based on AmerenUE's recent and estimated return on common equity before its rates were reduced, then AmerenUE would be in a perpetual overearnings situation because the test of reasonableness would have been the return on equity that Staff and this Commission determined to be excessive. Of course, this analogy presumes that the Staff would have let this test of reasonableness influence its cost of common equity recommendation in the AmerenUE complaint case, which wasn't the case. This is the very reason that the recommended return on equity in a rate case proceeding is based on the cost of common equity and not on what past returns on common equity have been.

Q. On page 9, lines 4 through 6 of his rebuttal testimony, Dr. Murry criticizes your comparable companies because of what he claims are the use of "unhealthy" utilities to compare to a "healthy" electric utility. Would you agree that MPS are currently considered "healthy" utilities?

A. No, not from a creditworthiness perspective, because of their link to the parent company, Aquila. In fact, even though Dr. Murry is correct that DPL's bond rating had dropped to BB as of December 10, 2003, which was after my testimony was filed on December 9, 2003, all of my comparable companies have a better credit rating than Aquila, B, and therefore, MPS.

Q. Aren't you trying to determine what the cost of capital would be for MPS if they weren't part of Aquila?

A. Yes. Contrary to Dr. Murry's accusation on page 14, lines 22 through 23 of his rebuttal testimony that I substituted a "mindless set of calculations and averages for an analysis of the market data," I critically analyzed the results of my DCF analysis to arrive at my estimated growth rate of 3.10 percent to 4.10 percent. My recommended growth rate resulted in my reasonable cost of common equity recommendation of 8.64 percent to 9.64 percent to apply to the regulated utility divisions, MPS.

Q. Do you have any information that verifies the reasonableness of the 3.10 to 4.10 percent growth rate that you recommended in this case?

A. Yes.

An indicator that my estimated growth rate is reasonable is the fact that the Department of Energy's "Annual Energy Outlook 2004" states "[c]ontinued saturation of electric appliances, installation of more efficient equipment, and the promulgation of efficiency standards are expected to hold growth in electricity sales to an average of 1.8 percent per year between 2002 and 2025." A Standard & Poor's January 2000 report in its Global Utility Rating Service confirms that this is typical for Aquila's service area. This report indicated that Aquila's (then UtiliCorp's) "annual electric sales and customer growth have averaged about 2 percent and are expected to continue at that growth rate for the foreseeable future. Sales growth will be supported by expected modest increases in customer base." This can be considered as a good proxy of the projected customer and sales growth rate for MPS. It is important to consider these growth rates when estimating the possible growth of MPS because they are captive entities that are limited in customer growth by their certificated areas of service. This means that other than any additional customers that may be added to their systems in the future, the only other means of revenue growth is through increased consumption of electricity. Of course, some growth in earnings can come from the reduction of expenses. In light of the above estimates on electric sales growth/demand, I believe that my 3.1 to 4.1 percent growth rate is reasonable.

A second test of reasonableness are comments from Aquila itself. Aquila recognized the lower growth associated with regulated electric utility operations in its 2000 Annual Report when it stated, "most regulated utilities achieve lower earnings growth that is well below the financial goals we have set for UtiliCorp [now "Aquila"] the past several years." Aquila emphasized the lower growth of regulated operations again in its 2001 Annual Report when it stated the following:

> About two-thirds of our projected earnings this year will be from energy merchant and risk management activities and from international network operations. All of those have higher returns and higher growth potential than our networks in the United States, which are the most regulated of all our businesses. Still, the Domestic Networks segment remains a stable base of earnings and cash flow.

I believe all of the above indicators on electricity demand growth show the reasonableness of my recommended growth rate in this case.

Q. Do you have any comments regarding Dr. Murry's criticism about your selection of comparable companies that have total capitalization of less than $5 billion because he feels that this allows for too large of companies to be used in your proxy analysis?

A. Yes. As indicated on Schedule 9 attached to my direct testimony, Aquila's total capitalization as of the test year was around $4.5 billion. Because MPS are part of the larger company, Aquila, it is appropriate to evaluate companies that have similar capitalization levels. Actually, if the parent company of a division or subsidiary utility operating in Missouri is predominately in the same business as the Missouri utility and its stock is publicly traded and pays a dividend, then Staff tends to use the parent company's cost of common equity as the proxy for the cost of common equity for the Missouri utility. The Commission accepted this methodology in the St. Louis County Water rate case, Case No. WR-2000-844. In its Report And Order the Commission stated:

> The Commission concludes that the evidence in this case shows the DCF model to be the best approach. The Commission also concludes that, of the applications of the DCF model in this case, Staff's DCF analysis of AWK is the most pertinent to the determination of the Company's cost of capital. Staff's approach is the best because it is the purest application of the DCF model in the sense that it relies primarily on publicly reported data with little adjustment by the analyst. It is also the most appropriate because it uses the best proxy for the Company the Company's parent. The analysis performed by Public Counsel witness Burdette and Company witness Walker do not as accurately reflect the cost of equity for the Company because their proxy groups do not as closely approximate the Company as does AWK. In addition, they both made significant adjustments to the results of their DCF analysis. Mr. Walker's use of electric utilities to determine the Company's ROE is a significant flaw.

Because MPS receive their capital from the parent company, Aquila, it is appropriate to use companies that have capitalization levels similar to that of

Aquila. The studies that have been done about the "small size effect" relate to stand-alone, publicly-traded companies, not divisions of larger companies.

Q. Did the use of DQE and IDACORP in your comparable companies bias the results of your analysis as Dr. Murry claims on page 11, line 12 through 13 of his rebuttal testimony?

A. No. These companies met the criteria I applied to the electric utility companies on Schedule 11 of my direct testimony. If anything, excluding these companies would have biased my results. I evaluated all of the financial data for my comparable companies and determined a reasonable recommended cost of common equity for the Missouri regulated divisions, MPS.

Q. On page 12, line 2 and line 9, Dr. Murry criticizes the average historical and projected growth rates of two of your comparable companies. Did you recommend these growth rates in your overall recommended cost of common equity for MPS ?

A. No. My recommended range of growth is 3.10 to 4.10 percent. This is clearly stated on Schedule 16 attached to my direct testimony.

Q. Dr. Murry indicates that because you included a company in your comparable group that cut its dividend, you have violated an assumption underlying the DCF model. How do you respond?

A. As indicated on page 25, lines 5 through 7 of my direct testimony, more often than not the assumptions underlying the DCF model are rarely met, but the DCF model is a reasonable working model describing an actual investor's expectations and resulting behaviors. As with any analysis, the rate-of-return witness has to review the financial data in light of these assumptions, but the fact that these assumptions may not hold true does not mean that using the model with companies that are not constantly growing their dividends renders it useless. Although The Empire District Electric Company (Empire) is not able to constantly grow its dividends because of high payout ratios, both Dr. Murry and I applied the DCF model directly to Empire in their last rate case, Case No. ER-2002-424. Empire's 5-year dividends per share (DPS) growth rate was 0 percent in the last rate case and the 10-year DPS growth rate was .48 percent. However, I recommended a growth rate of 3 percent to 4 percent for purposes of my recommended cost of common equity in that case. Obviously, the analyst has to review the various growth rates to determine if they appear to be reasonable going forward, just as Dr. Murry rejected most of his low DPS growth rates indicated on Schedules DAM-8 and DAM-11, attached to his direct testimony in this case.

Q. On page 14, line 21 through page 15, line 3 of his rebuttal testimony, Dr. Murry indicates that you substituted a "mindless set of calculations and averages for an analysis of the market data…" He also characterizes your analysis as "formulistic calculations" that were reduced to "meaningless data manipulations." How do you respond to these generally negative comments about your analysis and what he implies is your lack of analysis of the market data?

A. I find some of these comments interesting in light of the recent capital and economic environment. Interest rates are at forty to fifty-year lows and have even come down further since Aquila filed its last rate case in June 2001, yet Dr. Murry's recommended cost of common equity (12.00 percent to 12.50 percent) is actually higher than what Aquila recommended in the last rate case (11.75 percent to 12.25 percent).

Most rate of return witnesses, including company rate of return witnesses, freely admit that the cost of capital, including the cost of common equity for utilities, is highly correlated with the level of interest rates. As interest rates rise, the cost of capital for utilities rises. As interest rates fall, the cost of capital for utilities falls. We are currently in a low interest rate environment and therefore a low cost of capital environment.

I also considered some of the recent comments and analysis of some well known and respected individuals in the finance field when determining if my overall recommendation was reasonable. Therefore, contrary to Dr. Murry's statement that my analysis is "mindless" and doesn't take into consideration market data, I was very cognizant of the market when evaluating the reasonableness of my recommendation.

Q. Who are some of the well respected financial experts that you believe have good insight into the market and what have their comments been recently?

A. The experts include Warren Buffett, Jeremy Siegel and Cliff Asness. Warren Buffett is CEO of Berkshire Hathaway and is probably the most respected investor in the United States. On December 20, 2001, in an interview on CNBC, Mr. Warren Buffett indicated that "returns in the stock market should come in around an average 7-8 percent over the next ten years." He also said that he's "not finding" undervalued companies in this market, indicating that he remains watchful of valuation levels for stocks. As recently as the release of Berkshire Hathaway's 2002 Annual Report, Mr. Buffett stated that he was finding very few stocks that were even mildly attractive even after the previous three years of falling stock prices. One would imagine that with the recent run up in stock prices that this would only mean that Mr. Buffett is currently even more cautious about investing in equities.

The other two, Cliff Asness, University of Chicago Ph.D., who writes influential studies in academic journals while running the $5 billion hedge fund AQR Capital Management, and Jeremy Siegel of The Wharton School of the University of Pennsylvania, whose book, *Stocks for the Long Run*, helped mold academic thinking on how equities perform over long periods, were recently featured in a recent June 16, 2003 article in *Fortune* magazine, "Can Stocks Defy Gravity? That's what Wall Street wants you to believe. Don't buy it. The best minds say the market will rise, but it won't soar." Although these are the two main academicians featured in the article, Kenneth French of Dartmouth also urges caution when investing in today's market. Kenneth French and Eugene Fama have published many influential stock market studies in the past two decades.

All of the influential individuals featured in this article have come to the conclusion that the equity risk premium, which is the additional return that investors demand over risk-free government securities, is now lower. As a result of the lower equity risk premium, they predict that the stock market as a whole can only provide 6 percent to 8 percent returns for the foreseeable future. Jeremy Siegel, when speaking about total market returns, specifically states: "Better-than-average earnings, if they happen, could get us perhaps 8%. But 10% assumes earnings growth that is just too big." It is obvious that well-respected investors and academicians are not predicting very high returns for the near future because of current stock valuation levels. This translates into a low cost of common equity environment.

Comparing my recommended cost of common equity of 8.64 percent to 9.64 percent to the predictions of anywhere from 6 to 10 percent for the entire market by these well respected individuals offers a barometer to the reasonableness of my recommendation in this case. In light of the fact that regulated utilities are less risky than the market, and therefore investors would normally require less return than the market, my recommendation is generous considering the current stock market environment.

Q. On page 16, line 1 through page 17, line 2 of his rebuttal testimony, Dr. Murry criticizes your CAPM analysis that indicated a negative risk premium. Does your recommended cost of common equity contemplate a negative risk premium?

A. No. I think it is clear from page 30, lines 9 through 15 of my direct testimony that I am not recommending a cost of common equity based on my short-term risk premium CAPM results. However, I do point out the reasons why the CAPM results using the risk premium from 1993 to 2002 are extremely low. While I agree with Dr. Murry that investors in common stocks will expect a risk premium over risk-free U.S. Treasury bonds in order to make that investment worthwhile, I don't think it is appropriate to ignore the fact that there are times when risk premiums are negative. This may not be what an investor expects, but the unfortunate reality of investing is that there are times when investors' expectations are not going to be achieved and it would be irresponsible for an investor to ignore this reality. Actual returns can be much higher and much lower than what an investor expects, but over time, an investor can expect that returns will converge around a mean, which is a concept referred to as "mean reversion."

Q. On page 17, lines 3 through 9 of his rebuttal testimony, Dr. Murry indicates that you did not select the correct risk premium for your CAPM analysis for the period 1926 through 2002. Did you select the correct risk premium?

A. Yes. The attached Schedule 1 is a copy of the table that I used from Ibbotson Associates, Inc.'s Stocks, Bonds, Bills, and Inflation: 2003 Yearbook. I subtracted the arithmetic average annual returns on Long-Term Government Bonds (5.8 percent) from the arithmetic average annual returns on Large Company Stocks (12.2 percent) for the period 1926 through 2002 in order to arrive at a risk premium of 6.4 percent.

Q. On page 17, lines 10 through 20 of his rebuttal testimony, Dr. Murry indicates that you should have made a "size adjustment" to your CAPM analysis. Do you agree?

A. No. The adjustment for size premium that Dr. Murry advocates is based on a study of all of the stocks in the New York Stock Exchange, the American Stock Exchange and the Nasdaq National Market. The study did not apply specifically to regulated utilities. Annie Wong, associate professor at Western Connecticut State University, performed a study that was published in the Journal of the Midwest Finance Association, Volume 22, that refutes the need for an adjustment based upon the smaller size of public utilities. She indicates:

> First, given firm size, utility stocks are consistently less risky than industrial stocks. Second, industrial betas tend to decrease with firm size but utility betas do not. These findings may be attributed to the fact that all public utilities operate in an environment with regional monopolistic power and regulated financial structure. As a result, the business and financial risks are very similar among the utilities regardless of their size. Therefore, utility betas would not necessarily be expected to be related to firm size.

Because smaller utilities operate in a regulated environment, just as large utilities do, making an adjustment for firm size appears to be questionable, especially when the smaller utility is part of a larger company.

Q. On page 19, lines 1 through 17 of his rebuttal testimony, Dr. Murry claims that you disregarded the financial integrity measures that you calculated on Schedule 21 attached to your direct testimony. Did you disregard these measures?

A. No. On page 32, lines 4 through 7 of my direct testimony I discuss the pretax coverage ratios that I calculated on Schedule 21 and I observed that these ratios fall between the lower quartile and median of a BBB-rated electric utility as reported by Standard & Poor's on July 7, 2000. I also explained some of the limitations of this schedule on page 31, line 20 through page 32, line 3 of my direct testimony. Because Aquila is no longer investment grade, I had to make some assumptions about the interest expense to use in order to calculate the pretax interest coverage ratios indicated on Schedule 21. It is also possible to argue that the interest expense indicated on Schedule 21 attached to my direct testimony could have been lower if MPS's debt costs were not linked to Aquila's overall business risk. It is also possible that the interest expense indicated on Schedule 21 could have been lower if Aquila's financial condition allowed it to take advantage of current lower interest rates by refinancing some of its debt as other Missouri electric utilities have done.

Q. Do you have any examples of Missouri utilities that have been able to refinance some of their debt to take advantage of current lower interest rates?

A. Yes. On May 16, 2003, Empire announced that it was refinancing some of its outstanding debt. On March 15, 2003 and August 15, 2002, AmerenUE announced that it was refinancing various debt issuances. AmerenUE announced their refinancings in the following press releases:

> March 5, 2003 ¾ AmerenUE, a subsidiary of Ameren Corporation (NYSE: AEE), announced today that it is

> offering $184,000,000 of 5.50% senior secured notes due March 15, 2034. The transaction is expected to close on March 10, 2003. AmerenUE intends to use the net offering proceeds of approximately $180,000,000, along with other funds to redeem prior to maturity $104,000,000 principal amount of outstanding 8.25% first mortgage bonds due October 15, 2022, at a redemption price of 103.61% of par, plus accrued interest, and to repay short-term debt incurred to pay at maturity $75,000,000 principal amount of 8.33% first mortgage bonds that were due in December 2002. The lead underwriters for the offering are BNY Capital Markets, Inc. and J.P. Morgan Securities Inc.

> Aug. 15 /PRNewswire-FirstCall/ -- AmerenUE, a subsidiary of Ameren Corporation (NYSE: AEE), announced today that it is offering $173,000,000 of 5.25% senior secured notes due Sept. 1, 2012. The transaction is expected to close on Aug. 22, 2002. AmerenUE intends to use the net offering proceeds of approximately $171,400,000 to redeem prior to maturity $125,000,000 principal amount of outstanding 8.75% first mortgage bonds due Dec. 1, 2021, at a redemption price of 104.38% of par, plus accrued interest, and to redeem $41,437,500 of Series $1.735 preferred stock at par, plus accrued dividends. The underwriters for the offering are Banc of America Securities, LLC, Credit Suisse First Boston and U.S. Bancorp Piper Jaffray Inc.

Therefore, "healthy" Missouri utilities are cutting their interest expenses by capitalizing on the current low cost of capital environment because of lower interest rates.

Q. What will be the effect of Aquila's inability to take advantage of the current lower cost of debt environment?

A. It will keep the cost of debt for its regulated Missouri utilities at a higher level than other "healthy" regulated Missouri utilities' cost of debt.

Q. Do you have any other closing comments about the reasonableness of your recommended cost of common equity in this proceeding?

A. Yes. I mentioned an article earlier in my surrebuttal testimony about what well respected investors and academicians are expecting for future returns in the market. This article also discussed what type of risk premiums investors can expect for stock returns over treasury bond returns for the next ten years or so based on the current prices of stocks. The article indicates that investors can expect to collect only 3 percent more on the stock market as a whole than on Ten-Year Treasury Bonds. If one were to look at the beta adjusted risk premium for my comparable electric utility companies and Dr. Murry's comparable electric utility companies, the risk premium would be even less than this 3 percent. Based on the average beta of .72 for my comparable companies, the expected risk premium over Ten-Year Treasury Bonds would be 216 basis points. Based on the average beta of .62 for Dr. Murry's comparable companies the expected risk premium over Ten-Year Treasury Bonds would be 186 basis points. The midpoint of my recommended cost of common equity for MPS is currently 501 basis points higher than the Ten-Year Treasury Bond yield of 4.13 percent as of January 30, 2004 as quoted on CBS MarketWatch's website, http://cbs.marketwatch.com. Therefore, based on current financial market conditions, my recommendation is more than reasonable.

<u>Response to Ms. Abbott's Rebuttal Testimony</u>

Q. What is your general response to Ms. Abbott's rebuttal testimony?

A. Ms. Abbott gives her opinion on what she thinks MPS's credit rating would be on a stand-alone basis if they were not a part of the Aquila corporate structure. Considering Aquila's current financial condition and the higher cost of capital that it incurs to make investments in its utility properties, it would be nice to pretend that Aquila's utilities are not affected by Aquila's problems, but unfortunately this is not the case. The reason why Aquila will have low financial coverage ratios after it exits all of its non-regulated businesses is not because of my recommended rate of return in this case, but because of the **____** billion of non-regulated debt that will remain after Aquila restructures itself into a domestic utility. Aquila provided this projected amount of residual non-regulated debt after its restructuring process in the proceedings for Case No. EF-2003-0465, *In the Matter of the Application of Aquila, Inc. for Authority to Assign, Transfer, Mortgage or Encumber Its Franchise, Works or System.* This residual amount of non-regulated debt left on Aquila's books has reduced the debt capacity of Aquila for investment in its utility properties. Because MPS currently have to rely on Aquila for its capital needs, this also reduces MPS's debt capacity. The debt capacity that Aquila does have will come at a higher cost.

It is not just the amount of debt that the regulated utilities will be burdened with that will affect Aquila's interest coverage ratios, but also the cost of this debt that will affect these coverage ratios. I have already discussed the fact that even before Aquila was downgraded below investment grade because of its non-regulated business failures, its credit rating was suppressed by Aquila's non-regulated activities. The coverage ratios that Ms. Abbott calculates are making assumptions that MPS are stand-alone, but unfortunately the cost of debt for MPS have been increased by Aquila's non-regulated activities. Ms. Abbott did not make a downward adjustment to what MPS's cost of debt would be if their costs were not increased by Aquila's non-regulated business risk exposure.

Additionally, because of Aquila's current financial condition as a result of its failed non-regulated businesses, it cannot take advantage of the current low interest

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rate environment by refinancing the debt it currently has on its books at more favorable interest rates. Many of Missouri's utilities have been taking advantage of this lower cost of debt, just as homeowners have been able to when refinancing their mortgages. Again, Ms. Abbott did not make a downward adjustment to take this into consideration.

Consequently, Ms. Abbott's analysis should be disregarded in this case. She wants to pretend that MPS have not been affected by Aquila's financial condition, but as I have demonstrated, this isn't the case.

Q. Do some of Ms. Abbott's comments in her rebuttal testimony cause you some concern as to the ability of Aquila to continue to ensure that MPS will be able to provide safe and adequate service?

A. Yes. She says that her analysis indicates that if the Commission accepts Staff's position in this case, it would probably result in a B credit rating for MPS if they were stand-alone companies. She also discusses how this B credit rating would impact Missouri utilities. On page 20, lines 1 through 7, she indicates the following:

> If the core businesses of the Company, which is what investors believe they are investing in, are to be subjected to punitive regulatory treatment, investors opinions will revert to the previous skeptical mode, making money much more expensive for Aquila to attain. In the long run, ratepayers pay for that higher cost of debt. **A more direct and immediate impact on ratepayers is the quality of the service they receive.** (emphasis added)

Consequently, Ms. Abbott is indicating that if Aquila experiences an increase in its cost of capital, then it will affect the quality of service that ratepayers receive.

Q. What is Aquila's current credit rating?

A. B.

Q. Has this resulted in an increased cost of capital for Aquila?

A. Yes.

Q. What caused Aquila's credit rating to be downgraded to its current level of B?

A. Aquila's failed non-regulated investments.

Q. Does Ms. Abbott point out how these failed non-regulated investments may ultimately impact the service to Missouri ratepayers?

A. Yes.

Q. Aquila has maintained that it would not attempt to pass along capital costs that are higher than a BBB-rated electric utility. Does it appear that Aquila may be positioning itself to attempt to pass along higher costs than a BBB-rated electric utility in future rate cases?

A. Yes. It appears that Aquila will attempt to perform a credit analysis of what their regulated utilities would be rated if they were stand-alone companies and then indicate that the higher costs that these divisions are incurring are a result of the regulatory environment in Missouri.

Q. Will it be clear as to whether Missouri regulation is a cause of higher costs of capital for MPS if they remain divisions of Aquila?

A. No.

Q. Would there be any way for this to be more discernible in the future?

A. Yes. If the Missouri utilities were spun-off into their own subsidiary and this subsidiary were ring-fenced from the rest of Aquila, then Aquila's management could have more credible discussions with the Staff of the Missouri Public Service Commission on the effects that Missouri regulation has on the cost of service to Missouri ratepayers.

Q. Ms. Abbott is pretending that MPS are stand-alone companies in order to evaluate their creditworthiness. Do you have to pretend in order to know what L&P's credit rating was before it was acquired by Aquila?

A. No. L&P's credit rating was an A- before Aquila acquired it on December 31, 2000. Therefore, it is obvious what its credit rating potential was before it was acquired by Aquila, and therefore, influenced by Aquila's non-regulated operations.

Q. On page 5, lines 19 through 21 of her rebuttal testimony, Ms. Abbott indicates that Moody's states the following about Aquila: "future projected revenues and cash flow of its utilities are contingent upon favorable regulatory decisions regarding its pending rate cases." From what perspective is Moody's indicating that Aquila needs "favorable regulatory decisions?"

A. Obviously this is from the perspective of creditors. However, it is not Staff's responsibility to ensure that its rate case recommendations are favorable to creditors. Staff is responsible for balancing the interests of ratepayers and investors and Staff has done so in this case.

Q. Should this Commission regulate the rates of its utilities with any specific credit rating in mind?

A. No. While Staff believes that it should provide Missouri utilities a fair opportunity to maintain its financial health, Staff also recognizes that there are some things that are not within its control that can adversely impact Missouri utilities, such as the presence of non-regulated operations as already discussed. The Staff has recommended a fair and reasonable rate of return in this case. It is not Staff's responsibility to recommend that rates be increased in order for a company to improve its credit rating to some certain level, especially when that company's credit rating has deteriorated because of activities other than Missouri's regulated operations.

Q. Ms. Abbott discusses Standard & Poor's business risk ranking system on page 10, lines 9 through 15 of her rebuttal testimony. What has happened to Aquila's business risk profile (ranked on a scale of one to ten with ten indicating the most business risk) as ranked by Standard & Poor's since 1996?

A. It has increased from a four to a six. It is only logical to conclude that Aquila's increased business risk profile resulted from non-regulated business exposure as a result of the reasons that I have already discussed. In fact, when Aquila's non-regulated subsidiary ("Aquila" before UtiliCorp adopted the name for itself) was rated by Standard & Poor's (S&P), S&P assigned the non-regulated subsidiary a business profile ranking of seven. This supports my previous testimony that Aquila had to maintain better financial ratios, including a higher common equity ratio, in the past because of its exposure to non-regulated operations. Ms. Abbott acknowledges this on page 13, lines 1 and 2 of her rebuttal testimony when she indicates that as "business risk grows, the financial metrics need to be stronger."

Response to Mr. Reed's Rebuttal Testimony

Q. What is your general response to Mr. Reed's testimony?

A. Mr. Reed apparently has some insight that investors are not expecting the Commission to adopt Staff's position in this case because he indicates the markets are not currently expecting this. I presume he is referring to the recent increase in Aquila's stock price even after the Staff filed its case on December 9, 2003. He anticipates that if the Commission adopts Staff's position that this negative surprise will have a dramatic effect on Aquila's stock price. Staff is not responsible for ensuring that Aquila's stock price remains at any given level. In fact, Staff cannot rely on an analysis of Aquila's stock for purposes of its recommendation in this case because Aquila's cost of capital exceeds what is reasonable for a regulated electric utility. It is Staff's duty to determine the cost of service for MPS, which includes a fair return on MPS's rate base.

I have recommended a fair rate of return based on the current capital and economic environment. This recommended rate of return is based on a reasonable capital structure deemed reasonable by Aquila itself over the last twelve years. My recommendation is not punitive. It reflects an estimate of the cost of capital that Aquila would be incurring for its utilities if it hadn't suffered from failed non-regulated investments. Actually, I have already argued that the cost of debt that is part of my rate of return recommendation would have been lower if MPS were truly stand-alone entities that did not have their credit ratings affected by Aquila's non-regulated investments.

Q. Mr. Reed discusses allowed returns and earned returns for other utility companies in other states as reported by Regulatory Research Associates (RRA). How do you respond?

A. I have done a thorough and complete analysis of the cost of common equity for a comparable group of companies, primarily using the DCF model, which incorporates the current capital and economic environments. I utilized this proxy cost of common equity to recommend a fair rate of return to be applied to the rate base of MPS

. I have reservations about drawing inferences from the allowed ROE's in other jurisdictions based on the very reasons that Mr. Reed discusses in his testimony. There are many reasons why an allowed return on equity may be higher than the cost of common equity for utility companies specific to each case in question. The Staff of the Missouri Public Service Commission does not use allowed ROE's in other jurisdictions in order to recommend a fair and reasonable ROE for utility companies in Missouri. We predominately utilize the Discounted Cash Flow model in order to make a fair and reasonable recommendation based on the capital and economic environments. If a Commission were to constantly rely on what other Commissions were authorizing, or even its own authorizations in prior cases, in order to determine what is fair, then the allowed return on equity would never be reflective of the current capital and economic environment.

Q. Do any of Mr. Reed's comments in his testimony support the reasonableness of your recommended cost of common equity in this proceeding?

A. Yes. On page 19, line 21 through 23 through page 20, line 1, Mr. Reed states the following:

> In general, equity markets classify utility stocks as an equity that has many of the attributes of a bond. As such, all of the credit issues discussed by Aquila Witness Susan Abbott in her rebuttal testimony are also relevant to how equity investors perceive and value Aquila's stock.

Consequently, Mr. Reed is acknowledging that the cost of common equity for utilities is closely tied to the cost of debt because they have the same attributes. This is acknowledged by most expert rate of return witnesses in utility rate case proceedings. Mr. Reed indicates earlier in his testimony that my recommendation runs "completely contrary to current trends in financial markets." Contrary to Mr. Reed's statement, my recommendation in this case reflects the current economic environment of interest rates being at their lowest levels in forty years and closer to normal based on the level of interest rates before the last forty years. I commented earlier about other Missouri utilities taking advantage of the current lower interest rates by refinancing their existing debt. If the cost of debt, which Mr. Reed acknowledges have similar attributes to utility stocks, is at forty-year lows, then it is only logical to conclude that the cost of common equity is also much lower. My recommendation reflects the current financial environment that at least financially healthy utilities are able to capitalize on in order to reduce their capital costs.

Q. On page 17, lines 9 through 17 of his rebuttal testimony, Mr. Reed discusses the last MPS rate case in which Staff recommended a 9.93 percent cost of common equity based on a 48.51 percent common equity ratio. He indicates that this past recommendation should be considered as a lower bound for what is reasonable in this case because he indicates that no changes have occurred in industry norms on the cost of capital since then. Do you agree?

A. No. I have already discussed my concerns with the fact that Dr. Murry is recommending a higher cost of common equity in this case than the cost of common equity that MPS recommended in its last rate case. Dr. Murry did not reconcile this even though interest rates have come down even further since the last case. Some "healthy" Missouri utilities are currently taking advantage of these lower interest rates and therefore, reducing their cost of debt that will eventually be reflected in rates in their next rate case.

Q. What has changed since the last rate case, Case No. ER-2001-672?

A. Aquila has encountered financial difficulties because of its failed non-regulated investments. Aquila is in the process of restructuring itself into a regulated, domestic utility. These are the only operations that will be left to possibly allow Aquila to return itself to an investment grade utility company.

Q. Has Aquila made any comments that cause you some concern about its motives in any rate increase request that it makes with this Commission?

A. Yes. In an April 16, 2003 article in the *Kansas City Star*, reporter Steve Everly stated the following:

> The new focus puts pressure on the financial performance of the utilities, which has lagged in the past. Support staff for the utilities were laid off last year to cut expenses, and Aquila executives said Tuesday that they would be **aggressive** in seeking rate increases to raise revenues.

Because Aquila's financial condition has changed since its last rate case just a couple of years ago as a result of the failure of its non-regulated investments, I am concerned about such comments. If Aquila felt that the performance of its MPS division was lagging because of Missouri regulation in the last rate case, then I am not sure why they would have agreed to a rate decrease in that case. The only reason I can surmise that Aquila is going to be "aggressive" in pursuing rate increases now is because it now has to rely on its regulated utilities to return it to the financial health that it had before the non-regulated business failures. Clearly, this burden should not be placed on the ratepayers of Missouri. Aquila should only be allowed to recover a cost of capital that would be commensurate with its cost of capital based on the capital structure as of the test year with a cost of common equity that is reflective of the current capital and economic environment.

Q. Mr. Reed stated that Staff's recommended common equity ratio of 48.51 percent in the last case should be considered as the lower bounds for what is an appropriate common equity ratio in this case. Do you agree?

A. No. In the last rate case, Staff's recommended common equity ratio was based on Aquila's actual consolidated capital structure. Although this common equity ratio was higher than Aquila's average common equity ratio in the past, Staff still recommended this common equity ratio in its capital structure recommendation because this common equity ratio reflected the actual amount of common equity in Aquila's capital structure. Even if Aquila is able to return itself to an investment-grade, domestic, regulated utility, based on Aquila's historical capital structures, Staff has no reason to believe that Aquila will actually capitalize its utilities at a 48 percent common equity ratio in the future. This is exactly why I relied on how Aquila was financed in the past, along with the comparable companies' capital structures, to determine if my recommended capital structure as of the test year was appropriate.

Q. Mr. Reed discusses the financial markets' general desire for companies that have stronger balance sheets and lower operating risks. What is your general understanding as to why financial markets would like to see stronger balance sheets and lower operating risks in the utility industry?

A. It is generally understood that the focus on stronger balance sheets and lower operating risks in the utility industry is a result of the non-regulated activities of utilities that chose to embrace this strategy. Ratepayers should not be expected to strengthen balance sheets of utility companies that experienced significant losses due to non-regulated investments. Ratepayers did not stand to benefit from the gains due to these investments and they should not stand to lose from these investments.

Q. Does Mr. Reed contradict any of Aquila's prior positions, including in this case, about the verifiability of the divisional capital structures of MPS?

A. Yes. On page 11, lines 19 through 20 of his rebuttal testimony, Mr. Reed states that: "[a]s divisions of Aquila, Inc. their capital structures are not separately discernible from that of the overall corporation." Mr. Reed's statement confirms my position that the "allocated capital structures" of MPS are completely fictitious. This is a capital structure process that Aquila has maintained is accurate for ratemaking purposes for the last 15 years in cases before this Commission. Now one of their own witnesses is recognizing the fallacy of the position that it has presented to this Commission in every rate case since Aquila instituted its allocated capital structure process.

Q. On page 22 and 23 of his rebuttal testimony, Mr. Reed discusses some of the things that he feels that equity markets are watching very closely for regulated electric utilities, such as the allowed returns in new cases. Do you have any evidence from the popular financial press that indicates that equity investors are expecting lower allowed returns than in the past, which is much of the information that Mr. Reed relies upon to refute the reasonableness of your recommendation in this case?

A. Yes. In an article, "Utility Cutbacks Worried States Before Blackout: Rate Freezes Spurred by Deregulation Weighed on Staffing, Maintenance," on August 29, 2003, in the Wall Street Journal, there was a discussion about how frozen rates actually worked in favor of utilities. The article specifically stated that, "The frozen rates actually worked in the utilities' favor, by allowing them to get higher rates of return than would have been authorized in today's low-interest-rate environment. But with rates frozen, the easiest way to get dollars to the bottom line is by whacking expenses." Consequently, the equity markets already recognize that it is likely that commissions are not going to authorize as high of returns for utilities as in the recent past because of the current low-interest-rate environment.

Q. Do any of the court cases you cited in your direct testimony confirm that previous recommended rates of return may be too high or low based on different capital and economic environments?

A. Yes. This is addressed in the Bluefield Water Works and Improvement Company (1923) case when the court stated the following:

> A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

This is why it is important to perform a thorough, objective analysis of the cost of common equity in each rate case that comes before this Commission.

Q. On page 29, line 1 through 3 of his rebuttal testimony, Mr. Reed indicates that it is the "end result, not the process" that determines the reasonableness of a rate of return recommendation. What were Staff's overall rate of return recommendations in the recent Empire rate case, Case No. ER-2002-424, AmerenUE complaint case, Case No. EC-2002-1 and the previous MPS rate case, Case No. ER-2001-672?

A. Staff's overall rate-of-return recommendation for Empire in its last rate case ranged from 8.27 percent to 8.72 percent. Staff's overall rate of return recommendation in the previous MPS rate case ranged from 8.49 percent to 8.98 percent.

Staff's overall recommendation in the AmerenUE complaint case ranged from 8.01 percent to 8.61 percent. Staff's overall rate of return recommendation in this case ranges from 7.97 percent to 8.32 percent. Considering the fact that I did not make a downward adjustment to my embedded cost of debt due to various considerations that I have already mentioned, I find this recommendation to be quite reasonable.

Q. Does Staff typically consider how its overall rate-of-return recommendation compares to its other rate-of-return recommendations in order to test it for reasonableness?

A. No. I am providing the overall rate-of-return recommendation for previous cases because Mr. Reed is focusing on the recommended cost of common equity and the common equity ratio in these cases. Ultimately, it is the rate of return, which is made up of all of the weighted costs of the various forms of capital which includes equity and debt, that gets applied to rate base when calculating a revenue requirement. Some companies may have higher embedded costs of debt than others so when the weighted cost of debt is combined with the weighted cost of common equity recommendation this will increase the overall recommended rate of return.

Q. On page 24, lines 16 through 18 of his rebuttal testimony, Mr. Reed indicates that if this Commission adopts Staff's recommendation in this case that capital would "quickly exit Aquila's stock in search of returns that are commensurate with the risks of utility stock ownership." Hasn't this already occurred?

A. Yes. The equity capital that was reflected in Aquila's market price per share before its non-regulated losses has since long exited Aquila's stock because the risks of ownership of Aquila's stock was far higher than that of a traditional, regulated utility company's stock.

Q. Does Mr. Reed make any comments that cause you concern about the effect that Aquila's failed non-regulated investments will have on the future health of Missouri's utilities?

A. Yes. On page 26 of his rebuttal testimony Mr. Reed states the following:

> Of equal importance, Aquila would face restricted access to capital markets, and would likely face great difficulty in raising new capital for maintenance and expansion of utility assets. One only has to look at the financial collapse of PG&E, Mirant, NRG, Enron and the energy merchant business units of other companies to see how severe the consequences can be when a firm's access to capital markets is cut off. The electric utilities that have faced these challenges have often had to resort to extreme levels of spending reductions which inevitably degrade utility service and raise rates to consumers for years into the future.

While Mr. Reed is attempting to support his concern about the effect that he feels Staff's recommendation would have on the Missouri utilities owned by Aquila, he is pointing out some of the real problems Aquila **has already caused** because of its precarious financial situation as a result of non-regulated business failures (emphasis added). If Mr. Reed's concerns should become a reality, then he has just pointed out the detriments to Missouri ratepayers that have resulted from Aquila's failed non-regulated investments, which had nothing to do with Missouri regulation.

Summary and Conclusions

Q. Please summarize the conclusions of your surrebuttal testimony.

A. My conclusions regarding the capital structure and cost of common equity are listed below.

1. The use of the capital structures proposed by OPC and Aquila are inappropriate. Neither witness has recognized any short-term debt in their capital structure recommendations. OPC excluded current maturities on long-term debt, which is both inappropriate and inconsistent with even OPC precedent. The calculation of the cost of capital for MPS should be based on Aquila's actual consolidated capital structure as of December 31, 2002, as shown on Schedule 9 attached to my direct testimony;
2. My cost of common equity stated in Schedule 23 attached to my direct testimony, which is 8.64 percent to 9.64 percent, would produce a fair and reasonable rate of return of 7.97 percent to 8.32 percent for the Missouri jurisdictional electric utility rate base for MPS.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

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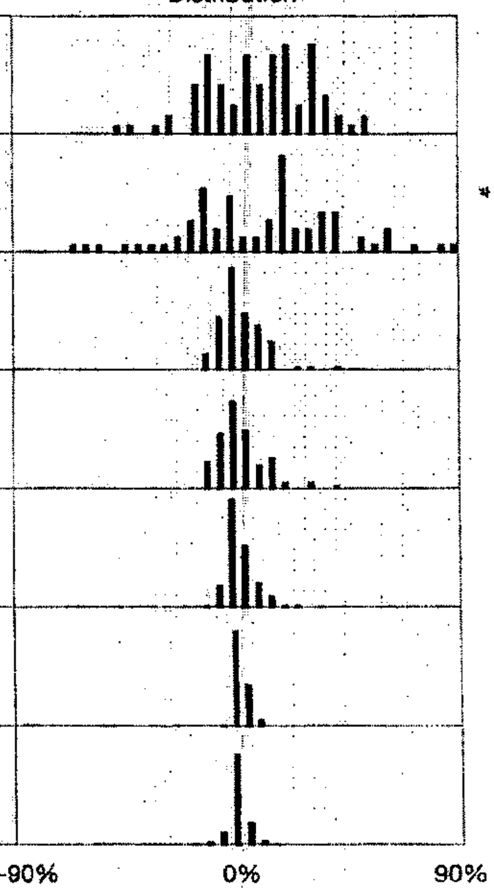
Schedule 1-1

Table 2-1

Basic Series: Summary Statistics of Annual Total Returns

from 1926 to 2002

Series	Geometric Mean	Arithmetic Mean	Standard Deviation	Distribution
Large Company Stocks	10.2%	12.2%	20.5%	
Small Company Stocks	12.1	16.9	33.2	*
Long-Term Corporate Bonds	5.9	6.2	8.7	
Long-Term Government	5.5	5.8	9.4	
Intermediate-Term Government	5.4	5.6	5.8	
U.S. Treasury Bills	3.8	3.8	3.2	
Inflation	3.0	3.1	4.4	



*The 1933 Small Company Stocks Total Return was 142.9 percent.

Schedule 1-2