UTILICORP UNITED INC.

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company for authority to merge St. Joseph Light & Power Company with and into UtiliCorp United Inc. and, in connection therewith, certain other related transactions	)))))))	Case No. EM-2000-292

UtiliCorp United Inc. and St. Joseph Light & Power Company Merger

Surrebuttal Testimony

June 26, 2000

ORIGINAL

Exhibit No.:	
Issue:	St. Joseph Light & Power Company Acquisition Adjustment-Price
Witness:	Lyle D. Miller
Sponsoring Party:	St. Joseph Light & Power Company and UtiliCorp United Inc.
Case No.:	EM-2000-292
Date Prepared:	June 26, 2000

MISSOURI PUBLIC SERVICE COMMISSION
Case No. EM-2000-292

Surrebuttal Testimony

of

Lyle D. Miller

Jefferson City, Missouri

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
SURREBUTTAL TESTIMONY OF LYLE D. MILLER
ON BEHALF OF ST. JOSEPH LIGHT & POWER COMPANY
CASE NO. EM-2000-292

Q. Please state your name.

A. My name is Lyle D. Miller.

Q. Please state your business address.

A. My business address is 1585 Broadway, New York, New York 10036.

Q. What is your present occupation?

A. I am employed as a Principal in the Investment Banking Division of Morgan Stanley & Co. Incorporated ("Morgan Stanley"). Specifically, my area of focus is providing merger and acquisition advisory services to utility and energy clients of the firm. I have been with Morgan Stanley since April 1993, beginning as an Associate in Morgan Stanley's Corporate Finance Department with a focus on energy and infrastructure clients. From August 1996 through May 1998, I was seconded to China International Capital Corporation ("CICC"), a joint-venture investment bank in Beijing, PRC, of which Morgan Stanley owns 35%. During my tenure at CICC, I served as the Head of Investment Banking. Since returning to the United States, I have been in my present position. Prior to joining Morgan Stanley, I worked for Argent Group Limited ("Argent") from June 1989 to June 1991 and Capstar Partners ("Capstar") from June 1991 through April 1993. Both Argent and Capstar are "boutique" investment banking firms focused on highly-structured financing and advisory assignments.

Q. What is your educational background?

A. In 1983, I earned a Bachelor of Science degree in Business from Ball State University. In 1989, I earned a Master of Business Administration degree with an emphasis in Finance from the John M. Olin School of Business at Washington University in St. Louis.

Q. What was your role in the proposed transaction between St. Joseph Light & Power Company and UtiliCorp United Inc.?

A. Morgan Stanley acted as financial advisor to St. Joseph Light & Power Company ("SJLP" or "Company") in the proposed transaction. My role in the assignment was that of the day-to-day team leader. In such capacity, I led a team consisting of one Associate and one Analyst in conducting the two-phase auction process and ultimate negotiations with UtiliCorp United Inc. ("UtiliCorp"). In addition to the primary team, three other senior level bankers within Morgan Stanley's utility and utility Mergers & Acquisition ("M&A") areas played significant support and/or supervisory roles.

Q. What is the purpose of this testimony?

A. Mr. David Broadwater of the Missouri Public Service Commission Staff raised certain issues concerning the valuation of SJLP in his rebuttal testimony. As a member of the M&A team that worked on the transaction on behalf of Morgan Stanley, I am providing this testimony to respectfully express our views on Mr. Broadwater's assumptions and correct certain conclusions mentioned in his testimony.

Q. Please provide some background about Morgan Stanley.

A. Morgan Stanley is regarded as one of the premier investment banks in the world. The M&A Department has an outstanding reputation and our clients rely heavily upon our strategic advice and valuation expertise. We are frequently called upon to render fairness

opinions, and the valuation work we perform for our clients spans different industries. Thus, we have depth and breadth in terms of our knowledge and experience.

Q. Please provide some insight into how you value a company.

A. Morgan Stanley views valuation as a combination of art and science. We use the standard tools and techniques of valuation, and then use our best judgment and experience to derive a range of values. There is no one "right" answer or value. Thus, when we valued SJLP, we used the standard valuation tools (comparable company analysis, precedent transaction analysis, and the discounted cash flow analysis) to triangulate to an equity value. As part of the analysis we relied upon our judgment, experience, and internal discussions to use the appropriate metrics (discount rates, growth rates, comparable companies analysis) to derive a range of values.

Q. Mr. Broadwater has mentioned that UtiliCorp's analysis did not go far enough. Do you agree?

A. We do not know what analysis UtiliCorp did or did not perform. However, we performed extensive valuations of SJLP and, using the methodology described below, derived a range of equity values for the Company.

Q. Please describe the valuation methodology that Morgan Stanley used and the results derived for SJLP.

A. First of all, the "market" price of SJLP is not $23.00/share, as Mr. Broadwater contends. The "market" price is the publicly traded value of the stock. The purpose of the comparable company valuation was to validate the trading price of SJLP stock at the time of valuation using a set of comparable companies. This type of valuation has the following characteristics:

- it is the "fully distributed" trading value of the company;
- it provides a company's implied value in the public equity markets through analysis of comparable companies' trading and operating statistics;
- it applies multiples derived from similar "comparable" publicly traded companies to the subject company's operating statistics; and
- it does not include a control premium.

The precedent transaction analysis estimates value based on what other companies in that particular industry and with similar characteristics have sold for, i.e. one can derive a range of values representing the control premium, which is the price that a buyer would pay to achieve control of the company. The valuation is realistic in the sense that past transactions were successfully completed at certain multiples. The analysis therefore indicates a range of plausibility for offered multiples or premiums to unaffected stock price. This analysis has the following characteristics:

- it provides a private market benchmark in a "change of control" scenario (i.e., acquisition of the company);
- it applies multiples derived from similar or "comparable" precedent M&A transactions to the subject company's operating statistics; and
- it includes a control premium.

Hence, the first method validates the current market price, while the second method helps derive a premium consistent with other comparable transactions. The third method of determining value, which Mr. Broadwater describes and where we have differences of

opinion as to his conclusions, is the Discounted Cash Flow (DCF) Analysis. Please see Schedules LDM-1 and LDM-2 for a summary of the valuation methodologies.

Q. Please describe the methodology of the DCF Analysis discussed by Mr. Broadwater.

A. DCF Analysis values a company or assets based on the net present value ("NPV") of projected cash flows generated by the company to all providers of capital. Cash flows are discounted using the weighted average cost of capital ("WACC") as the discount rate to reflect the time value of money and the riskiness of the cash flows. *A DCF analysis yields the theoretical value of a business regardless of capital structure. Capital structure affects value only through its impact on the WACC.* The DCF method is used as an additional point of reference when valuing a company because it provides a theoretical benchmark.

The main advantages of this methodology are:

- it is generally considered the most theoretically sound valuation method;
- it is forward-looking analysis, based on cash flow (less affected by accounting rules), which allows the company's expected operating strategy to be incorporated into the model;
- it is less influenced by volatile public market conditions; and
- it allows a valuation of the different components of a business or of synergies separately from the business.

Q. Please describe the methodology Morgan Stanley used to value SJLP using a DCF Analysis.

A. The methodology used in our DCF valuation of SJLP was the following:

- Morgan Stanley used the financial projections provided by SJLP to develop the cash flow numbers;
- we determined the methodology for calculating the terminal value – in this case, we used a range of growth rates ranging from 1.25% to 1.75% for the analysis;
- we calculated the appropriate WACC;
- the cash flows and the terminal value were discounted over the projection period using the WACC to obtain an Aggregate Value; and
- net debt was deducted from the Aggregate Value to determine the Equity Value.

Q. In your opinion, did Mr. Broadwater use the correct WACC in his DCF Analysis?

A. No. Mr. Broadwater states that the applicable WACC would be 13.017%, the cost of capital established in SJLP's last rate case. As more fully explained below, we believe that the applicable discount rate is the WACC that reflects: (1) the implied WACC of the seller's industry (i.e., based on comparable companies) and (2) the tax deductibility of interest expense.

The cash flows as used in Mr. Broadwater's DCF Analysis do not include the tax benefits of debt. Free Cash Flows as used in the DCF Analysis are the cash flows that would be available to the firm if interest payments were not deductible. The tax advantages of deductible interest payments are included in the discount rate; the more the tax advantages, the lower the discount rate. The WACC of 13.017% that Mr. Broadwater advocates does not factor in the interest tax shield. Using a 40% tax rate, SJLP's WACC is approximately 8%. This is based on interest rates as of March 2000. When the calculation was originally done at the end of 1998 and the early part of 1999, interest

rates (10-year Treasury) and betas were lower. Hence, SJLP's WACC as calculated at that time lay approximately in the range between 6.5% and 8.5%. As mentioned above, capital structure affects value only through the adjustment in the discount rate. Mr. Broadwater's analysis uses a pre-tax discount rate, which should be adjusted for the applicable tax shield. Also, the rate that Mr. Broadwater uses should be changed to reflect the rates that were prevalent at the time of the transaction.

Q. Please discuss the process used by Morgan Stanley in arriving at the WACC used to discount SJLP's projected cash flows.

A. The general steps are outlined below. Please refer to Schedules LDM-1 and LDM-2 for the actual numbers used in the calculation.

- The first step was to obtain the predicted equity Betas of comparable companies from Barra. Barra publishes a predicted beta for all publicly quoted companies. This is an "Equity Beta" or a "Levered Beta" (i.e., is calculated assuming current leverage ratios: Total Debt / Market Capitalization). This information was valid as of January/February 1999.
- These Betas reflect the business and financial risk of the various comparable companies. Generally, and as shown in the schedules, it is better to use an average or median of betas for companies in the same industry rather than the beta for a single company due to estimation errors of calculating a beta for any one particular company. In order to adjust for leverage, the Betas of these comparable companies have to be unlevered. Using the formula to unlever the Betas:

$$\text{Unlevered Beta} = \frac{\text{Levered Beta}}{1 + (D/V)(1-t) + (Pref./V)}$$

Where V = total market capitalization (market equity value + net debt)

t = tax rate

- The mean/median of the unlevered Betas of the comparable companies serves as approximation of the business risk of the company being valued. To reflect the financial risk, we re-levered the Beta with the desired financial structure which was a range with debt going from 40% of total capitalization to 90%.
- When we de-levered and re-levered the Betas, and calculated the WACC, market values for both the company's equity and debt were used. In the case of debt, however, the simplifying assumption that book value is equal to market value, was made.
- Using the Capital Asset Pricing Model, we calculated the cost of equity of SJLP: [Risk Free Rate + ((Re-Levered Beta) x Market Risk Premium)] where the Risk Free Rate is assumed to equal the current yield on long-term treasury bonds (10 years). The Market Risk Premium is the premium that investor's demand for investing in the overall market portfolio compared to a risk free investment. Morgan Stanley uses 7.4% (arithmetic average).

With simple weightings we then calculated the WACC for SJLP:

WACC = Cost of Equity x (E/V)+ Cost of Debt x (D/V)(1-t)+ Cost of Preferred x (Pref./V)

As shown in the schedules, the WACC was approximately in the range between 6.20% and 6.50%. Given SJLP's business position and revenue mix and the macroeconomic environment, Morgan Stanley used the range between 6.50% and 8.50% for the WACC. This range was used to discount the unlevered free cash flows. The net present values of the unlevered free cash flows over the projection period plus the terminal value yielded the Aggregate (Asset) Value of the business/assets. Assets and liabilities not accounted for were added or subtracted respectively in order to arrive at an equity value of the business/assets. Assets that must be added included cash. The liabilities that were subtracted were the short term and long term financial debt. These additions and subtractions were in present value terms.

The resulting value is the equity value of the business/assets, and after dividing by the fully diluted shares, yielded the per share value.

Q. What is your response to Mr. Broadwater's position that the Staff's value of SJLP is the correct value to be used in this case?

A. I respectfully disagree with Mr. Broadwater's position. His position is that the most appropriate value for SJLP is the value that uses UtiliCorp's WACC as the discount rate. He then uses the pre-tax WACC for UtiliCorp as the discount rate, which, as explained above, is not the appropriate discount rate. Additionally it is not appropriate to use the acquirer's WACC to discount the target company's cash flows as outlined below.

As previously noted, the appropriate discount rate is based on the target (SJLP) and not the acquirer (UtiliCorp), since the discount rate in the DCF Analysis attempts to evaluate

the riskiness of SJLP's cash flows. The only WACC that is material is the average WACC for the target's industry. The WACC of the acquirer has no bearing on the value of the target. An acquirer's WACC can be useful for purposes of capital budgeting decisions or Internal Rate of Return ("IRR") "hurdle rate" analysis; it is not meaningful for purposes of valuing a potential target. If an acquirer's IRR or cost of capital requirements are not met by making a particular investment in a company because of the use of different discount rates, the acquirer may choose not make the investment; it does not imply that the value of the target is less. The only relevant WACC measure is the industry average cost of capital demanded by investors in a particular line of business. Additionally, the discount rate measures the riskiness of the target's cash flows; hence it is only appropriate to use the discount rate determined by using companies comparable to the target.

For these reasons, it would not be appropriate to use UtiliCorp's WACC as the discount rate for SJLP's cash flows.

Q. Please summarize your testimony.

A. Valuation metrics should be dated appropriately – calculations using interest rates, betas, etc., should be for the time period in question; using current rates may well lead to different results for valuation and therefore render any issues regarding valuation methodology meaningless.

The WACC should include the interest tax shield on the debt. This is the appropriate way to reflect the capital structure. Using the pre-tax cost means that one is undervaluing the company by using a higher discount rate.

The target company's WACC (or more accurately the target industry's WACC) should be used to discount the cash flows. Using the acquirer's WACC will lead to erroneous results.

Q. Does this conclude your testimony?

A. Yes.

Unlevered Beta Calculation

Company Name	Predicted Equity Beta (1)	Total Debt / Market Equity (2) (%)	Total Debt / Market Cap (2) (%)	Pfd / Market Equity (2) (%)	Unlevered (Asset) Beta
Black Hills Corporation	0.31	34.79	25.81	0.00	0.25
Empire District Electric Co.	0.10	66.22	37.95	8.29	0.07
Madison Gas and Electric Company	0.08	51.95	34.19	0.00	0.06
Niagara Mohawk Power Corporation	0.57	246.64	67.52	18.65	0.21
Otter Tail Power Company	0.38	92.92	43.80	19.23	0.21
SIGCORP, Inc.	0.20	55.01	34.85	2.84	0.15
WPS Resources Corporation	0.25	50.85	31.09	12.73	0.17
Comparable Mean	**0.27**	**85.48**	**39.31**	**8.82**	**0.16**
Comparable Median	**0.25**	**55.01**	**34.85**	**8.29**	**0.17**

Schedule LDM-1

Weighted Average Cost of Capital Calculation

Total Debt / Market Equity (%)	Pfd / Market Equity (%)	Relevered Beta	Cost of Debt (Pre-tax) (%)	Cost of Debt (After-tax) (%)	Cost of Preferred (After-tax) (%)	Cost of Equity (%)	Wt. Avg. Cost of Capital (%)
Relevering of Comparable Median Asset Beta Based on Various Capital Structures							
40.00	8.29	0.23	6.10	3.66	9.00	7.30	6.42
50.00	8.29	0.24	6.20	3.72	9.00	7.38	6.31
60.00	8.29	0.25	6.30	3.78	9.00	7.46	6.22
70.00	8.29	0.26	6.40	3.84	9.00	7.54	6.15
80.00	8.29	0.27	6.50	3.90	9.00	7.61	6.10
90.00	8.29	0.28	6.60	3.96	9.00	7.69	6.05
						7.50	**6.19**

Assumptions:

Risk Free Rate (3)	5.60 %
Market Risk Premium	7.40
Marginal Tax Rate (t)	40.00

Formulas: Unlevered Beta (4) = $\frac{\text{Levered Beta}}{1 + (D/E)(1 - t) + (Pfd/E)}$

Cost of Equity = Risk Free Rate + Country Risk Premium + Levered Beta * (Mkt Risk Premium)

Notes:

(1) Source: Barra U.S. Equity Beta Book as of 06/30/98.

(2) Based on share prices as of 03/01/99.

(3) Current 10-year Treasury Yield as of 03/01/99.

(4) D = Debt, E =Equity, t = Marginal Tax Rate, Pfd = Preferred Stock.

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County of New York)
)
State of New York)

AFFIDAVIT OF LYLE D. MILLER

Lyle D. Miller, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of Lyle D. Miller"; that said testimony was prepared by him and/or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information, and belief.

Lyle D. Miller

Lyle D. Miller

Subscribed and sworn before me this 28th day of June, 2000.

Fiona M. Murray

Notary Public

My Commission expires:

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FIONA M. MURRAY
Notary Public, State of New York
No: 01MU6019233
Qualified in Queens County
Commission Expires February 01, 20 01