

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
SURREBUTTAL TESTIMONY OF JOHN J. REED
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
CASE NOS. ER-2004-0034 AND HR-2004-0024 (CONSOLIDATED)**

1 **Q. PLEASE STATE YOUR NAME.**

2 A. My name is John J. Reed.

3 **Q. MR. REED, HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS**
4 **PROCEEDING BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION**
5 **(“COMMISSION”)?**

6 A. Yes, I have. I submitted rebuttal testimony on behalf of Aquila Inc. (“Aquila” or
7 “Company”) on January 23, 2004.

8 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

9 A. My surrebuttal testimony responds to the rebuttal testimony of Commission Staff Witness
10 David Murray, which was also filed on January 23, 2004. My surrebuttal focuses on the
11 additional support that Staff Witness Murray offers for his recommended common equity
12 ratio for Aquila. Specifically, I will respond to the following statements and conclusions
13 offered by Staff Witness Murray:

14 1. That is inappropriate to use Aquila’s most recent actual capital structure for
15 ratemaking purposes because it “is not consistent with the comparable companies’
16 capital structure[s]”, and, “more importantly, Aquila’s common equity ratio as of the
17 update period is not consistent with how Aquila was financed in the past.” (Murray
18 Rebuttal, page 4, lines 5-8)

19 2. “If a hypothetical capital structure were to be used an appropriate common equity
20 ratio would be in the range of 33 percent to 42 percent, not at the level of 47.5 percent
21 recommended by Dr. Murray...” (Murray Rebuttal, page 13, lines 1-3)

1 3. "Aquila issues the debt and equity for the capital needs of its divisions. Therefore,
2 investors are only interested in Aquila's consolidated operations." (Murray Rebuttal,
3 page 10, lines 19-20)
4

5 **Q. DO YOU AGREE WITH THE FIRST OF THESE THREE STATEMENTS, I.E.**
6 **THAT AQUILA'S MOST ACTUAL RECENT CAPITAL STRUCTURE IS NOT**
7 **APPROPRIATE TO USE FOR RATEMAKING PURPOSES?**

8 A. Yes, I do. What is remarkable is that the grounds on which Staff Witness Murray
9 concludes that the actual equity ratio is unsuitable apply equally to his recommended use
10 of an actual Aquila capital structure as of nine months earlier.

11 Staff Witness Murray has concluded that the September 30, 2003 actual equity ratio of
12 30.77% is inconsistent with the equity ratio of comparable companies and is inconsistent
13 with the way in which Aquila was financed in the past. Yet, he adheres to his
14 recommended use of the December 31, 2002 actual equity ratio of 35.31% for ratemaking
15 purposes.

16 **Q. HOW DOES STAFF WITNESS MURRAY'S RECOMMENDED EQUITY RATIO**
17 **COMPARE TO COMPARABLE ELECTRIC UTILITIES?**

18 A. It is far below the industry average equity ratios for investment grade utilities, and even
19 further below the equity ratio used for those companies in ratemaking proceedings.

20 Staff Witness Murray attempts to analyze industry average equity ratios at pages 12-13 of
21 his Rebuttal Testimony, but his analysis suffers from four flaws: he uses a very small
22 sample; he does not eliminate companies from the average that are in financial distress;
23 he only looks at one year of data; and he does not examine the equity ratio used to set
24 rates for the utility portions of these companies.

1 **Q. PLEASE EXPLAIN YOUR CONCERN WITH THE SIZE OF THE SAMPLE**
2 **STAFF WITNESS MURRAY USES.**

3 A. For this analysis, Mr. Murray uses the C.A. Turner Utility Reports as his data source,
4 which reports data for only 24 electric companies, of which only 15 are BBB-rated. Even
5 so, these one-year averages of 41% equity for the 24 companies and 38% for the 15
6 companies do not support his recommended level of 35%. When Mr. Murray expanded
7 his data source to Value Line, he reported data for only one region's utilities, the central
8 region, and he still only looked at one year, 2002.

9 My Surrebuttal Schedule JJR-1 provides the year-end equity ratio for all 61 of the electric
10 utilities that Value Line covers, and for all of the years (1993-2003) that it currently
11 reports. As shown on this schedule, the overall average equity ratio for these companies,
12 on an unadjusted basis, is 44.1%

13 **Q. WHAT ADJUSTMENTS DO YOU PROPOSE TO THESE DATA?**

14 A. I propose to eliminate Aquila from the averages, and the following companies which are
15 below investment grade:

Allegheny Energy
Avista Corp.
CMS Energy Corp.
DPL Inc.
Edison Int'l
PG&E Corp.
Sierra Pacific Res.
UniSource Energy
Westar Energy

16
17 The companies I would exclude from the averages are shaded on Surrebuttal Schedule
18 JJR-1. Not surprisingly, these companies tend to have very low equity ratios, which are
19 symptomatic of the financial distress they are experiencing. Excluding these companies

1 from the calculations produces an average equity ratio of 45.6% for 1993-2003. Clearly,
2 the data for other investment grade electric utilities supports Aquila's recommended
3 equity ratio of 47.5%, and demonstrates the unreasonableness of Staff Witness Murray's
4 recommendation of 35.31%.

5 **Q. ARE THERE OTHER DATA THAT REFUTE THE POSITION ADVOCATED**
6 **BY STAFF WITNESS MURRAY ON PAGE 3, LINES 15 AND 16 OF HIS**
7 **REBUTTAL AND SUPPORT THE REASONABLENESS OF AQUILA'S**
8 **PROPOSED EQUITY RATIO?**

9 A. Yes, there are. First, the target equity ratios used by Standard & Poors ("S&P") in
10 assigning debt ratings to utilities support Aquila's position in this case. As shown on
11 Schedule SDA-1, which was attached to the Rebuttal Testimony of Susan D. Abbott,
12 S&P currently uses a target equity ratio of 45% to 53% for a BBB-rated utility with
13 average business risk, and a target equity ratio of 53% to 58.5% for an A-rated utility of
14 average business risk. Based on the guidelines published by S&P, Staff Witness
15 Murray's proposed equity ratio of 35.31% (resulting from his use of Aquila's
16 consolidated capital structure) is entirely inconsistent with the capital structure of an
17 investment grade utility.

18 Second, as discussed in my rebuttal testimony, regulators across the country are focused
19 on increasing the equity ratios and financial strength of utilities, not pushing them down
20 to levels that are associated with energy companies that are in or emerging from financial
21 distress. As shown on page 15 of my Rebuttal Testimony, regulators in electric rate cases
22 that were decided in 2003 used an average equity ratio of 48.43%. Over the past seven

1 years, the average equity ratio used in electric rate decisions was 47.25%. This is
2 essentially equal to what Aquila is proposing in this case.

3 One state commission staff, the California Office of Ratepayer Advocates (“ORA”),
4 conducted a study of what an “optimum” capital structure would be for California’s
5 public utilities. That study, which was submitted in the case that set the allowed rates of
6 return for 2003 for all of California’s energy utilities, defined an optimum capital
7 structure as one which, from the ratepayers’ perspectives, minimized costs over the long
8 term. This study concluded that the “optimum” equity ratios for California’s utilities
9 were as follows:

<u>Company</u>	<u>ORA “Optimum” Equity Ratio</u>	<u>CPUC Decision</u>
Pacific Gas & Electric	45.20%	48.00%
Southern California Edison	45.85%	48.00%
San Diego Gas & Electric	46.55%	49.00%
Sierra Pacific Power	48.27%	42.00%

10
11 It is interesting to note that the California Public Utilities Commission (“CPUC”) felt that
12 the ORA’s “optimum” equity ratios were generally too low and too restrictive, and it
13 adopted the equity ratios as proposed by the utilities (Sierra Pacific only sought a 42.00%
14 equity ratio). It also is interesting to note that:

- 15 1. In every case, the year-end 2002 and 2003 actual equity ratios for each of the
16 consolidated companies was lower than that which the CPUC chose to use for
17 ratemaking;
- 18 2. Only one of the four companies (San Diego Gas & Electric) is at or above investment
19 grade;
- 20 3. The CPUC found that these higher equity ratios were in the public interest because
21 they were “intended to either return their credit ratings to investment grade from a
22 speculative grade or to maintain an investment grade rating” and were “designed to
23 attract capital.”

1 The needs faced by California's utilities are very similar to those currently facing Aquila.
2 Consolidated corporate equity ratios that have been affected by the financial distress of
3 other operations should not be the basis for setting the rates of the utility if we want the
4 utility to be able to return to financial health.

5 **Q. AT THE BEGINNING OF THIS TESTIMONY YOU INDICATED THAT YOU**
6 **WOULD RESPOND TO STAFF WITNESS MURRAY'S COMMENTS ON THE**
7 **USE OF A HYPOTHETICAL CAPITAL STRUCTURE, AND HIS CONCLUSION**
8 **THAT IF A HYPOTHETICAL CAPITAL STRUCTURE WERE TO BE USED, IT**
9 **SHOULD BE IN THE RANGE OF 33% TO 42%. WHAT ARE YOUR**
10 **COMMENTS ON THESE STATEMENTS?**

11 A. At page 8 of his rebuttal testimony, Staff Witness Murray cites comments by Aquila's
12 management regarding how the Company's financial distress has affected its equity ratio.
13 As Mr. Rick Dobson of Aquila said: "The significant amount of impairments we took in
14 2002 have eroded a lot of book equity..." Notwithstanding this fact, Mr. Murray
15 proposes to use the Aquila, Inc. 2002 year-end equity ratio for setting rates in this
16 proceeding.

17 The impairments that Mr. Dobson spoke of, when combined with the operating losses
18 that Aquila experienced, produced a \$2.1 billion loss for Aquila in 2002. These losses
19 continued, on a much smaller scale, in 2003. The 2002 loss alone reduced Aquila's
20 consolidated equity ratio by 11.0 percentage points (from 44.2% to 33.2%). It is the
21 depressed year-end 2002 ratio that Staff Witness Murray proposes to use in this case.

22 **Q. HOW DO YOU RESPOND?**

1 A. The losses experienced by Aquila in 2002 did not result in any way from the Company's
2 utility operations in the U.S. They resulted from impairments and restructuring charges
3 related to Aquila's telecommunications, technology, energy merchant, and international
4 investments. Mr. Murray's position would use the distress of these companies as the
5 basis for significantly *reducing* the rates of Aquila's utility businesses in Missouri,
6 through the adoption of an equity ratio that reflects the 11 percentage point drop caused
7 by those other businesses. That position is inequitable and unsupportable.

8 Under these circumstances, i.e. when a company's actual capital structure is unreasonable
9 or out of line with industry standards, Mr. Murray recommends that a hypothetical capital
10 structure be used. Aquila's witness, Dr. Donald Murry, adopts the Company's target
11 equity ratios as the appropriate replacement. I agree with that choice. However, Staff
12 Witness Murray's approach, when applied to a corrected set of data, produces essentially
13 the same result. Staff Witness Murray recommends that the hypothetical capital structure
14 be based on equity ratios of other electric utilities. As shown on Surrebuttal JJR-1, this
15 would lead to the use of a 45.6% equity ratio, which is close to Dr. Murry's
16 recommendation of a 47.5% equity ratio, and a long way from the 35.31% that Staff
17 Witness Murray recommends.

18 **Q. YOU ALSO STATED AT THE OUTSET OF THIS TESTIMONY THAT YOU**
19 **WISHED TO COMMENT ON STAFF WITNESS MURRAY'S STATEMENTS**
20 **ON PAGE 10 OF HIS REBUTTAL THAT "INVESTORS ARE ONLY**
21 **INTERESTED IN AQUILA'S CONSOLIDATED OPERATIONS", DUE TO THE**
22 **FACT THAT AQUILA ISSUES THE DEBT AND EQUITY FOR THE CAPITAL**

1 **NEEDS OF ITS DIVISIONS. WHAT ARE YOUR COMMENTS ON THESE**
2 **STATEMENTS?**

3 A. First of all, I disagree with these statements. Investors are concerned about Aquila's
4 future, not its past. Aquila's stated plan is to return to its roots, i.e. regulated utilities.
5 For that reason, investors are very concerned about the financial performance of and
6 outlook for Aquila's regulated businesses.

7 Furthermore, it is a widely accepted financial management principle that the costs of
8 capital or "hurdle" rates of return applicable to a diversified business should be
9 differentiated by business unit. The risks of energy commodity trading are far different
10 than the risks of electric distribution. A sophisticated investor wants to be sure that
11 Aquila is at least earning the "hurdle" rate or cost of equity in each of its business units
12 that is applicable to the specific business unit. If the Company is unable to meet the
13 applicable hurdle rate in a business unit, investors expect it to restructure or eliminate that
14 business unit.

15 The fact that a single legal entity, i.e. Aquila, Inc., provides the debt and equity to each of
16 its businesses cannot be extrapolated to suggest that the capital structures or costs of
17 capital are the same for all business units. This error would be compounded if one were
18 to further extrapolate that the actual consolidated common equity ratio at any point in
19 time is the appropriate equity ratio to be used in setting the rates for the public utility
20 business units.

21 **Q. WHAT ARE YOUR CONCLUSIONS REGARDING STAFF WITNESS**
22 **MURRAY'S REBUTTAL TESTIMONY AS IT RELATES TO THE ISSUE OF**
23 **THE APPROPRIATE EQUITY RATIO FOR AQUILA-MPS AND AQUILA-L&P?**

1 A. Staff Witness Murray's Rebuttal Testimony does not support his recommended common
2 equity ratio of 35.31%. The standards he employs inexorably lead to the conclusion that
3 Aquila's proposed equity ratio of 47.5% is reasonable, balanced, and in the public
4 interest. This level of equity should be used in setting the rates for Aquila-MPS and
5 Aquila-L&P so that Aquila can move towards an investment grade rating, attract capital
6 on reasonable terms, and have a reasonable opportunity of earning a rate of return that is
7 equivalent to that being earned by firms of comparable risk.

8 **Q. DOES THAT CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

9 A. Yes, it does.