the subject of this case is their electric operations.

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

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

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

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

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

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

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

A. I haven't quantified that.

Q. So you don't know?

A. I don't know.

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

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

Q. The same type of business operations?

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

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

A. Yes.

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

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

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

A. Of comparable risks to electric operations, correct.

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

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

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

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

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

A. Can you please define pure gas?

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

A. Vertically integrated?

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

A. They generate --

Q. Right.

A. -- electricity?

Q. Sure.

A. Nuclear generation?

Q. You make the assumption.

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

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

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

A. Yes.

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

A. Yes. That's very important.

Q. And why is that important?

A. Because that entails all business and financial risk.

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

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

Q. You didn't do what analysis?

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

Q. Do you have any idea at all?

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

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

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

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

A. You would think so.

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

A. No. I have no idea.

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

A. That's correct.

Q. And what is DPL, Inc.?

A. Dayton Power & Light.

Q. And where is it located?

A. Ohio.

Q. And what kind of business is it in?

A. It's obviously an electric utility.

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

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

MR. SWEARENGEN: Could we take a brief recess?

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

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

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

JUDGE JONES: Does anyone have any objection to that?

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

MR. SWEARENGEN: Thank you.

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

(A recess was taken.)

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

Mr. Swearengen, you may proceed.

MR. SWEARENGEN: Thank you, Judge.

BY MR. SWEARENGEN:

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

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

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

A. Yes.

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

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

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

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

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

A. No, I was not.

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

investment grade?
A. I would agree with that.
Q. And, therefore, as a result, DPL would not meet your criteria No. 7, At least an investment grade rating?
A. If I were to update my study, that's correct.
Q. So based on that, would you agree with me that DPL should be removed from your proxy group by your own definition?
A. If I updated the study, I would agree with that. But, no, since when I did the study they were investment grade, they met that criteria at that time.
Q. And when did you do that study?
A. Probably shortly before -- I believe a lot of the -- a lot of the research, Value Line reports that I used were dated October 3rd, 2003, testimony was filed December 9th. So within that time frame. I'm sure it was whenever I was looking at that. Maybe -- to be honest with you, as far as specific dates that I was preparing the study, I can't tell you.
Q. Let me ask you this. You're not disputing the fact that the credit rating has been lowered from triple B to double B for that company?
A. No.
Q. And you would agree that it, therefore, would

not meet one of your screening criteria; is that true?
A. If the study was updated, that's correct.
Q. And your testimony here on the stand, would you consider that to be an update to your study?
A. No. I'm standing by the testimony that was -- that's been filed. We're discussing some of the things that may have occurred since my testimony was filed, but I haven't changed my recommended return on equity nor has any other witness in this case.
Q. I'm not asking you about that. I'm asking you about your selection of that particular company as one of the six companies in your proxy group. And I think -- where do you set out the criteria that you used to select the companies for your proxy group? Where do I find that?
A. Schedule 11, I believe.
Q. Is it anywhere in your Direct Testimony?
A. Oh, as far as the Direct Testimony? I believe we talked about that earlier when we were talking about risk.
Q. What page is that on?
A. I'll have to -- page 26.
Q. Page 26. And if I look there and I look at criteria No. 7, it says, At least investment grade rating?
A. Yes.
Q. And you used that criteria to eliminate six

additional companies from the pool of companies that you were looking at that; is that true?

A. At that time, that's correct.

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

A. Yes.

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

A. The analysis I did at the time contemplated a triple B credit rating, so the data I was looking at at the time reflected that triple B credit rating. I have not bothered to look at any additional information as far as the financial information for -- for the discounted cash flow analysis of DPL since they've been downgraded.

Q. So the fact that that company no longer meets your own criteria doesn't concern you at all?

A. I wouldn't say it doesn't concern me, but it doesn't change my recommendation.

Q. And why is that?

A. Because I evaluated all of my comparable companies when I arrived at my recommendation of the 9.6-- excuse me, 8.64 to 9.64. And all the -- I mean, there were more than -- there are more than just -- there's more than just one company in that comparable group.

Q. Let me ask you this. All other things being equal, if you were to do this study today, all other things being equal except DPL is no longer investment grade credit rating, wouldn't you agree that you would eliminate them from your proxy group?

A. I would eliminate them, but I'm not saying that my recommendation would change.

Q. Okay. And that being the case, you'd be left in your proxy group with just five companies, all other things being equal; is that true?

A. Well, who knows what might happen with some of the other companies.

Q. No. I understand that. I said all other things being equal, nothing else changes, assuming all other facts being equal.

A. If you want to make that assumption, that would be the case.

Q. Okay. Now, DQE, Inc. is in your proxy group; is that correct?

A. That's correct.

Q. And what is that company?

A. It's a predominantly electric utility. I believe that they operate I believe mainly in the state of Pennsylvania, electric distribution. I know they had some other operations they just sold. Obviously we're familiar with the fact that they had AquaSource, they sold that to Philadelphia Suburban, but they're an electric utility.

Q. Have you reviewed any financial literature with respect to that company?

A. Value Line and Standard and Poor's information, once again.

Q. Are you aware of a Value Line report dated December 5, 2003, which indicates that potential investors should exercise caution before taking a stake here, meaning making an investment in this company?

A. I didn't review the December Value Line sheet.

MR. SWEARENGEN: May I approach the witness, your Honor?

JUDGE JONES: Yes, you may.

BY MR. SWEARENGEN:

Q. Mr. Murray, I just handed you a document, a Value Line document. Can you tell the Commission what that is, please?

A. Yes. It's a Value Line -- what they refer to as tariff sheet for Dukane Light. For whatever reason, they've changed it to Dukane Light. It used to be DQE on my tariff sheet. And it's a report issued by Value Line as of December 5th, 2003 with financial information and some written analysis.

Q. Now, the statement that I indicated was contained in that document appears at the very end of it; is that not true?

A. Yes. It reads that through 2008, I believe -- it's hard to read, I think it is a fax copy -- potential investors should exercise caution before taking a stake here, which would actually drive the dividend yield up.

Q. And why would it drive the dividend yield up?

A. If there's commentary from analysts within the investment community to use caution when investing in stock, then obviously the stock price of that company may depreciate because there's a caution.

It's just -- obviously the -- as we know, there's very few sell orders put out there by Wall Street analysts, but as far as some more independent analysts, if they're telling investors to exercise some caution, they may, you know, choose to, you know, either decrease their position or may choose not to buy the stock. And when that price goes down, the dividend yield would go up. And the cost of -- therefore, the cost of capital to that company goes up.

Q. Is that because it's becoming riskier?

A. Obviously they believe there's some risk; otherwise, they wouldn't say use some caution.

Q. Have you done any detailed study of this company at all?

A. Just what's in my schedules and my general knowledge through Value Line, Standard and Poor's.

Q. Are you aware then that DQE is trying to divest itself of past investments and financial energy services as well as telecommunications operations?

A. Yes. They're divesting about three units. We're very familiar with AquaSource because they operate in the state of Missouri.

Q. And are you aware that the company has an ongoing Internal Revenue Service investigation involving its tax returns for the period 1994 through 1997?

A. I believe I saw something to that extent. I believe it was in the S&P report.

Q. And isn't it true that the company cut its dividend by 25 percent in 2003?

A. I'll take your word for the percentage, but I do know they cut their dividend.

Q. Am I correct in understanding your testimony and schedules that you use DQE's 25.5 percent equity ratio, which was its equity ratio at the end of 2002, in the calculation of your proxy equity ratio average of

36.8 percent?

A. That's correct.

Q. Would you agree that all other things being equal, the financial risk for that company, for DQE, exceeds that of the other companies in your proxy group?

A. All other things being equal, correct.

Q. So then, in summary, assuming that your proxy group has some validity, one of those companies, DPL, fails to meet one of your own criteria No. 7, At least investment grade credit rating. Correct?

A. Not at the time.

Q. It does as we speak here today though, does it not?

A. If I were to update the study, you would be correct.

Q. And a second company, DQE, would it be fair to say that company has so much uncertainty surrounding it that -- especially given its low equity ratio, that it was forced to reduce its dividend in 2003 and there's a warning from Value Line to investors about investing in that company?

A. Yes. I took all those things into consideration when I came up with my overall recommendation in this case.

Q. Let me ask you this. If you eliminated those two companies from your group of six proxy companies, would you agree then that the average equity ratio of your proxy group would be raised from 36.8 percent to about 43 percent?

A. I'll take your word for the average.

Q. Then do you have any reason to dispute that?

A. No. I don't have --

Q. Is that a difficult calculation to make?

A. Well, I'd have to average four --

Q. How long would it take you to do that?

A. I could do it right now.

Q. Okay.

A. What was the number you indicated?

Q. 43 percent.

A. 42.6 to be exact, but you're right.

Q. Okay. Thank you.

Now, before lunch we had a discussion about financial integrity. Do you recall that discussion?

A. Yes.

Q. And you indicated that based on the United States Supreme Court Hope decision, the return that this Commission authorizes should be sufficient to assure a confidence in the financial integrity of MPS and L&P; is that true?

A. Yes.

Q. So to maintain the credit of those entities

and to attract capital; is that true?
A. Yes.
Q. And that's still your testimony this afternoon?
A. That's correct.
Q. Thanks.
Turn to page 31 of your Direct Testimony, if you would.
A. Yes.
Q. There at the bottom of page 31, beginning on line 18 and continuing over on the top of page 32, you discuss the calculation on the pre-tax interest coverage ratio; is that correct?
A. Yes.
Q. First of all, what is a pre-tax interest coverage ratio?
A. It's just earnings before interest and taxes divided by interest. Just done -- trying to give an idea what the coverage of the interest expense might be.
Q. On page 32 at line 6 and 7 you say, This range of pre-tax interest coverage ratios falls between the lower quartile and median quartile for a triple B related electric utility. Correct?
A. Yes. And actually, I'm sorry, I didn't make this correction, but it shouldn't indicate median quartile.

It should just indicate median.

Q. So I should strike quartile?

A. Yes. I apologize.

Q. And I think you testified earlier that a triple B rating is the minimum rating for an electric utility to be considered investment grade?

A. That's correct.

Q. And then you go on from that point and discuss on page 32 and later a rate of return for Aquila's MPS and L&P operations; is that true?

A. Yes.

Q. And, once again, let me ask you to make sure that we're clear. Would you agree in order for a return to assure confidence in the financial integrity of the enterprise, which is the words the Supreme Court uses but in this case that would be MPS and L&P, would it be your intention that your recommendation in this case will result in MPS and L&P as stand-alone entities existing at an investment grade level?

A. I'm -- I never tried to give the impression that I knew exactly what their credit rating would be on a stand-alone basis, because that's a very hard thing to determine. I -- my recommended rate of return is fair and reasonable.

Now, if -- if the -- if that were to want to be determined, I am aware that S&P and Moody's both have services that the company could pursue. I think Moody's refers to it as rating assessment service. S&P refers to it as a rating evaluation service.

That indicates that if you -- if they were wanting -- if a company was wanting to try to assess the creditworthiness of a stand-alone company or stand-alone entity which could be a division, the company could pursue such a -- such an endeavor with Moody's and S&P.

And that would give -- that would be the only true way to give an independent and full-fledged, detailed analysis of what MoPub and St. Joe would be rated on a stand-alone basis. You can't just look at the quantitative ratios that's published by S&P for their targets because obviously, as we pointed out earlier, a lot of times those ratios are not falling within those targets.

And I'm aware from my conversations with Standard and Poor's and Moody's, that they compare the actual ratios that occur to companies -- other companies in the same industry, their actual ratios.

And that's why the financial medians are important to look at because they look at those in conjunction with those -- with those benchmarks. And -- but I am aware that Moody's and Standard and Poor's has indicated that they wouldn't be, you know, surprised if --

with this current environment where there are companies that have a lot of nonregulated activities and that there's proceedings going on in commissions where there's a dispute as to what the credit rating might be if the division were stand-alone, you know, that they -- you know, that they would possibly entertain the possibility of a company -- the commission would have to work with the company, but the company could request such an analysis to be done, which would be about as detailed and objective as you can get in determining what the -- what the integrity of the company would be.

Q. Well, you're the chief financial witness testifying in this case for the Staff of the Public Service Commission; isn't that true?

A. Yes.

Q. And I think you said this morning that you agreed -- and, once again, taking you back to the Hope case, that the return that this Commission authorizes -- and they're going to look at your recommendation in doing that -- should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital?

A. Yes.

Q. And given that standard, what have you done to test whether or not your recommendation in this case, if adopted by the Commission, will, in fact, meet that standard annunciated by the United States Supreme Court?

A. I believe it's detailed throughout all my testimony. I mean, one of the first calculations I performed was a pre-tax interest coverage calculation. And I recognized -- to be quite honest with you, at the time I debated whether or not to even use this pre-tax interest coverage calculation or put it in my testimony --

Q. Well, let me --

A. -- because of the concern that the debt cost for -- that are included in this pre-tax interest coverage calculation may be higher than what a utility could have received if they had a capital structure similar to Aquila's on a consolidated basis and they didn't have the exposure to the nonregulated operations.

Q. Let me back you up just a second. When you sat down to write your testimony in this proceeding -- and you said that this was your testimony, you wrote it and you put it in this language from the United States Supreme Court decision, and you've acknowledged that, you've indicated that you think this Commission needs to follow that -- was it your intention that your recommendation that you're presenting to the Commission will result in MPS and L&P as stand-alone entities existing at an investment grade level?

A. I -- once again, I never have come out and said that they would be an investment grade credit rating. I --

Q. That wasn't my question. My question was, was it your intent that your recommendation would result in MPS and L&P as stand-alone entities existing at an investment grade level?

A. No, that was never my intent to try to evaluate that.

Q. Thank you.

Now, you agree with me, do you not, that the Commission has jurisdiction over Aquila's regulated operations in Missouri; is that right?

A. Yes.

Q. And we talked about those being hard assets in the ground?

A. Yes.

Q. And you said you had some knowledge with those; is that true?

A. Yes.

Q. Would you agree that to the extent possible, the Commission should exclude the effects of Aquila's other investments and other business undertakings in determining a return in this case for these two operating divisions?

A. Exclude from what? I'm sorry. You'll have to give me some clarification, please.

Q. Do you believe that the Commission, to the extent possible, should exclude the effects of Aquila's other undertakings, other investments, nonregulated operations and what have you, in determining a return in this case for the MPS and L&P operating divisions?

A. I believe the Commission should adopt a capital structure that reflects how UtiliCorp has historically been financed, which --

Q. That wasn't my question.

A. -- was not including the nonregulated operations.

Q. Now, that wasn't my question. My question was, do you think that the Commission should exclude the effects of Aquila's other investments and other business undertakings in determining a return in this case for the operating divisions?

A. Sure.

Q. If you turn to your Surrebuttal Testimony, please, page 21, and you have the question there on line 4, Aren't you trying to determine what the cost of capital would be for MPS and L&P if they weren't part of Aquila?

A. Yes.

Q. Answer, Yes.

And that's consistent with what you've just said?

A. Yes, it is.
Q. Okay. Now, if you'd turn to your Rebuttal Testimony, please, and turn to page 4.
A. Yes.
Q. There at lines 12 through 14 in response to a question you state, It is important to match the capital structure components with their embedded costs as of the same date because they are closely related; otherwise, there is a mismatch of the cost and the capital structure components.
Is that your testimony?
A. Yes, it is.
Q. And is that still your testimony today?
A. Yes, it is.
Q. And would you agree with me that Aquila, the corporation, has assets located in many states?
A. Yes. Seven to be exact, I believe.
Q. And would you agree that Aquila, the corporation, has nonregulated businesses?
A. There are some that they're winding down, that's correct, and I think one remaining international operation.
Q. Notwithstanding those facts, that it has businesses in other states and it has nonregulated operations, you are suggesting to the Commission that it

utilize the corporation -- the corporate capital structure for rate-making purposes in this case; isn't that true?

A. That's correct.

Q. Let me ask you this, Mr. Murray, what have you done to identify the capital structure for MPS that provides utility service to the MPS customers?

A. MPS and L&P don't have a capital structure so there's nothing to do to identify that. It's a -- it's been called an allocated capital structure by the company, which was based on a hypothetical study done in 1988.

And since that time, there's been the representation given that there's some -- an actual tangible capital structure there when even Aquila's own witness, Mr. John Reed, indicates that divisional capital structures are not discernible. It's not a reflection of reality.

Q. So the answer to the question is you haven't done anything to identify the capital structure for MPS that provides service to the MPS ratepayers; isn't that true?

A. Because capital structure doesn't exist.

Q. So you haven't done anything to attempt to identify it?

A. Exactly.

Q. And if I ask you the same question about the L&P operations, would your answer be the same?

A. Yes.

Q. And I think you indicated you have some knowledge of Aquila's assigned capital process?

A. Yes, I do.

Q. And has that not been the subject of some prior Commission decisions?

A. Probably since 1988, I believe so, that's correct.

Q. Do you know whether or not the Staff, the Commission Staff, has ever audited or attempted to verify that the capital which Aquila has assigned to MPS was, in fact, used or not used to build the assets that provide utility service to those customers, the MPS customers?

A. Can you please define audit or verify?

Q. Well, you can use your own definition of that. Have you done anything to substantiate that?

A. The numbers just don't add up as far as my -- you know, my review. And based on comments made by Aquila personnel in the most recent collateralization case, that more equity is allocated to the nonregulated and less equity is allocated to the regulated, it's only natural and logical to understand that if that's the case, that the equity ratios that are allocated to the regulated would be less than the consolidated capital structure.

So I have tried to verify -- you know, I've tried to understand the process and the process just doesn't add up. It's fuzzy to me.

Q. What have you done to verify that the capital which Aquila has assigned to MPS was, in fact, used or not used to build the assets to provide utility service to MPS customers?

A. The only thing I'm aware of as far as -- and you have investments that are incurring in these properties I'm sure for quite some time. But I'm aware that in 1980 there was an equity ratio ruled on in that case of 27.5 percent equity.

Q. Well, that wasn't my question. My question was -- you said you tried to verify this. And my question is, what did you do to try to verify that the capital which Aquila has assigned to MPS was, in fact, used or not used to build the assets that provide service to the MPS customers?

A. Well, I've looked at the fact that it's been -- it's been presented that this -- is the allocated capital structure is the actual capital structure that -- that supports the assets of MoPub and St. Joe.

Q. I'm not asking you what's been presented. I'm asking you what you have done to verify that.

A. I've reviewed what's been presented and I don't agree with it.

Q. And you don't agree with it?

A. No.

Q. And what have you reviewed?

A. I've reviewed the business allocation procedure, I've reviewed the testimony that contradicts itself from the company itself. And, like I said, the numbers don't just add up from a financial theory standpoint. It doesn't make sense. Now, have I written a report on this other than testimony? No.

Q. Well, that was going to be my next question. So since you don't think it makes any sense, do you know whether or not the Staff has ever recommended changes to Aquila's allocation method so that the cost of capital of MPS would more accurately reflect the cost of providing service to Missouri ratepayers?

A. No. Because we recommend the consolidated capital structure. There wouldn't really be a purpose for us to do that.

Q. Isn't it a fact that in Case ER-93-337 this Commission adopted the assigned capital structure for rate-making purposes?

A. That's correct. And there's two cases where they adopted the consolidated that were fully litigated, a '97 case and the 1990 case.

Q. Are you saying that the ER-93-337 wasn't fully litigated?

A. That's been my understanding all along.

Q. Has somebody told you that?
A. That's -- I believe so.
Q. Who told you that?
A. It's been subject to testimony for quite some time.
Q. Who told you that that case wasn't fully litigated?
A. I believe it was when I was reviewing the previous Staff consultant's testimony, Stephen Hill in the 1997 case. And Bob Schallenberg indicated that -- whenever I was discussing something with him about it, that there was a hang-up on one specific issue that --
Q. Are either of those people lawyers, Bob Schallenberg or Stephen Hill? Who's Stephen Hill?
A. Last time -- he's a consultant the Staff has hired. Last time we hired him was back in '97, which was a MoPub case.
Q. You hired him in '97 and he told you the '93 case wasn't fully litigated?
A. Yeah. That was indicated in his testimony. I didn't see anything to dispute that.
Q. Have you read the decisions in the 93-337 case?
A. Not the full decisions.
Q. How many decisions are there, do you know?

A. I don't know.

Q. And so when you say you haven't read the full decisions, what have you read? What parts of the decisions have you read?

A. The rate of return report and order. I've seen that portion of it.

Q. Have you read the portion of the orders that pertain to capital structure?

A. That includes the rate of return capital structure.

MR. SWEARENGEN: Could I approach the witness?

JUDGE JONES: Yes, you may.

BY MR. SWEARENGEN:

Q. I'm going to hand you a portion of a Report and Order in ER-90-337 that concerns rate of return, capital structure. You say you're familiar with that. Could you read into the record the material that I've bracketed here on page 17?

A. Sure. In comparing Public Counsel's proposed capital structure and MoPub's proposal, the Commission finds that MoPub's divisional capital structure is the most appropriate. MoPub's divisional capital structure is testable, understandable, based on public facts and material, has been in continuous operation for more than five years and has been subjected to substantial regulatory review.

MoPub's capital structure is reproducible in that all the material assumptions and data involved in its formation are either published, distributed to regulatory authorities or otherwise publicly available.

Also, MoPub's booked capital structure is reasonable due to its continuity. Modifications are made only to reflect year-to-year historical development. It is not as subject to manipulation as Public Counsel's hypothetical capital structure.

Furthermore, Public Counsel's hypothetical capital structure cannot reflect the history of activity within a utility nor the particular risk of that utility as does MoPub's booked capital structure. Thus, the Commission finds that the use of Public Counsel's proposed capital structure is not appropriate in this case.

Q. Now, you said you read that decision previously; is that true?

A. Yes.

MR. SWEARENGEN: May I approach the witness again, please?

JUDGE JONES: Yes.

BY MR. SWEARENGEN:

Q. What's the date of that decision? Do you know offhand?

A. June 18th, 1993.

Q. Okay. Thank you.

Now, I'm going to hand you another decision in that same case dated April 4, 1997, almost four years later, same case, and ask you to read the bracketed material beginning on page 38 concerning return on equity, capital structure. Start there and read over to the end of that capital structure paragraph, please.

A. Okay. This is Report and Order on remand in Case No. ER-93-337 issued April 4th, 1997.

Here's the reading: Because MoPub must raise capital through UtiliCorp, the use of UtiliCorp's consolidated capital structure may be a valid approach. However, this is not the best approach for this case because UtiliCorp's comprised of both operating utility divisions and unregulated subsidiaries and its capital structure -- excuse me, its capital structure reflects that mix.

Use of MoPub's assigned capital structure will help insulate it to some extent from UtiliCorp's unregulated subsidiaries. And the assigned structure is actually analogous to the capital structures of comparable electric utilities.

Q. Is that the end of that discussion?

A. No. I have one more paragraph.

Q. Thank you.

A. Although the capital structures proposed by MoPub and Public Counsel -- excuse me, Public Counsel are substantially the same, the Commission determines that use of MoPub's assigned capital structure is warranted.

This structure was assigned to MoPub several years prior to this case based upon a comprehensive system of capital structure allocation by UtiliCorp in conformity with Securities Exchange Commission requirements and generally accepted accounting principles. Use of it will allow year-to-year continuity and permit easier period-to-period comparisons.

Finally, the Commission determines that in this case it will not impose a different capital structure on a utility where the management of the company has chosen an appropriate capital structure.

That's it.

Q. Now, once again, what's the date of that decision?

A. Date of that is it was issued on April 4th, '97; effective date April 15th, 1997.

Q. Thank you.

Now, how many years have you been with the Commission?

A. Going on four years in June.

Q. And you're aware, I assume, of cases that took place prior to that time, including this one that we just discussed?

A. I'm aware of those cases.

Q. Are you aware of any rate case before this Commission that lasted over four years?

A. I don't know the details behind that case so I -- as far as if that rate case lasted that long?

Q. Well, you just said the first order was issued --

A. It was remanded. I'm not an attorney --

Q. I understand that.

A. -- so you're asking me questions that --

Q. Would you agree with me the first order was issued in June of 1993? I think we've established that. And the last one you read from was in April '97?

A. It was remanded, yes.

Q. And you still think that case wasn't fully litigated. Is that your testimony?

A. That's in my testimony.

Q. That's based on something somebody named Stephen Hill told you?

A. I believe that's his name, and I believe that's correct.

Q. Okay. Back to your recommendation for a capital structure in this case, make sure I've got the numbers right. Is it 35.31 percent common? Is that what you're proposing?

A. That's correct.

Q. And you've got a little piece of short-term debt, .38 percent; is that correct?

A. That's correct.

Q. And 64.31 percent long-term debt?

A. That sounds correct.

Q. Okay. Are you familiar with the term "investment grade bond"?

A. Yes, I am.

Q. And would you agree with me that for purposes of this case, Aquila has agreed that the cost of debt should be set at a level not to exceed the Standard and Poor rate for a triple B rated bond?

A. I'm aware of that commitment.

Q. And is that the lowest investment grade bond, a triple -- a Standard and Poor triple B bond?

A. A triple B minus actually is the lowest.

Q. And does Aquila currently have that rating --

A. No.

Q. -- a triple B rating?

Would you agree that if the bond rating of a company declines, you would expect that company's cost to borrow to increase?

A. Yes.

Q. And would you agree that the Standard and Poor's guideline for a triple B utility of average risk is 45 percent debt and 55 percent common equity?

A. Are you referring to the guidelines --

Q. Yes.

A. -- from this?

I want to say it was 47 to 55 not 45 to 55, but I could verify that.

The financial target for a business position of five for a triple B rated company is 47 to 55.

Q. And what's a business position five? What's that mean?

A. Basically you have business profiles from 1 to 10, 1 being the least risky, 10 being the most risky. Whenever you have a business profile that indicates less risk, the financial ratios, metrics do not have to be as solid, if you will, if that -- as far as the financial health in order to have, say, the same credit rating as a company with a business profile of five.

They have some more business risk so they need to have, say, for instance, more equity in their capital structure to -- to compensate for that additional risk in order to have the same credit rating.

And a company with a business profile of 1, 2

3 -- I don't see many with a 1, but 2 and 3 usually are water companies. A 4 is probably a fully regulated electric utility. You get to 5 and 6 and you're looking at vertically integrated regulated utilities with some -- some nonregulated.

Aquila when -- the nonregulated Aquila merchant operation business profile I believe was a 7, so when you get into energy marketing and trading, wholesale power, tolling agreements, etc., you're looking in the 7, 8 range. And that's how that -- how that's measured.

Q. Okay. Thank you.

You did say though that the -- back to the S&P guidelines for a triple B utility of average risk, the common equity ratio, the guideline is 55 percent?

A. Yes. The benchmark is 47 to 55.

Q. 47 to 55 on common; is that right?

A. No. This is total debt to total capital.

Q. Okay. There's a range. Is that what you're saying?

A. Yes. For triple B. This is not an exact science by any means. And these targets, you know, a lot of times aren't even met to achieve a certain credit rating.

Q. Your comparable companies, what document would I look at in your testimony that would show me the common equity ratios of your comparable companies?

A. Actually, I think we were just referring to them. Something about 25 percent for DPL and DQE. That is Schedule 20 in column 1.

Q. Schedule 20 to your Direct Testimony?

A. Direct Testimony, column 1.

Q. Schedule 20, column 1. And how many of those companies fall into this Standard and Poor's guideline range that you were just talking about?

A. It's interesting, there's only one. And actually that company is an A-rated company. You actually have NSTAR, which is an A-rated company, that has 37.8 percent common equity total capital. So I'm sure that falls even further outside the range that are normally required for -- or I wouldn't say required, but that's the target for an A-rated utility with, say, a business position of five.

So that just illustrates more that this is more of an art than it is a science in assessing the creditworthiness because these benchmarks tend not to be met by some of these companies.

Q. You've got two in there that we talked about earlier that I think you agreed probably don't belong in your group. And that's DPL, Inc. and DQE; is that true?

A. I don't think we agreed that they don't belong in my group, but those -- you know, those -- they had triple

B credit rating at the time and, once again, those fell out of the guidelines that are indicated by Standard and Poor's in their financial targets.

Q. How much is DPL, Inc. out of the guideline?

A. Over 20 percent.

Q. And how about DQE? How much is it out of the guideline?

A. Over 20 percent.

Q. Would you agree that the lower the interest coverage, the greater the financial risk?

A. Holding all things equal, yes.

Q. And holding all things equal, would you agree that the greater the financial risk, the higher the cost of the common stock?

A. Yes.

Q. Is it true that a higher interest coverage indicates greater security to the investor and suggests to the investor that he will receive his anticipated interest payments?

A. Holding business risk equal once again, yes.

Q. Do you still have Schedule 20 there in front of you?

A. Yes, I do.

Q. And what does column 3 show?

A. Column 3 shows pre-tax interest coverage ratios for my comparable companies.

Q. And the average is 2.65 times; is that true?

A. That's correct.

Q. And then if you turn to the next schedule, I believe, Schedule 21 --

A. Yes.

Q. -- do you show there what your recommended proposed interest coverage will be for Aquila?

A. Yes. With many assumptions, I have calculated it a pre-tax interest coverage ratio there.

Q. Is that in the third column on that page under the 9.64 percentage?

A. Well, there's actually a range. If you go down to item 8, it shows the pre-tax -- with many assumptions, it shows the pre-tax interest coverage ratio of 2.11 for 8.64, 2.17 for 9.14, 2.23 for 9.64.

Q. And those interest coverage figures that you just read into the record correspond to the range of your proposed return on equity in this case, 8.64 to 9.64; is that right?

A. That's correct.

Q. So on the high end of your recommended ROE range, the 9.64, the proposed interest coverage is only 2.23 times; is that right?

A. That's correct. And I did -- as I explained in my testimony, I still have many reservations from drawing too much of an inference from -- from this test of reasonableness because of the fact that Aquila's credit ratings are a result of its consolidated operations; therefore, the credit quality of the debt that is assigned to MoPub and St. Joe is a function of the nonregulated operations of Aquila and also Aquila's leveraged capital structure, which is all I'm trying to reflect in my recommendation here.

Since the debt costs are what they are and what they're -- what they're assigned to MoPub and St. Joe, it's only natural to go ahead and use the capital structure that is a function of that credit rating and the costs associated with it.

Q. With your recommended capital structure, did you calculate what return on common stock equity would have produced a pre-tax coverage equal to the average of your comparable companies, which you said was 2.65 times?

A. No. That doesn't drive my recommendation.

Q. Did you make that calculation?

A. No.

Q. Is that a hard calculation to make?

A. I've never made it. I don't know, you know, if -- probably have to do some algebra.

Q. You can't do it on the witness stand this

afternoon?
A. I could do it for you later. I really don't feel like doing it right here.
Q. Let me ask you this. Would 14.16 percent return on common stock equity sound like a number that might make that turn out to be 2.65 times?
A. You'd have to show me the calculations.
Q. Okay. Could you make that calculation while we're on recess?
A. If you have the calculations, I mean, I can review your calculation because I wouldn't want to confuse our methodologies here.
Q. You didn't do this calculation, did you?
A. No. I said it's not something -- pre-tax interest coverage -- a desired pre-tax interest coverage ratio calculation is not driving my recommendation. It's the other way around.
I come up with a recommendation, I use pre-tax interest coverage ratio to test the reasonableness. As far as I know, it's never been a matter of pre-tax interest -- a desired pre-tax interest coverage ratio driving what a recommendation should be.
Q. And you said you did it to test the reasonableness, and that's the essence of my question. Did you calculate what return on common stock equity would have

produced a pre-tax coverage equal to the average of your comparable companies, which you said was 2.65 times?

A. No.

Q. And don't you think you should have done that to test the reasonableness of it?

A. No.

Q. Why not?

A. Because I looked at -- I evaluated the current interest rate environment, I looked at the growth rates in my DCF model, I looked at the dividend yields in my DCF model, I evaluated all six of my comparable companies. And I realized that some of those comparable companies had some problems and I took that into consideration when I made my recommendation. I calculat--

Q. How did you take that into consideration when you made your recommendation, the fact that some of your comparable companies had problems?

A. If you want to take a look with me, I'll explain it to you.

Q. Yeah. I'd love to. First of all, what companies are you talking about that have problems?

A. Well, there's obviously volatile growth rates because it's the nature of the industry right now, unfortunately.

Q. Which companies in your comparable companies had problems?

A. Well, let -- as soon as I turn to it, I can just start going through some of this with you.

Q. Okay.

A. Okay. If you turn to Schedule 14.

Q. And that's to your Direct Testimony?

A. Yes.

Q. Okay. Which of your comparable companies listed there -- and you have all six of them -- are having problems?

A. And when I say "problems," I'm referring to the fact that their growth rates are differing as far as historical and projected. You've already pointed out some things about DPL and DQE with their negative growth rates and historical growth rates.

And one of the things that happens when a company has a negative historical growth rate, a lot of times their near term projected growth rate will be higher than what is actually sustainable.

I actually discussed this in the last Empire rate case when they had an anomalous year -- because of the fact that Value Line has a projected earnings per share five years out -- three to five years out, that they expect them to return back to a normal level, but because they had an anomalous year, their base year to use to calculate that projected compound growth rate is going to be lower than it normally would be so an analyst has to take this into consideration.

Q. You're talking about the Empire District Electric Company?

A. I'm explaining what has to be taken into consideration.

Q. Well, are you talking about the Empire District Electric Company?

A. I'm using it as an example to explain what has to be taken into consideration when you look at growth rates.

Q. That's not one of your comparable companies though?

A. No. I'm using an example to explain here --

Q. That's fine.

A. -- as to why you have to take these things into consideration.

Q. I just wanted to make sure that that wasn't being substituted here. Go ahead.

A. No, it's just an example. I'm just trying to help explain.

So if -- when you look at the growth rates within -- you know, within my comparable groups there, you look at some of the average historical and projected. For

DPL and DQE, as you pointed out, you know, there are some issues there, but I'm not going to exclude them. I have confidence enough in myself to be able to sort through this information and come up with a reasonable recommendation.

And for the average historical and projected growth of DPL and DQE, you're right, the average historical growth and projected growth is 1.5 for DPL, for DQE it's negative 1.01.

Well, if you look at a company like Cleco and Hawaiian Electric, which is one of more captive electric utilities just because of the nature of the fact that it's on an island, they have very little growth.

And that's -- that's not -- that's not surprising to me because the growth for a electric utility is a lot of times based on what they call organic growth, which is growth and demand for electricity, which, you know, may not be growing as high as at one time because of energy efficiency issues, could be growth in customers within -- within their jurisdiction. So I gave some weight to that. I also gave some weight to NSTAR because NSTAR looks like it had historical and projected growth rates that were, you know, fairly -- you know, fairly similar.

So I looked at all that and took that in consideration. And -- and as you can see, my proposed range of growth was, you know, 10 basis points below my highest average historical and projected, which was NSTAR. 3.1 gives some weight do Hawaiian Electric. And then if you go to Schedule 16 there, you'll see that as far as my column 5, my -- the high end of my recommendation is actually higher than the overall results that I came up for any of my companies, which was 9.48 for Cleco. The high end of my range is 9.64.

So, once again, I'm looking at NSTAR, I -- I looked at some of these results and decided, you know, I need to analyze this, just like Dr. Murry calculated several DCF calculations with just the dividend growth. And he was coming up with absurd results, 6, 7 percent. I mean, you can make these calculations and you can look at them. It doesn't mean you're going to necessarily go with that recommendation.

Q. I want to take you back to your statement you made earlier that some of these companies have problems and you never really defined what you meant by problems, but you referenced specifically DPL, Inc. and DQE, Inc. Are any of the other companies in your proxy group -- any of the remaining four companies problem companies from your standpoint?

A. No. And when I say "problems," I'm saying that there was some things I looked at as far as their growth rates. I had to recognize that there was some things going on there with the negative historical and -- and the -- you know, the positive forward-looking growth and weighing my decision on what -- what is reasonable to recommend in this case.

Q. So when you said problems, other than DQE and DPL, Inc. you didn't really mean that the companies had problems?

A. I just meant that it presented problems with my analysis, that I had to --

Q. Okay.

A. -- if I can say, I had to use a little judgment here.

Q. Let me ask you this. Would you agree that if there is an increase in the rate of inflation, it is likely that the Federal Reserve will increase the level of interest rates?

A. Well, that depends to be -- if the economy starts to pick up and the Federal Reserve will, you know, eventually act. They've made some unprecedented announcements that they do not intend to raise their federal funds rate for any -- any time soon.

Q. What if there's an increase in the rate of inflation? What do you think the Federal Reserve will do?

A. Your guess is as good as mine on that. I mean, that's -- analysts are trying to figure that out all the time. I don't know.

Q. What normally happens if there's an increase in the rate of inflation with respect to what the Federal Reserve does in terms of the level of interest rates?

A. Well, if it's a sustainable amount of inflation, they may raise the fed funds rate, but they have to weigh a lot of factors -- more factors than I can even try to get into here. And I don't know.

Q. If you turn to your Direct Testimony, Schedule 6, there you list several economic forecasts; isn't that true?

A. Yes.

Q. And what does the Value Line Investment Survey indicate that the inflation rate was in 2003?

A. 1.9.

Q. And what does it say the inflation rate will be in 2004?

A. 2.

Q. 2 percent?

A. 2 percent. Sorry.

Q. And what does it say the inflation rate will be in 2005?

A. 2.1 percent.

Q. And would that indicate to you that analysts expect inflation to increase?