A. Yes. And that would be reflected in my DCF model.

Q. It will be reflected in your DCF model or is reflected in your --

A. It is.

Q. Okay. And how did you account for that in your DCF analysis?

A. I'm trying to measure investor expectations. And obviously investors review all this financial information when determining whether or not a specific security is attractive just as whenever dividends -- whenever double taxation of dividends was decided to, you know, start ratcheting that down to a point where it was down towards a capital gains level, utilities stock prices went up, they take that in consideration.

Take in consideration the fact that they cannot get as an attractive return on fixed interest rate investments because the level of interest rates are lower and that results in -- in investors being attracted towards equities.

Q. Now, you did a CAPM analysis as well; is that true?

A. Yes.

Q. Did you account for this expectation of increasing interest rates in the future in your CAPM analysis?

A. The -- the yield on the 30 -- and this is going to be a roundabout answer, you're going to have to excuse me. The yield on a 30-year --

Q. We haven't had any of those today, have we?

A. The yield on a 30-year treasury, the interest to yield to maturity for that security, that is an indicator of investors' expectations on what they think interest rates will do. So that does take into consideration inflation. It's not easy to come up with just -- this is not something that's -- like I said, it's more of an art than it is science.

Q. Are bonds less risky investments than the common stocks of the same company?

A. Yes.

Q. Are you familiar with the textbook Principles of Public Utility Rates by James Bonbright?

A. I believe Dr. Murry cited that. I just -- I'm familiar with his quotation.

Q. Have you ever looked at that book yourself?

A. No.

Q. There's a statement I think that Dr. Murry indicated that appears on page 308 of that textbook to this effect, Some analysts and commissions base their overall estimate on what they regard as a typical objective or ideal capital structure without regard to the actual capitalization of the company under review.

Are you familiar with that concept?

A. If you can refer me, I want to take a, you know, look specifically at his quote.

Q. I may be able to do that.

MR. SWEARENGEN: Could we have just a minute here?

JUDGE JONES: Yes.

MR. SWEARENGEN: Do you want to take a short recess?

JUDGE JONES: Is it going to take long for you to find what you need?

MR. SWEARENGEN: I've got it.

JUDGE JONES: You've got it, so we don't need to take a recess.

MR. SWEARENGEN: I thought maybe the reporter was getting tired.

May I approach the witness?

JUDGE JONES: Yes, you may.

MR. SWEARENGEN: I've got a copy.

BY MR. SWEARENGEN:

Q. For the record, Mr. Murray, I've handed you what I believe to be that portion of the text that we were just discussing that contains that statement.

A. Yes.

Q. My question is, do you agree with that statement?

A. You're referring to the statement, Some analysts and commissions base their overall estimate on what they regard as a typical objective or ideal capital structure?

That's the statement that you're referring to specifically --

Q. Yes, sir.

A. -- that's highlighted?

I agree with that statement. I agree that there's many opinions on that as well as far as what's typical, what's objective, what's ideal.

Q. One thing -- and are you familiar with any analysts that have said that or adopted that principle?

A. Not to my knowledge. As far as anybody specifically, no.

Q. But you would agree with it, nonetheless?

A. I'd agree that there are many things that you can do to evaluate whether or not a capital structure is, you know, typical or objective.

Q. You agree with the concept regardless of who said it --

A. Yes.

Q. -- is that a fair statement?
A. Yes.
Q. And if I said it, you would agree with it. Is that a fair statement?
A. Well --
Q. The reason I ask that, is that it says, Some commissions base their overall estimates on what they regard as typical objective or ideal capital structure. And I thought you said this morning that you've never read any decisions of other state commissions on that topic, so that's why I ask that question.
A. Okay.
Q. Do you agree that there's a school of thought that adheres to the principle that the cost of capital and rate-making should be based on what is reasonable and prudent for a regulated utility?
A. Can you show me what you're referencing, once again?
Q. I can show you my outline of my questions and that's all. I have no text to refer you to. I'm just asking you as a general proposition, do you agree or disagree with that? You accepted the other statement with me saying it. I wanted to see if you'd accept this one.
A. Can you repeat it one more time, please?
Q. Do you agree that there is a school of thought

that adheres to the principle that the cost of capital in rate-making should be based on what is reasonable and prudent for a regulated utility?

A. I'm not sure what the basis of -- I'm trying to get some clarification here as far as the cost of capital for a reasonable and prudent utility. If we're talking about cost of capital, I agree.

Q. Okay. Thank you.

And did you calculate a cost of common stock equity for Aquila, Incorporated or for the Missouri regulated electric operations MPS and L&P?

A. MPS and L&P.

Q. Your capital structure, however, is the Aquila corporate capital structure; is that true?

A. That's MPS and L&P's capital structure.

Q. It's the Aquila corporate capital structure; isn't that true?

A. That's where the numbers came from, but it's MPS and L&P capital structure.

Q. So your testimony now is that MPS and L&P have a capital structure?

A. Yes. The actual consolidated capital structure of Aquila.

Q. If you turn to your Rebuttal Testimony, please, on page 8 starting on line 30. Do you have that in front of you?

A. Yes, I do.

Q. You make the statement, It is inappropriate to utilize Aquila's allocated capital structure for rate-making purposes in this case because, quite simply, Aquila does not have the equity to allocate to its divisions to maintain its target equity ratios.

Is that your testimony?

A. That's my testimony.

Q. Would you agree with me that large corporations, conglomerates, what have you, oftentimes allocate capital costs to various divisions in order to make capital budgeting decisions?

A. I'm familiar with the fact that there may be some discount rates that are determined. As far as the accounting capital cost, I'm not -- I can't speak to that.

Q. You don't know. Does Aquila allocate the capital costs of utility assets to the relevant operating utility divisions? Is that your understanding of what Aquila does?

A. I know they have assigned -- they have assign debt cost, and I guess that's the basis behind their allocated capital structure system.

Q. Let me ask you this. You read into the record a while ago excerpts from the Commission's decisions in

ER-93-37 that went into some detail about that, did you not?

A. Yes.

Q. Have you ever read any of the record or transcript of proceedings or the testimony that was filed in that case, ER-93-37?

A. I think I stated before I read just the part of the Report and Order that dealt with the rate of return and -- and capital structure.

Q. And did the Commission not in that case endorse the approach to the divisional capital structure that Aquila was supporting in that case?

A. In that case.

Q. They did. Right?

A. In that case.

Q. Let me ask you this. Is an allocation of capital to the operating division that uses the asset likely to be a closer estimate of the capital of that division then the sum of the capital for all of the divisions together?

A. Can you repeat the question, please?

Q. Sure. Is an allocation of capital to the operating division that uses the asset likely to be a closer estimate of the capital of that division then the sum of the capital for all of the divisions together?

A. I would say that the -- the capital is assigned or allocated to all the divisions of the consolidated operation of Aquila would -- would obviously have to add up to the consolidated equity ratio.

Q. Say that again.

A. Because of the fact -- especially considering the fact that Aquila is reverting back to a regulated -- domestic regulated utility. Their consolidated capital structure is going to be much more -- you know, it's going to be aligned with their regulated utilities because obviously if you have -- let's see, I think they have seven states that they operate in.

If there's seven divisions and they're maintaining that they're allocating 47.5 percent equity to those seven divisions and their consolidated equity ratio is 35 percent that shows on the annual report, you asked me if I've ever done any auditing of this, but the numbers just wouldn't add up.

Q. Let me ask you a question about that. I think earlier you said that Aquila has unregulated operations; isn't that true?

A. That they're winding down, that's correct.

Q. Yeah. And isn't all of that reflected on their financial statements and on the capital structure that you're proposing for use in this case?

A. Yes. But Mister -- I believe it's Mr. Empson indicated in the collateralization case that they actually allocate more equity to nonregulated. So it only stands to reason that the equity ratio that actually if the allocation process was done correctly, would be less than the consolidated because they're having to put more equity towards their nonregulated operations.

Q. Well, let's take you back to my question. Wouldn't you agree that an allocation of capital to the operating division that uses the asset be a closer estimate of the capital of that division than simply adding up the capital of all the divisions together?

A. No.

Q. You disagree with that?

A. Disagree.

Q. If one could demonstrate that the divisional capital structure is a more accurate estimate of the capital used to support the utility services of the division, would you use it as the capital structure for rate-making for that utility?

A. Repeat the question, please.

Q. If one could demonstrate that the divisional capital structure is a more accurate estimate of the capital used to support the utility services of the division, would you use it as the capital structure for rate-making for that utility?

A. That's a question I don't think that could ever be proved. I don't think anybody can prove that there's a capital structure that is actually supporting the division other than the consolidated capital structure of the utility.

Q. Well, didn't the Commission back in ER-93-37 conclude just the opposite?

A. Well, they concluded just the op-- what I'm referring to in the 1990 and 1997 case.

Q. Let's talk about 93-37 and those decisions that you read into the record. Don't you think there was something to support the Commission's decision in that regard?

A. The Commission weighed its evidence in that case.

Q. And do you think the facts they relied on were made up?

A. I'm saying it doesn't add up for me at this point in time. I do not see how this capital structure system has any support or evidence. And I've not seen any support or evidence submitted by the company to -- to convince me that this is the actual capital structure that supports the assets of MoPub and St. Joe.

Q. Well, what information would show you or convince you that the divisional capital structures of MPS and L&P were closer estimates of the actual capital used to serve those customers than the capital structure of Aquila, Inc.?

A. Spin them off as a subsidiary and have them issue their own debt.

Q. That's an event. I asked you what information would show you.

A. There isn't any information that would convince me.

Q. Okay. Okay. But there apparently was back in 1993; isn't that true?

A. I wasn't here in 1993.

Q. So you don't know?

A. The Commission weighed the evidence at the time. I was not the witness in 1993.

Q. Do you know who was?

A. Actually, I do not. May have been Jay Moore. I believe he was here at that time.

Q. Who's Jay Moore?

A. He used to be manager of the financial analysis department, but I don't know for sure.

Q. If Aquila allocated the nonregulated losses to nonregulated operations, would there be plenty of equity capital to finance MPS?

A. I'm sorry. Repeat the question again.

Q. If Aquila allocated the nonregulated losses to nonregulated operations, would there be plenty of equity capital to finance MPS?

A. At what level? When you say plenty of equity to finance MPS, at what level are you referring to?

Q. At any level.

A. They would have whatever equity -- when you say plenty of equity, obviously when I'm recommending a 35 percent equity ratio, individuals do not think that's plenty of equity. You know, there -- they have had to take write-downs to their equity ratio.

Q. What about at a 45 or 47 percent equity ratio?

A. I don't believe it's available to be allocated.

Q. If they allocated their nonregulated losses to nonregulated operations, you don't think that would be possible?

A. I haven't seen anything where they're separating the nonregulated losses and for that matter the nonregulated debt from the equity that was there before they -- Aquila's equity ratio started to decrease dramatically. I've not seen any separation.

Q. If you turn to page 11 of your Rebuttal Testimony, please. Are you there?

A. Yes.

Q. The answer that begins on line 9, I would have proposed to use a hypothetical capital structure. I would not accept the allocated capital structure proposed by Aquila because, as I have demonstrated, it is a fictitious capital structure.

That's your testimony?

A. Yes, it is.

Q. And what do you mean by the term "fictitious capital structure"?

A. It's not there. It's not tangible. Aquila's own witness, Mr. Reed, has indicated that divisional capital structures are not discernible.

I'm being attacked here and I -- there's a witness on the -- you know, with Aquila that has testimony that indicates a divisional capital structure is not discernible, which hence, means it's non-identifiable, its non-tangible, it's fictitious.

If Aquila wants to represent they want to use a hypothetical capital structure, that's fine, but with -- with trying to give the impression that there's actually some equity there at these divisions when we know that it's not because their current financial situation, I just -- I think that that's something that is -- is false and fictitious.

Q. Is "fictitious capital structure" a term that I would find in a college level textbook?

A. If you looked hard enough, you might. It's not --

Q. Have you ever seen it?

A. It's not a generally recognized financial term.

Q. Have you ever seen it?

A. In my college financial text? I don't recall.

Q. Okay. How does a fictitious capital structure, however you define that, differ from a hypothetical capital structure?

A. Like I said, a hypothetical I think is the same as a fictitious capital structure. A hypothetical capital structure is used primarily just to come up with a discount rate.

There's no attempt, when you're using a hypothetical capital structure, to give the representation that that capital is -- that mix of capital is actually there. It's just to determine what the discount rate to use is for -- you know, as a net present value calculation for a project, whether it's a go or not.

Q. Has this Commission ever used a hypothetical capital structure for purposes of setting rates?

A. St. Joseph Light & Power, I believe.

Q. Really?

A. I believe it was proposed. I recall that it was proposed. I don't know if it was accepted or if that was settled.

Q. Proposed by who?

A. Proposed by Staff.

Q. Staff proposed a hypothetical capital structure in a case involving St. Joseph Light & Power Company?

A. I believe that was the case.

Q. What case was that?

A. Before they got acquired by Aquila. I don't recall the exact case number.

Q. Was that the right thing to do in that case?

A. I -- Staff was -- that was their determination at the time. I don't know if I would have made the same determination or not.

Q. And why did they make that determination that a hypothetical capital structure should be used?

A. For whatever reason, they felt like it wasn't reasonable.

Q. What wasn't reasonable?

A. The capital structure.

Q. You mean the actual capital structure of the company?

A. The actual consolidated capital structure.

Q. Consolidated capital structure. What do you

mean by that with respect to St. Joe Light & Power consolidated capital structure?
A. Its actual capital structure that's on the books reported to the SEC.
Q. Have you read that case? Are you familiar with that case where the hypothetical capital structure was proposed by the Staff?
A. Not in detail.
Q. Okay. Well, what did the Commission decide in that case?
A. You know, I don't recall if they -- if they adopted that or not.
Q. If the purpose of all this is to determine an appropriate capital structure for rate-making purposes, what is the difference between a hypothetical capital structure and an allocated capital structure?
A. Well, I believe -- I believe there's some dispute on that. I think in the collateralization case there was, you know, some indication from the company that Staff was trying to make a distinction without a difference.
There is definitely a difference. A hypothetical capital structure is used when the capital structure is determined to be unreasonable, whether it's because it's not consistent with the company's historical capital structure or whether it's not consistent with

comparable companies, what have you. There's a decision to use a hypothetical capital structure.

Q. Is it a real capital structure, a hypothetical?

A. No. Hypothetical is not a real capital structure.

Q. So is it a fictitious capital structure?

A. It's just used to come up with a discount rate. No, there's no -- there's no representation that that capital is actually there.

Q. So if it's not real, it's fictitious. Right?

A. Exactly.

Q. Okay.

A. I mean --

Q. Hypothetical capital structure would fit your definition of a fictitious capital structure; is that true?

A. Yes. But the allocated capital structure that -- that Aquila uses for MoPub and St. Joe is a capital structure that -- that they have been giving -- trying to give this Commission that it's the actual capital structure that is the actual capital that capitalizes MoPub and St. Joe. And I do not agree with that.

Q. What did the Commission say about that back in 1993?

A. I think we've read that, but they've also had opinions that contradict that in 1990 and 1997.

Q. Did they ever issue an opinion that said what they said in '93 wasn't right, or did they just simply issue an opinion saying for purposes of rate-making in this case, we're going to go with the corporate capital structure?

A. I think they kept it within that case.

Q. Yeah.

MR. SWEARENGEN: Do you want to take a short break, Judge?

JUDGE JONES: No.

MR. SWEARENGEN: Do you want to keep plugging ahead?

JUDGE JONES: At least until 3:00.

MR. SWEARENGEN: I'll go get some more questions then.

BY MR. SWEARENGEN:

Q. Now, you've been wanting to talk all day about the DCF process. Is that a fair statement?

A. I'll say I wasn't wanting to talk at all today. And that's an inside joke.

Q. Okay.

A. But if you'd like to, I will.

Q. Let me ask you this. You mentioned earlier you've done a DCF analysis in this case and a CAPM -- you've gone through the CAPM process; is that true?

A. Yes.
Q. And is it fair to say that those are both theoretical processes or attempts to measure the returns required by investors?
A. Yes.
Q. And would you agree that those processes are based generally on the price of those equities, their projected future cash flows and their volatility?
A. I'd say the discounted cash flow is -- specifically addresses the prices of the stocks, the dividends associated with those stocks, potential growth rates for capital appreciation going forward, the capital asset pricing model doesn't necessarily involve the price of the stock.
It involves the beta, which is the measure of the volatility of the stock as it relates to the market added to some -- some interest rate which is usually a risk-free treasury with the beta times the market return to come up with an estimate. So that's not directly related to the price of stock as far as the CAPM.
Q. Would you turn to Schedule 16 to your Direct Testimony?
A. Yes.
Q. Is it on that schedule, Mr. Murray, that you set out your DCF estimated cost of common equity for your

six comparable companies?

A. Yes.

Q. And you came up with an estimated cost of common equity range of 8.64 percent to 9.4-- excuse me, 9.64 percent; is that correct?

A. That's correct.

Q. And I think you said earlier that you applied that result to the Aquila corporate capital structure which existed at the end of 2002?

A. Applied it to the corporate common equity ratio or common equity amount, that's correct.

Q. Right. Have you ever heard the term "company-specific DCF analysis"?

A. Yes, I have.

Q. And what is your understanding of the meaning of that term?

A. If -- and this hasn't been the case for Aquila in at least the last couple cases, but if -- if we have a Missouri utility that has -- that pays a dividend, it is, you know, predominately in the industry that we're trying to determine a cost of equity for, we will use the market information for that company specifically in order to arrive at a recommendation for, you know, the cost of common equity for that specific company such as Empire.

Q. Okay. Now, and you've done that in the past for companies? You haven't done it in this case for Aquila, I think you said; is that right?

A. That's correct.

Q. For MPS and L&P; is that right? You haven't done it for MPS and L&P?

A. No. It's impossible.

Q. But you have done it in the past for companies such as Empire you suggested?

A. I believe Empire is the only case that I've been able to do a company-specific analysis.

Q. Let me ask you this question. And I hate to keep taking you back to the Hope case, but I think I'm going to maybe one more time. How does a company-specific DCF analysis in and of itself meet the requirement of the Hope case of looking at the returns of comparable companies?

A. Well, it gives an idea as to what the cost of the common equity is for the company. And the most important thing for an investor to be assured of is that they're going to be able -- if they make an investment in the company, that the return they require, which is the cost of common equity, needs to be achieved by that company in order for them to make that investment attractive or worthwhile.

And so that ties directly into the Hope case in the fact that this would assure confidence in the financial integrity of the enterprise so as to maintain credit and attract capital, because we are recommending the allowed return based on the cost of capital, which, like I said, that -- that level has to be met in order for investors to be attracted to the security.

Q. Now, that's the second part of the Hope test that we've talked about, maintaining -- or assuring confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital.

But the first part of the Hope test is what I was really referring you to. And that says, The return to the equity owner should be commensurate with the returns on investments and other enterprises having corresponding risks.

And so my question is, when you do what you define as a company-specific DCF analysis, how does that in and of itself meet the Hope case requirement?

A. Well, like I said, there's been, you know, I think different readings and as you pointed out before, I'm not an attorney, but there's -- there's been many -- there's been a transition from looking at the earnings back in the 19-- like I said, 1940's or what have you where these models may not even have been coming into play.

These are models that are a result of financial research, financial types of break-throughs on how to evaluate the cost of capital. Actually, the original intent behind the dividend growth model was in order to determine what is a reasonable stock price, not actually the rate of return for a utility -- for a utility in the rate of return arena, but I know that there are still some analysts that do comparable earnings analysis.

I think the last Missouri-American case I -- there was an analysts that did the comparable earnings analysis. But for the most part every -- every case I've worked on, we all -- rate of return witnesses use cost of capital models to determine what is a fair rate of return.

Q. I think I understand what you're saying, but my question is, as far as you know, the Hope case is still the law; isn't that true? I know you're not a lawyer and I'm not trying to put you on the spot in that regard, but when you read those words, the standard -- the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks, how do you square that with a company-specific DCF analysis where you don't even look at --

A. Well --

Q. -- other enterprises with corresponding risks?

A. Let me -- let me back up to -- let's talk about when I did a company-specific DCF analysis. Now, that's not the only analysis I did to come up with the recommendation. We -- I specifically in the Empire case still looked at some comparable company cost of capital analysis to just test the reasonableness of that recommendation. So I did look at comparable companies and I looked at the cost of capital of those comparable companies to determine the reasonableness of that recommendation.

Q. So your understanding would be that -- I don't want to put words in your mouth, but I think what I'm hearing you say is that a company-specific DCF analysis in and of itself may not meet the Hope requirement, but if you do that and then go out and look at some comparable companies to test the result of your DCF analysis, that may meet the requirements of the Hope case?

A. If I was looking at the cost of capital of those other -- just like I said, just to test the reasonableness, it just gives an idea as to whether or not it's reasonable. I'm not saying that I would necessarily, excuse me, alter my recommendation. As long as my recommendation looked reasonable --

Q. Well, let's say hypothetically you did a company-specific DCF analysis and you came up with a recommended return on equity of let's just say 10 percent. And then you went out and you selected a group of truly comparable companies and you did a DCF analysis on each one of those companies and then averaged them together and the

average was 12 percent. What would that tell you about your company-specific DCF analysis that resulted in 10 percent?
A. Well, because of the fact that I did a company-specific DCF analysis, I would realize I did a very detailed analysis such as I did in Empire to have a very strong comfort level that that is the cost of capital to that company. And if -- if the cost of capital was higher for some of those comparable companies, there must be a reason for it.
Q. Well, wouldn't you try to look into it? I mean, if there was some reason, some problem with those companies, then maybe they really weren't comparable?
A. I'm not sure. If I knew -- if I knew the subject company well enough, which I obviously do any time I do a company-specific DCF analysis, I have a very -- I'll tell you, I have a fairly good comfort level that my cost of capital recommendation is reasonable already, but I can look at some of those just to get an idea. And unless there's something that's just totally out of whack, I'm not going to --
Q. Well, what I'm trying to get at is -- and I'm trying to figure out how things work here with the Staff and their return on equity recommendations. And I understand what the DCF-specific analysis is and I think you've explained that.

What I'm trying to find out is when you do that, you say you test the reasonableness of it. And I gave you an example where the comparables come out at 12 percent and you're at 10 and what do you do under that circumstance? Do you adjust your 10 upwards?

A. Like I said, it depends on how comfortable I am with how -- what's going on with Empire at the time -- I'm using Empire here because --

Q. Sure. That's fine

A. -- obviously that's one of the few companies that we can do this. And how comfortable I am with what's going on with the reason why their cost of capital is at a certain level. Obviously if there's nuances going on that are out of their control, I may take that into consideration. But, you know, for the most part if I'm comfortable with how I arrived at it, I'm not going to change it.

Q. You're not going to change it regardless of what the results are for your comparable companies?

A. Like I said, it just depends on what's going on with Empire at that time or whatever company at that time.

Q. What would cause you to change it based on a different result for your comparable companies?

A. Like I say, if there's an act of God that occurred that caused, you know, unbelievable loss to -- that's out of their control.

Q. To who?

A. To the utility company.

Q. Which one?

A. Just -- I thought we were using hypotheticals here.

Q. Well, that's fine.

MS. O'NEILL: Your Honor, at this point I think I'm going to object. I'm losing the relevance thread here. We've gone into hypotheticals on hypotheticals now and we're talking about an analysis that wasn't actually done in this case is my understanding.

MR. SWEARENGEN: If I could speak to that, I think the witness has placed a lot of weight on the DCF analysis and what I'm trying to do is relate that back to what I believe to be the required standards under the Hope case and I'm trying to find out the process that he goes through on that.

And that's I think certainly relevant to the Staff's recommendation in this case and their thinking as to what their obligations are in making a recommendation to this Commission.

JUDGE JONES: I tend to agree with you, but the hypotheticals are getting boring. It's difficult to follow when it just goes on and on and on.

MR. SWEARENGEN: It's a boring topic. I'll try to move along.

JUDGE JONES: Try to wrap it up.

With that, the objection's overruled.

MR. SWEARENGEN: Let me see if I can move on here.

BY MR. SWEARENGEN:

Q. Look at page 21 of your Surrebuttal Testimony, if you would, please.

A. Yes.

Q. There on lines 10 and 11 you say that your recommended growth rate resulted in your reasonable cost of common equity recommendation of 8.64 to 9.64 percent to apply to the regulated divisions of MPS and L&P; is that true?

A. Yes.

Q. And in this DCF analysis that you performed you used an estimated growth rate of 3.1 percent to 4.1 percent; is that true?

A. That's correct.

Q. And I think you said further down at page 21 to justify the reasonableness of that growth rate, you said you looked at the service area conditions for MPS and L&P; is that true?

A. Can you refer me to specific lines?
Q. Yes. Down in line 19, 20, and 21.
A. Yes.
Q. Now, the growth rate that you used in your DCF calculation, the 3.1 percent to 4.1 percent, was added to the yields of your comparable companies; isn't that true?
A. That's correct.
Q. Wouldn't you agree with me that the service area economics of Aquila, the MPS and the L&P service area economics, have no meaning or relevance to the DCF calculations for the other companies?
A. No. It just -- it gives the test of reasonableness as to what those growth rates -- it gives an indication as to what a regulated electric utility would be looking at as far as -- like I said, organic growth is the term I used before, which is -- you know, unfortunately, we don't have a lot of purely regulated electric utility companies out there.
Q. What you did was you took company-specific L&P, MPS information -- growth rate information and then added that to your comparable companies to get your number; is that true?
A. I didn't add that to my comparable companies. I was just kind of giving an idea of what would drive growth for a regulated electric utility. And that's, you know, the

demand for electricity obviously.

Q. At page 27 of your Surrebuttal Testimony at line 12, you talk about influential individuals. Do you recall that testimony?

A. Yes, I do.

Q. And you indicate that these people believe that because of high current stock market evaluations, equity returns would only be in the 6 to 8 percent range over the foreseeable future; is that right?

A. Can you refer me to specific lines again?

Q. I would refer you to line 18, I see an 8 percent there.

A. Line 18?

Q. Line 12 you talk about the influential individuals, 6 to 10 percent for the entire market down in line 23.

A. Okay.

Q. Is it your testimony that overall stock market valuations should determine the appropriate return on equity for a public utility?

A. Yes. That drives the cost of common equity.

Q. And what is the Dow Jones Industrial Average today, do you know, or what was it yesterday?

A. It's been right around the 10,500 level. I don't remember specifically.

Q. Was it at about the 7,500 level two years ago, three years ago, do you recall?
A. I don't recall the specifics. I know it was -- obviously went down after March 2000. The specific levels I don't recall.
Q. You don't recall when it was ever at 7,500?
A. I don't recall specific dates.
Q. Let me ask you this question. Turn to page 39 of your Surrebuttal Testimony. There, beginning on line 4 of page 39 you make this statement, The Staff of the Missouri Public Service Commission does not use allowed ROEs in other jurisdictions in order to recommend a fair and reasonable ROE for utility companies in Missouri; is that true?
A. Yes.
Q. And I think you testified this morning that at least you personally have never read any decisions from any other regulatory jurisdictions; isn't that true?
A. I don't make a habit of that.
Q. Is this a policy of the Commission Staff in a Commission rule someplace that you're aware of?
A. No.
Q. Do you know whether this policy of the Commission Staff has ever been adopted by the Commission through a Report and Order?

A. I'm not aware.

Q. Has this policy of the Commission Staff ever been reduced to writing?

A. I'm not aware.

Q. How do you know then that it's the policy of the Missouri Public Service Commission Staff?

A. Because I've worked in the financial analysis department for the last three years and I do know that each one of us in the department has not made -- that's not how we test the reasonableness of our allowed ROEs.

Q. And has someone told you that that's how the Commission Staff does business?

A. My bosses who I've been working under since I've been here.

Q. And who's that?

A. Ron Bible.

Q. And did he tell you that?

A. I don't know if he told me in those words, but we've discussed that that's not what -- we don't look at allowed ROEs or earned ROEs before we do our analysis to come up with our recommendation.

Q. Is it your testimony that what another state regulatory commission determines to be a fair return for a utility company is irrelevant?

A. It's -- it's not relevant to my cost of capital analysis as far as if -- if -- there's, you know, some parties that think that that's relevant and that's their position, but for -- I'm looking at market and economic data to look at the cost of capital.

And if I relied on past allowed ROEs or past earned ROEs, it would -- like I said, it would remain at a perpetually high level. It wouldn't reflect the updating economic conditions.

Q. And in looking at the cost of capital in this proceeding, are you not also making a recommendation to this Commission as an appropriate return for this company?

A. Yes.

Q. How do you square the policy of ignoring allowed ROEs in other jurisdictions with your earlier testimony about following the standards of the Hope case?

A. I think I've discussed this, you know, several times about the -- the fact that to attract capital and to maintain financial integrity. There are many things in the Hope case besides just comparable returns. And we've -- and, like I said, I've said that several times.

Q. So you can't square the two?

A. No, I can square the two. I said there are many things in the Hope and Bluefield case that talk about -- talks about comparable returns, but there's also discussions about the ability to attract capital and the ability to maintain financial integrity. And I have confidence that my recommendation will allow that.

Q. If you don't pay any attention to the comparable returns, how do you know that?

A. Because I'm allowing them to recover at least their cost of capital, if not higher than the cost of capital based on my review of current economic environment.

Q. But ignoring what other companies may be doing; is that true?

A. Like I said, I do not review what the allowed ROEs are or the earned ROEs are.

Q. You use the term I think on page 9 of your Surrebuttal Testimony -- with respect to capital structure, you use the term "clearly unsound."

A. I'm sorry. What line was that?

Q. Page 9, I think line 5.

A. Yes.

Q. Do you recall that?

A. Yes.

Q. What's an example of a clearly unsound capital structure, according to your use of that term?

A. A clearly unsound capital structure may be something that is a function of a capital structure that is not consistent with how a company has historically financed itself when it hasn't had to take write-downs or impairments or when it had -- it had regulated utility operations that it normally had, it was consistent with how it was financed in a period of time when they were not having to take large accounting losses. And that has been determined as sound by the company itself.

Q. At the bottom of page 40 of your Surrebuttal you ask the question, What has changed since the last rate case, ER-2001-672? And then you go ahead and provide an answer to that question.

What was the time period of that last rate case, do you recall?

A. I believe the update period was June 30th, 200-- or maybe the test year was June 30th, 2001. I believe it was supposed to be updated through 2002.

I do recall that there were some things going on at that time -- I think there was discussion as to the fact that I recommended a 48 percent equity ratio. And the reason for that was because that was the actual equity ratio of Aquila at that time.

And in actuality, that equity ratio was higher because Aquila had to issue -- they issued stock to re-acquire the 20 percent of the nonregulated activities that, you know, they didn't -- that they had spun off at one time. So their equity ratio, which was in their capital structure, which was identifiable, which was available to its operations, was a result of them re-acquiring nonregulated activities. But I still chose to recommend that capital structure.

Q. Now, let me make sure I understand. In the last rate case you were the Staff witness?

A. Yes, I was.

Q. And utilized the corporate capital structure like you're using in this case?

A. Yes, we've consistently done that.

Q. And the equity ratio at that time was 48 percent?

A. Which was way above what they usually have, but it was their actual capital structure.

Q. And what was the date of that?

A. The date of that capital structure?

Q. Yes.

A. I want to say the test year was June 30th, 2001. It was supposed to be updated through January 2002 because -- I think it was January 2002 because I recall that Aquila was having to re-acquire their 20 percent of nonregulated activities because that's right after Enron went bankrupt and credit rating agencies told them they needed hard assets, the utility operations to support their nonregulated activities.

Q. Now just about, what, two years later there's a lot less equity in the actual Aquila corporate capital structure. Correct?

A. Compared to that time, but not compared to historical capitalization levels.

Q. And does that have anything to do with the Missouri regulated operations, this change from 48 percent to 35 or 36 or whatever it is now, according to you?

A. No. It has to do with the nonregulated operations.

Q. Okay. Have rating agencies and equity analysts' views of utility securities changed over the period of time since the last rate case, ER-2001-672?

A. Rating agencies' view of what companies?

Q. Utility securities.

A. I mean, I think it just depends on what kind of utility.

Q. Give some examples.

A. I mean, if you're talking about a regulated electric utility that didn't get into nonregulated activities, they are not -- they're not -- we're not as concerned or we're not changing their outlook on those companies as much as they were the companies that got heavily involved in nonregulated activities that required much more liquidity, much more hard assets to support those operations, much more cash flow to support those operations.

They did a 180 on the companies, but that's because they didn't realize how much risk was -- at first how much risk was actually involved. There's a lot of risk involved in nonregulated activities.

Q. So there has been a change in that regard?

A. Yes. As far as some of the metrics.

Q. Are credit standards tougher since the last rate case or are they more lax, in your view?

A. For what type of companies?

Q. For utility companies.

A. Like I said, it matters what type of utility company. I would say that if it was a traditionally regulated utility company, that that's not what caused the change in the business environment for utility -- the utility industry. It's the nonregulated activities that changed the environment.

So obviously the companies that got involved in that, those are the companies that are facing some of the more significant changes in views as far as why their balance sheets are -- have deteriorated and why they need to have hard assets to support those types of operations. And obviously companies such as Aquila, you know, decided that's not possible for them.

Q. Let me ask you this. Are analysts focused more or less on earnings quality and regulatory risks now or then?

A. I think analysts and investors alike are actually, you know -- are embracing the -- you know, the back-to-basics approach because they realize that investing in companies that aren't protected by the regulated commissions, they have quite a bit of risk involved with them and they lose lots of money, you know, if things don't go right.

MR. SWEARENGEN: Do you want to break now? I may be able to wind this up real fast if I have a few minutes to --

JUDGE JONES: Do you have many more questions?

MR. SWEARENGEN: I do have a few, but I could probably shorten it if we can take a short recess.

JUDGE JONES: We'll recess until quarter after 3:00.

MR. SWEARENGEN: Thank you, Judge.

(A recess was taken.)

JUDGE JONES: Okay. We're going back on the record with cross-examination of David Murray.

BY MR. SWEARENGEN:

Q. Mr. Murray, I'm going to try to shorten this up a little bit so we can finish. I have some questions about Schedule 20 to your Direct Testimony, if you would get that out, please.

A. Yes.
Q. And on that document you show selected financial ratios for your comparable electric utility companies. Correct?
A. Yes.
Q. And the column No. 5 is 2003 Projected Return on Common Equity?
A. Yes.
Q. And it shows or suggests the projected return for your six comparable companies is 12.83 percent; is that true?
A. Yes.
Q. And the lowest of those companies is IDACORP, is that how you pronounce it?
A. Yes.
Q. At 4.5 percent --
A. Yes.
Q. -- projected return?
If you would eliminate IDACORP from that list, which is the extreme outlier on the low end, would you agree with me that the projected return for your comparable companies would be 14.5 percent?
A. I'll accept that.
Q. And, once again, how did the projected returns for your comparables compare to what you're actually

recommending for MPS and L&P in this case?
A. Once again, these are projected actual returns on common equity. And that's higher. I'm looking at the cost of common equity.
Q. That's higher than what you're recommending for --
A. For cost of common equity.
Q. Right. And then look at column 3 on that document, the Pre-tax Interest Coverage Ratio. And you show the average for your comparables to be 2.65 times, and I think we talked about that earlier. Once again, IDACORP is in there as 0. And if you eliminated IDACORP at 0, would the average be 3.18 percent? Would you accept that?
A. I'll accept that.
Q. And your recommendation for Aquila in this case for L&P and MPS is 2.25?
A. With many qualifications, that's correct.
Q. Turn to Schedule 19 to your Direct Testimony, which I think is a risk premium cost of equity estimate for your comparables.
A. Yes.
Q. If you look at column 3, am I correct in understanding that the risk premium cost of equity estimates for your comparables is 11.51 percent?
A. Yes.

Q. And that, again, compares to your recommended range in this case for L&P and MPS of 8.6 to 9.6; is that true?

A. Yes. And that's a test of reasonableness and is a model that gives the least amount of weight of any of our models.

Q. And then if you'd turn to Schedule 14, please, the document that shows historical and projected growth rates for your comparable companies.

A. Yes.

Q. What is column 4 intended to show?

A. It's intended to show the projected and three- to five-year earnings for shared growth rate as indicated by Value Line in their tariff sheets.

Q. And your average for the companies there is 1 percent; is that true?

A. Yes.

Q. And to get to that 1 percent growth rate, you've used two companies that have a 0 percent projected growth rate; is that true?

A. That's correct.

Q. And that's Cleco and is it Hawaiian --

A. No -- Hawaiian, that's correct.

Q. And then you've also used IDACORP in there, which has a minus 11 percent projected growth rate; is that true?

A. That's correct.

Q. And then over on column 1 of that document, your historical growth rates, you have two companies, DPL, Inc. and DQE, Inc., which we've talked about before. And they both have negative growth rates; isn't that true?

A. That's correct.

Q. And again you've got IDACORP in there and it's barely above 0 in terms of growth rate; is that true?

A. For historical, that's correct.

Q. And so the average is .11 percent?

A. For historical, that's correct.

Q. And you've averaged that column 1 with the column 4 of 1 percent to produce your result of the average growth rate of historical and projected growth rates of 1.86 percent shown in column 6; is that true?

A. You just indicated column 4 and column 1. Actually, I averaged column 5 and column 1 to come up with my average growth rates in column 6.

Q. Okay. And in column 5 the average projected growth rate is 3.1?

A. 3.61. And that's for all the estimated sources, column 2, 3 and 4.

Q. Based on these numbers that we're looking at on these schedules, is it fair to say that the companies that you have selected can be said to be under financial stress or financial difficulty?

A. I'd say there are a couple of companies in there that have had difficult times in the earnings here recently.

Q. And would it be fair to say you're using the financial results of these companies -- these unhealthy utilities to formulate your recommendation for MPS and L&P in this case?

A. I'd say I took into consideration what has happened to them financially whenever I was choosing my recommended range of growth of 3.1 to 4.1. If you look at the average historical and projected growth rate of 1.86, it's quite obvious that I decided that I didn't think that was reasonable and for that -- you know, for the very reason that I analyzed the companies and what's going on with some of these companies to determine what I think is reasonable in this case.

Q. Do you recall getting a data request from the company where you were asked whether or not, in your opinion, a regulatory body should base its allowed return on the performance of a comparable company in financial distress? Do you recall that question?

A. I believe I recall that data request.

Q. And do you recall that your reply was, It is

Mr. Murray's opinion that a regulatory body should base its allowed return on the comparable group of companies when a company-specific analysis cannot be performed?

A. That sounds correct.

MR. SWEARENGEN: Okay. That's all I have. Thank you.

THE WITNESS: Thank you.

JUDGE JONES: Thank you.

Will there be any redirect from Staff?

MR. MEYER: Very briefly, your Honor.

JUDGE JONES: Go right ahead.

REDIRECT EXAMINATION BY MR. MEYER:

Q. Mr. Murray, earlier there was discussion of the premise that Staff's recommended cost of capital in this case surely must have related to a write-down of the broader company. I think that was a reference perhaps made also by Dr. Murry on behalf of Aquila. Is that, in fact, something that informed Staff's recommended cost of capital?

A. No. My cost of capital recommendation is based on obviously looking at the capital structure as of December 31st, 2002. And although they are correct there were many write-downs because of impairments and restructuring charges, tolling agreement losses, prepaids, things of that nature, though -- the equity ratio did come down, but when -- the equity ratio as of December 31st, 2002