

Exhibit No.:

Issues: Cost of Capital

Witness: Samuel C. Hadaway

Sponsoring Party: Aquila Networks-MPS
& L&P

Case No.: ER-

Before the Public Service Commission
of the State of Missouri

Direct Testimony

of

Samuel C. Hadaway

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ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
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**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
DIRECT TESTIMONY OF SAMUAL C. HADAWAY
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
CASE NO. ER-_____**

1 **I. INTRODUCTION AND EXECUTIVE SUMMARY**

2 **Q. Please state your name, occupation, and business address.**

3 A. My name is Samuel C. Hadaway. I am a Principal in FINANCO, Inc., Financial
4 Analysis Consultants, 3520 Executive Center Drive, Austin, Texas 78731.

5 **Q. On whose behalf are you testifying?**

6 A. I am testifying on behalf of Aquila, Inc. ("Aquila" or "Company") in this
7 proceeding before the Missouri Public Service Commission ("Commission").

8 **Q. Please state your educational background and describe your professional
9 training and experience.**

10 A. I have an economics degree from Southern Methodist University and MBA and
11 Ph.D. degrees in finance from the University of Texas at Austin ("UT Austin"). I
12 am presently an adjunct professor in the McCombs School of Business at UT
13 Austin. I have taught economics and finance courses at several universities, and I
14 have conducted research and directed graduate students' writing in these areas. I
15 was previously Director of the Economic Research Division at the Public Utility
16 Commission of Texas ("PUC"), where I supervised the PUC finance, economics,
17 and accounting staff and served as the PUC's chief financial witness in electric
18 and telephone utility rate cases. In various utility conferences I have taught
19 courses on cost of capital, capital structure, utility financial condition, and cost
20 allocation and rate design methods. I have made presentations before the New

1 York Society of Security Analysts, the National Rate of Return Analysts Forum,
2 and various other professional and legislative groups. I have served on the board
3 of directors and as a vice president of the Financial Management Association.

4 A list of my publications and the testimony I have given before various
5 regulatory bodies and in state and federal courts is contained in my resume, which
6 is included as Appendix A.

7 **Q. What is the purpose of your testimony?**

8 A. The purpose of my testimony is to estimate the market required rate of return on
9 equity ("ROE") for Aquila's Missouri Public Service and St. Joseph Light &
10 Power Missouri operating divisions ("MPS/LP") and to present and support the
11 requested capital structure and overall rates of return for the operating divisions.

12 **Q. Please outline and describe the testimony you will present.**

13 A. My testimony is divided into six sections. Following this introduction, in Section
14 II, I present and explain the requested capital structure and overall rates of return
15 for MPS/LP. In Section III, I discuss the concept of financial integrity and
16 explain why it is a key element in the regulatory process. In Section IV, I review
17 various methods for estimating the cost of equity capital. In this section, I discuss
18 the discounted cash flow ("DCF") model as well as risk premium methods and
19 other approaches often used to estimate the cost of capital. In Section V, I review
20 general capital market costs and conditions and discuss recent developments in
21 the electric utility industry that affect the cost of capital. In Section VI, I present
22 the details of my cost of equity studies and provide a summary table of my ROE
23 results.

1 **Q. Please summarize your cost of equity studies and state your overall rate of**
2 **return recommendation.**

3 A. First, my recommendation is premised upon the fair rate of return principles
4 established by the U.S. Supreme Court in *Federal Power Commission v. Hope*
5 *Natural Gas Company*, 320 US 591, 603 (1944) and *Blue field Waterworks v.*
6 *Public Service Commission*, 262 US 679, 693 (1923). That is to say, the return
7 authorized a utility by a regulatory body, such as the Commission, should be
8 commensurate with returns on investments in other enterprises having
9 corresponding risks. The return should also be sufficient to assure confidence in
10 the financial integrity of the utility so as to maintain its credit and to attract capital
11 so that it is able to properly discharge its public duties. Given these legal
12 principles, I have used several methods to determine an appropriate ROE and
13 overall rates of return for Aquila's Missouri operating divisions. These methods
14 and the underlying economic models are applied to an investment grade company
15 reference group of other similarly situated electric utilities.

16 **Q. Please explain.**

17 A. My ROE estimate is based on alternative versions of the DCF model and is
18 confirmed by my risk premium analysis and my review of projected interest rates
19 and economic conditions. The DCF model cannot be applied directly to Aquila
20 because the Company does not presently pay dividends to its shareholders and, in
21 any case, diverse "parent" Company financial data are not the appropriate basis
22 for setting the required rates of return for the MPS/LP operating divisions. For
23 this reason I apply the DCF model to a large sample reference group of

1 investment grade electric utilities selected from the *Value Line Investment Survey*.
2 To be included in my group, reference companies must have at least a BBB/Baa2
3 bond rating; they must derive at least 70 percent of revenues from regulated utility
4 sales; and they must have consistent financial records not affected by recent
5 mergers or restructuring, and a consistent dividend record with no recent dividend
6 cuts.

7 To test my DCF results, I also conduct a risk-premium analysis based on
8 ROEs allowed by state regulators relative to Moody's utility debt costs. In this
9 analysis, I also include S&P's forecasted higher interest rates for the coming year.
10 S&P forecasts that long-term government and corporate interest rates will
11 increase by an additional 40 to 60 basis points (0.40%-0.60%) during 2007.
12 Under current economic, market, and electric utility industry conditions, the
13 combination of the DCF and risk premium models, tempered by consensus
14 forecasts about future interest rates, provides an appropriate approach for
15 estimating MPS/LP's fair cost of equity capital.

16 **Q. Should the reference group ROE be applied directly to MPS/LP?**

17 A. No. The reference group is the appropriate starting point for estimating ROE, but
18 the reference group ROE is lower than the fair cost of equity for MPS/LP. This is
19 so because MPS/LP faces a higher construction budget as a percentage of existing
20 plant and higher operating risks than the average company in the reference group;
21 MPS/LP is smaller than the reference group companies; and because uncertainties
22 about fuel and purchased power cost recovery will continue until the issues
23 associated with recovery mechanisms are resolved. Under these circumstances

1 the Commission should add an ROE increment or adjustment to the reference
2 group ROE to account for MPS/LP's higher risks.

3 **Q. Why do you use this approach?**

4 A. Again, as I have indicated and as I will discuss in more detail below, this
5 approach of using a comparable reference group of investment grade utilities and
6 adjusting for risk is consistent with the legal requirements of *Hope* and *Bluefield*
7 and it is the appropriate method for determining a fair rate of return on MPS/LP
8 equity capital. It is important to note that the risk adjustment is not related to
9 Aquila's previously weak financial condition that resulted from the Company's
10 financial losses and restructuring. MPS/LP's specific risks and the need for the
11 risk adjustment stem from the higher construction and operating requirements
12 they face.

13 **Q. Please explain.**

14 A. In the assessment of a fair rate of return for MPS/LP, I have evaluated the specific
15 circumstances of these operating divisions relative to my reference group of
16 investment grade utilities. The two key additional risk factors for MPS/LP are the
17 size of their expected capital expenditure programs in Missouri and the additional
18 operating risks they face. As shown in my Schedule SCH-1, page 1 of 3, MPS/LP
19 capital expenditures over the next six years are expected to equal about 93 percent
20 of their current net plant. For the average reference company, capital spending
21 for the next six years is expected to be 59 percent of net plant. MPS/LP's larger
22 construction program increases their financing and regulatory risks and therefore

1 should be reflected in a higher allowed rate of return. The Missouri expenditure
2 program is discussed more fully in Company witness Ivan Vancas' testimony.

3 **Q. Are there other risk factors for MPS/LP?**

4 A. Yes. Other less easily quantified risk factors also include MPS/LP's smaller size
5 and remaining uncertainties with respect to of fuel and purchased power
6 adjustment clause ("FAC") implementation in Missouri. Because this latter risk
7 has been mitigated somewhat by legislation recently enacted by the Missouri
8 legislature, I have not added a specific risk increment for this factor. However, at
9 the time of this testimony, it is uncertain how FAC issues will be resolved for
10 MPS/LP, and any fuel and purchased power cost recovery risk that remains
11 should be compensated by a higher ROE. In Schedule SCH-1, pages 2 and 3, I
12 have listed the status of fuel and purchased power adjustment clauses for each
13 reference company. That analysis shows that two-thirds of the companies have
14 adjustment clauses. Additionally, there is sound academic evidence to support a
15 small company risk premium. Considering all of this and to specifically reflect
16 the MPS/LP's larger construction program, I have adjusted the reference group
17 ROE estimate upward by 25 basis points, to 11.5 percent for MPS/LP.

18 **Q. What DCF ROE range is indicated by your analysis?**

19 A. My reference group analysis indicates a reasonable DCF ROE range of 11.0
20 percent to 11.4 percent. As I will explain in more detail later, results from the
21 traditional constant growth DCF model fail to meet basic checks of
22 reasonableness and, therefore, are not included in my recommended range.

23 **Q. Please explain.**

1 A. Currently, the traditional constant growth DCF model does not reasonably reflect
2 the market cost of equity because that model, as typically applied, depends on
3 historically low dividend yields and pessimistic analysts' growth forecasts. These
4 near-term circumstances do not reasonably reflect longer-term expectations for
5 higher capital costs. My risk premium analysis, which serves as a check of
6 reasonableness for the DCF results, demonstrates this fact. My basic risk
7 premium analysis, based on allowed returns from other state regulators, indicates
8 that an ROE of 11.05 percent is appropriate, with other risk premium approaches
9 indicating ROEs of almost 12 percent.

10 Because recent historical data have a significant effect in the traditional
11 constant growth DCF model and because recent data appear to represent historic
12 lows in the economic cycle, those data should not be the primary basis for setting
13 MPS/LP's allowed rate of return.

14 **Q. What do you conclude from your analysis?**

15 A. Based on the combination of quantitative model results and my review of current
16 economic, market, and electric utility industry conditions, I estimate the reference
17 group companies' fair cost of equity at 11.25 percent. This estimate is consistent
18 with increased interest rates that have occurred since mid-2005 and with
19 projections for further interest rate increases over the coming year. The 11.25
20 percent base ROE estimate is therefore a reasonable estimate of capital costs that
21 will prevail during the period that the rates from this case are in effect. To reflect
22 the higher utility risk profile of MPS/LP as discussed previously, the ROE for the
23 operating divisions should be increased by 25 basis points relative to the cost of

1 equity for the reference group, which results in a requested ROE of 11.5 percent.

2 **Q. What is the cost of debt that you have used for MPS/LP?**

3 A. As shown on Schedule SCH-2, the cost of debt for the MPS and LP divisions are
4 6.73 percent and 7.95 percent, respectively. These figures result from the
5 Company's internal capital assignment process whereby it assigns capital to its
6 operating divisions on an "as needed basis." The cost of debt for each operating
7 division reflects the average cost rates for issues assigned to each division as of
8 December 31, 2005. All of the debt issues assigned to either division have been
9 assigned at "investment grade" rates per the Company's ongoing policy to protect
10 its ratepayers from the activities of its non-regulated businesses through its capital
11 assignment process.

12 **II. MPS/LP's CAPITAL STRUCTURE AND OVERALL RATE OF RETURN**

13 **Q. Please summarize the Company's requested capital structure and overall**
14 **rate of return.**

15 A. The following tables identify the requested capital structure components and the
16 resulting overall rates of return:

1 **Missouri Public Service**

2	<u>Capital Components</u>	<u>Ratio</u>	<u>Cost</u>	<u>Weighted Cost</u>
3	Debt	52.5%	6.73%	3.53%
4	Common Equity	<u>47.5%</u>	11.50%	<u>5.46%</u>
5	TOTAL	100.00%		8.99%

6 **St. Joseph Light & Power**

7	<u>Capital Components</u>	<u>Ratio</u>	<u>Cost</u>	<u>Weighted Cost</u>
8	Debt	52.5%	7.95%	4.17%
9	Common Equity	<u>47.5%</u>	11.50%	<u>5.46%</u>
10	TOTAL	100.00%		9.63%

11 **Q. What is the basis for the Company's requested capital structure and overall**
12 **rate of return?**

13 A. The Company is requesting a hypothetical capital structure based on its internal
14 capital assignment process and supported by the 2005 year-end capital structure
15 percentages of the investment grade 24-company reference group used to estimate
16 ROE. This approach is appropriate because it comports with the *Hope* and
17 *Bluefield* principles. That is to say, it matches the financial risk of the reference
18 group to the estimated ROE and resulting overall rates of return for MPS/LP. The
19 Company has used its internal capital assignment process to assign the
20 appropriate levels and amounts of equity and debt to its utility operating divisions
21 since 1987. Using this process, the Company has consistently assigned 47.5
22 percent equity and 52.5 percent debt to its electric utility operating divisions. As
23 shown on my Schedule SCH-3, the reference group capital structure percentages
24 at 48.5 percent common equity and 51.5 percent debt and preferred stock support
25 this level of capital assignment for the MPS/LP operations. As I will demonstrate
26 below, this approach also produces an overall rate of return that is consistent with
27 the lower end of the "optimal" utility capital structure range, with electric utility

1 industry norms, and with minimum Standard & Poor's ("S&P") bond rating
2 criteria for an investment grade bond rating.

3 **Q. What are the key financial ratios that determine whether a company has an**
4 **investment grade bond rating?**

5 A. The most important ratios are a utility's capitalization percentages and its cash
6 flow coverage of interest and debt requirements. Schedule SCH-4 contains S&P's
7 bond rating criteria ratio guidelines for its three key financial ratios. To have a
8 BBB bond rating, a utility with an operating risk profile of "6" is expected to have
9 a funds from operations ("FFO") interest coverage ratio of at least 3.0 times. This
10 means that net income plus non-cash expenses (such as depreciation) needs to be
11 at least three times interest requirements.¹ Similarly, the FFO/Total Debt ratio is
12 expected to be at least 18 percent for a BBB rating. This means that net income
13 plus non-cash expenses must equal 18 percent of outstanding debt, or conversely
14 that debt should not be larger than about five times FFO. The third key ratio is
15 Total Debt/Total Capital. For a BBB bond rating, total debt should not exceed 58
16 percent.

17 **Q. Are these financial ratios the only factors that may affect bond ratings?**

18 A. No. While absolute levels of financial ratios are extremely important, the rating
19 agencies also look at trends and target ratios as well as other more qualitative
20 factors. In the current "back to basics" environment, realistic plans for reducing
21 debt and improving capitalization ratios have become increasingly important. In

¹The "6" business position for MPS/LP is estimated from the assigned business position rankings of the other investor owned utilities in Missouri (Standard & Poor's, "U.S. Utility and Power Ranking List, May 2006).

1 this environment constructive regulatory support for improving a utility's
2 financial condition is a key factor.

3 **Q. How is the "optimal" capital structure for a utility measured?**

4 A. In theory, the "optimal" capital structure is the mix of debt and equity that gives
5 the lowest after-tax cost of capital. Although academic researchers have not
6 produced a consensus about a generally optimal capital structure, within the
7 electric utility industry an optimal capital structure range can be defined. This is
8 so because industry norms for utilities are more consistent than in most other
9 industries and industry norms play a very significant role in the utility bond rating
10 process. Also, within given categories of utilities, companies are viewed by bond
11 investors as close substitutes. In this environment, the cost of utility borrowing
12 varies directly with the companies' capital structure percentages and other bond
13 rating metrics. In my analysis, I use these bond rating criteria and the actual
14 borrowing costs by bond rating category to demonstrate the optimal capital
15 structure range.

16 **Q. Please discuss the relationship between bond ratings and the cost of capital.**

17 A. The relationship between bond ratings (risk) and the cost of capital is a
18 fundamental capital market principle. Specific factors for each company, such as
19 operating risks and debt and equity percentages (financial risk) determine a
20 company's total risk. This combination of operating and financial risks ultimately
21 determines the company's bond rating. For example, fully integrated utilities
22 with generation, transmission, and distribution functions are considered
23 operationally more risky than "wires only" transmission and distribution

1 companies. These and other operating characteristics are reflected in S&P
2 business profile rankings. In addition to operating risks, a company's additional
3 financial risk depends on the amounts of debt and equity it uses to finance its
4 assets. More debt and less equity, for any level of operating risk, will result in a
5 lower bond rating and higher interest costs for debt.

6 **Q. Is there an "optimal" bond rating?**

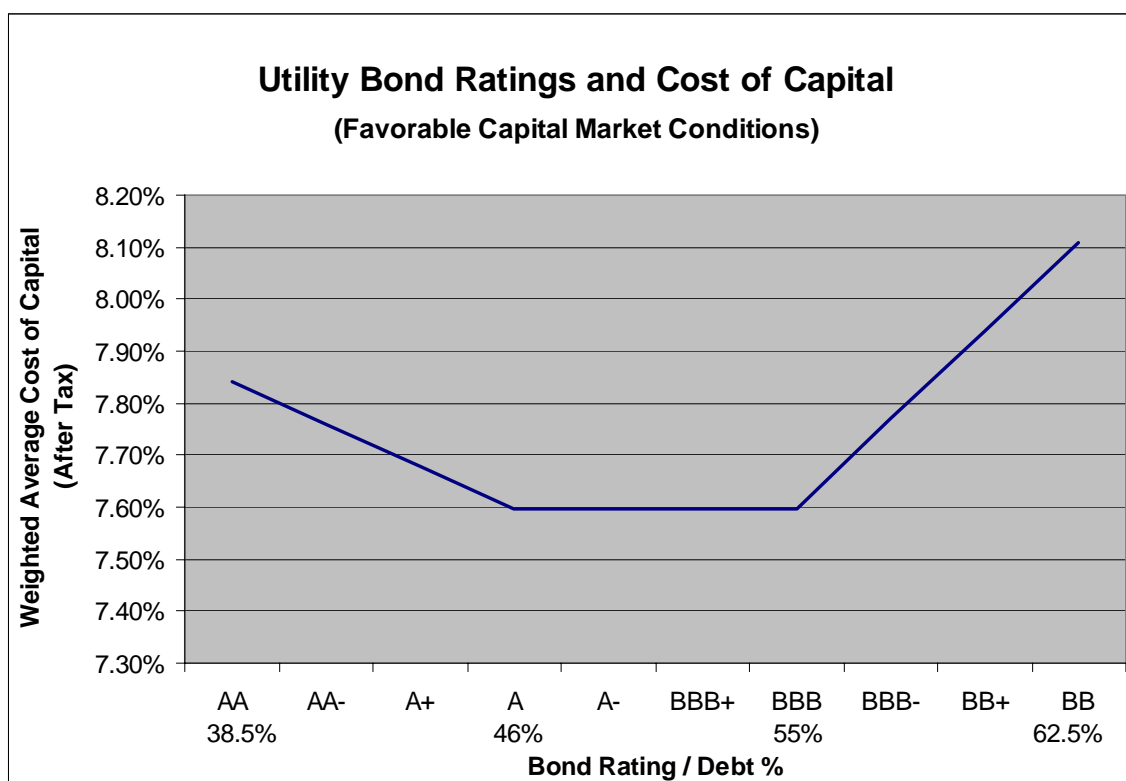
7 A. Yes, but the optimal bond rating at any point in time depends on both operating
8 and financial risks, and on existing capital market conditions. During periods of
9 low interest rates and stable market conditions, investors tend to accept lower
10 bond ratings (higher risks) with a relatively small increment to required interest
11 rates. The relative ease or stringency of market conditions can be measured by
12 the spreads (differences) in interest rates among bond rating categories. When
13 conditions are more settled, interest rate spreads are typically small, but when
14 conditions are unsettled, spreads are much wider. For example, with the low rate
15 environment during 2005, the average spread between Baa and A rated utility
16 debt was only 27 basis points (the average interest rate for Baa bonds was 5.92
17 percent versus 5.65 percent for A-rated bonds)². At other times under more
18 stringent market conditions, spreads can be much wider. Under extreme
19 conditions, such as those that existed in the early 1980s, there may be times when
20 no triple-B rated debt can be issued at all.

21 The bond rating-cost of capital relationship is depicted in the graph below.

22 The capital structure percentages for the bond ratings shown on the graph are

² Moody's (Mergent) Bond Record, January, 2006.

1 from S&P's Utility Bond Rating Criteria for an average electric utility business
2 risk profile of 5. The interest rate data are the average rates for 2005 for Moody's
3 investment grade utility categories, with spreads estimated for non-investment
4 grade categories and extrapolated within rating groups.



5
6 Based on average interest rates for 2005, the lowest overall cost of capital
7 occurred at debt percentages of between 46 percent and 55 percent, with resulting
8 bond ratings between single-A and triple-B. For companies with higher debt
9 percentages, the advantage of low cost debt and interest tax deductions were
10 overcome by sharply rising interest costs for non-investment grade companies.

11 **Q. What steps have been taken by Aquila to improve its financial condition?**

12 A. Aquila has sold, or is in the process of completing the sale of all of its non-
13 domestic investments and it has eliminated most of its non-regulated activities

1 and contracts. It also announced plans for further asset sales to include four of its
2 domestic regulated utility holdings for a total of \$897 million to be completed by
3 year end 2006. I have attached as Schedule SCH-5 an outline of the Company's
4 ongoing sales plan. That plan centers on raising significant further amounts of
5 cash through utility asset sales and using the cash to pay down as much as \$600
6 million of existing debt. The asset sale strategy has already significantly
7 improved Aquila's balance sheet position and will continue to provide much
8 improved access to required capital for utility infrastructure investments.
9 Schedule SCH-5 reveals that much of the necessary capital expenditure and debt
10 pay down requirements outlined by the Company for the next few years can be
11 met by the deployment of the proceeds of the asset sales program.

12 **Q. How did you evaluate the requested capital structure?**

13 A. I considered the bond rating and optimal capital structure issues discussed above
14 and I prepared an analysis of MPS/LP's financial condition under alternative
15 assumed outcomes from this rate case. In that analysis, I compare MPS/LP's
16 interest coverage ratios and debt ratios, under alternative rate case results, to the
17 S&P bond rating criteria discussed previously. This comparison shows the
18 implied bond ratings from each rate case alternative. The key result is that the
19 requested hypothetical capital structure is essential for an investment grade bond
20 rating. Rate case outcomes based on Aquila's consolidated corporate capital
21 structure produce financial ratios well below those required for an investment
22 grade rating. Such results are not consistent with using an investment grade
23 reference group to estimate ROE or using investment grade debt costs to calculate

1 the allowed overall rate of return. Such a mismatched approach would produce
2 results that violate the *Hope* and *Bluefield* requirements.

3 **Q. How is your capital structure analysis structured?**

4 A. To prepare the analysis, I developed a model that calculates the key S&P ratios
5 for alternative rate case outcomes. The results of my analysis are presented in
6 Schedule SCH-6. As shown on page 1 of Schedule SCH-6, Case 1 using
7 MLP/LP's requested capital structure and ROE produces investment grade
8 financial indicators. As shown on page 2 of Schedule SCH-6, however, Case 2,
9 based on Aquila's consolidated capital structure, produces non-investment grade
10 indicators for all but the FFO coverage ratio, which is in the lower half of the
11 triple-B range. The consolidated Debt/Capital ratio is below investment grade
12 requirements, which further emphasizes how important the hypothetical capital
13 structure is for the present case. On page 3 of SCH-6, in Case 3, I also
14 demonstrate the bond rating indicators that would result if no rate increase were
15 granted. From this scenario, all the indicators fall below investment grade with
16 half of the indicators in the single-B range. Clearly the results of either Case 2
17 (consolidated capital structure) or Case 3 (no rate increase) do not represent
18 adequate financial integrity.

19 **Q. Is it possible to evaluate the tradeoff between capital structure and ROE?**

20 A. Yes. If, for example, Aquila's consolidated corporate capital structure was used
21 for setting rates in this case, the ROE would have to be raised to account for the
22 additional financial risk caused by higher financial leverage resulting from the
23 increased debt. The tradeoff is measured in the overall rate of return.

1 **Q. Please explain.**

2 A. In Schedule SCH-7, I demonstrate the relationship between capital structure and
3 ROE. In that analysis, the first panel shows the overall, tax-inclusive rate of
4 return calculated from the 11.5 percent requested ROE and requested capital
5 structure consisting of 47.5 percent equity and 52.5 percent debt. The overall,
6 tax-inclusive rate of return for MPS, as shown on page 1 of Schedule SCH-7, is
7 12.40 percent.

8 In the second panel of Schedule SCH-7, I first recalculate the overall rate
9 of return using Aquila's consolidated corporate capital structure with 39.8 percent
10 equity and 60.2 percent debt. I then recalculate for the ROE that is required to
11 keep the overall, tax-inclusive rate of return at the same 12.40 percent found
12 previously in panel 1. To keep the overall return at 12.40 percent, the ROE must
13 be increased to 12.93 percent. Page 2 of Schedule SCH-7, provides the same
14 analysis using LP's higher cost of debt. The results are similar. In this case the
15 ROE must be increased from 11.5 percent to 12.78 percent to produce the same
16 tax-inclusive overall rate of return when more debt and less equity are used in the
17 capital structure. These results are consistent with my previous capital structure
18 discussion and with the fundamental financial principle of risk and return. In
19 other words, ROE would have to be raised to about 13 percent to keep MPS/LP at
20 the same revenue level if Aquila's consolidated capital structure is used.

21 **III. REGULATORY FINANCIAL INTEGRITY ISSUES**

22 **Q. Please define the term "financial integrity" and discuss its role in the**
23 **regulatory process.**

1 A. "Financial integrity" does not have a precise textbook definition. It generally
2 means that a company is creditworthy or financially sound, and that its credit is
3 unimpaired. Companies with sound financial integrity are said to have access to
4 capital at reasonable rates and on reasonable terms and conditions. Financial
5 integrity may also be defined in terms of bond ratings: Companies with
6 investment grade bond ratings (triple-B or above) have some degree of financial
7 integrity; companies with bond ratings below investment grade may be impaired.
8 Operationally, the meaning of financial integrity depends on the context in which
9 the term is used.

10 In regulatory practice most discussions of financial integrity center on the
11 requirements of *Hope* and *Bluefield*. The *Bluefield* decision in 1923 did not
12 explicitly use the term financial integrity, but instead used the words "financial
13 soundness" with respect to standards for rate of return:

14 The return should be reasonably sufficient to assure confidence in
15 the *financial soundness* of the utility and should be adequate, under
16 efficient and economical management, to maintain and support its
17 credit and enable it to raise the money necessary for the proper
18 discharge of its public duties. (emphasis supplied)

19 The *Hope Natural Gas* decision in 1944 reiterated the *Bluefield* rate of return
20 standard and specifically used the term financial integrity:

21 From the investor or company point of view it is important that
22 there be enough revenue not only for operating expenses, but also
23 for the capital costs of the business.... That return, moreover,
24 should be sufficient to assure confidence in the *financial integrity*
25 of the enterprise so as to maintain its credit and to attract
26 capital....(emphasis supplied)

27 Regulatory economists and financial witnesses in regulatory proceedings
28 routinely rely on the above noted passages. In most situations, "financial

1 integrity" means that a utility's rates are adequate to support its access to capital
2 on reasonable terms.

3 **Q. Is there a link between financial integrity and the regulatory process?**

4 A. Yes. Especially during periods of unsettled capital markets and when required
5 construction budgets are large, the link between financial integrity and the
6 regulatory process is clear. Financially weak utilities are often foreclosed from
7 the most economical sources of financing. For example, utilities that fail to meet
8 indenture earnings tests may be precluded from issuing first mortgage bonds and
9 may be forced to use unsecured debentures or bank lines of credit. Debentures
10 are typically rated at least one credit level lower than first mortgage bonds, with
11 commensurately higher interest costs. Similarly, bank credit lines are typically
12 more restrictive and administratively more expensive than higher grade forms of
13 traditional utility financing. I discuss the direct costs of weak utility financial
14 condition in more detail below.

15 **Q. Does the financial integrity standard have a role in evaluating the overall**
16 **reasonableness of a utility rate order?**

17 A. Yes. Regulators have the responsibility to ensure that the overall effect of a rate
18 order is just and reasonable to the utility and its customers. This required focus
19 on the reasonableness of the "end result" of the rate setting process is reflected in
20 Supreme Court decisions such as *Hope*, where Justice Douglas concluded:

21 And when the Commission's order is challenged in the courts, the
22 question is whether that order "*viewed in its entirety*" meets the
23 requirements of the Act. Under the statutory standard of "just and
24 reasonable" ... it is the *result reached* not the method employed
25 which is controlling....320 U.S. at 602. (emphasis supplied)

1 Forty-five years later, the Supreme Court reaffirmed *Hope* in the *Duquesne Light*
2 *Co.* decision:

3 [I]t is not theory but the impact of the rate order which counts. If
4 the *total effect* of the rate order cannot be said to be unreasonable,
5 judicial inquiry ... is at an end. 109 S. Ct. at 617.(emphasis
6 supplied) (quoting *Hope*)

7 In judging the "end result" or "total effect" of a rate order, it is the impact on the
8 utility's financial integrity, balanced against the customers' interest in reasonable
9 rates, that must be evaluated: "Rates which enable the company to operate
10 successfully, to *maintain its financial integrity*, to attract capital, and to
11 compensate its investors for the risk assumed certainly cannot be condemned as
12 invalid...." (*Hope*. 320 U.S. at 605) (emphasis supplied). As the regulator weighs
13 the possible disallowance of expenses essential to the provision of utility service,
14 the manner in which that discretionary authority is used can very appropriately be
15 affected by the end result of the decision on the utility's financial integrity.

16 **Q. What is required to reverse the effects of poor financial condition?**

17 A. The most important factor is a demonstrated commitment from the company and
18 its regulators and a consistently improving trend in financial results. For this
19 reason it typically takes a period of time to reestablish an investment grade bond
20 rating. To re-obtain an investment grade rating and to convince lenders to provide
21 capital at lower rates, a utility must demonstrate that its financial integrity has
22 been restored and that the process going forward can be expected to provide
23 stability. The mitigation of regulatory uncertainty and the provision of a
24 consistent plan for financial improvement are key elements in this process.

1 **Q. Does the electric utility industry's evolution toward competition affect**
2 **financial integrity?**

3 A. Yes. Financial integrity and the role of consistent regulatory policy are especially
4 important as the industry moves toward deregulation. In a deregulated
5 environment, increased business risk from less predictable revenues must be
6 offset by less financial risk. This means that to maintain a given bond rating a
7 utility must reduce its debt percentage of capital and improve its other financial
8 ratios. Electric utilities generally are attempting to accomplish this objective by
9 improved operating efficiencies and the repayment of debt. Legislative and
10 regulatory provisions that enhance investor confidence are also important. As
11 competition expands some utilities will face difficult choices concerning their
12 own financial health, the level and quality of service they can provide, and a high
13 level of vulnerability to unforeseen future circumstances. The continuing
14 consolidation of the industry through mergers and, in some cases, the outright sale
15 of utility service territory is a direct reflection of this dilemma.

16 **Q. Please summarize your discussion of "financial integrity" and its role in the**
17 **regulatory process.**

18 A. The term "financial integrity" generally means sound financial condition, which
19 provides reasonable access to capital markets. A company's level of financial
20 soundness can be measured with basic financial statistics. To the extent that
21 existing and projected measures of financial performance are adequate, financial
22 integrity is reflected in investment grade bond ratings. Companies that cannot

1 provide sound financial performance find their bond ratings lowered, their access
2 to capital diminished, and their borrowing costs higher.

3 For regulated companies financial integrity goes beyond basic financial
4 statistics, because the regulatory process itself has such a large potential effect on
5 financial performance. Credit concerns sometimes arise and bond ratings drop
6 based on a regulatory decision before any change is seen in a utility's financial
7 statistics. Similarly, bond ratings are often maintained by the rating agencies
8 without supporting financial statistics if it is believed that the regulatory process
9 will allow improved financial performance in the future.

10 For companies with impaired financial integrity and non-investment grade
11 bond ratings, access to capital is severely limited and financing costs are much
12 higher. For such companies traditional sources of utility capital, such as long-
13 term first mortgage bonds, are often unavailable. Particularly during periods of
14 market stress, non-investment grade companies may have little access to capital at
15 all. Also, even when capital is available, the much higher interest rates charged to
16 non-investment grade companies may foreclose their refinancing opportunities
17 and prevent their use of other favorable financing methods available to higher
18 rated companies. All these factors demonstrate the importance of maintaining
19 financial integrity and the key role that regulation plays in this process.

20 **IV. ESTIMATING THE COST OF EQUITY**

21 **Q. What is the purpose of this section of your testimony?**

22 A. The purpose of this section is to present a general definition of the "cost of
23 equity" and to compare the strengths and weaknesses of several of the most

1 widely used methods for estimating the cost of equity. Estimating the cost of
2 equity is fundamentally a matter of informed judgment. The various models
3 provide a concrete link to actual capital market data and assist with defining the
4 various relationships that underlie the ROE estimation process.

5 **Q. Please define the term "cost of equity capital" and provide an overview of**
6 **the cost estimation process.**

7 A. The cost of equity capital is the profit or rate of return that equity investors expect
8 to receive. In concept it is no different than the cost of debt or the cost of
9 preferred stock. The cost of equity is the rate of return that common stockholders
10 expect, just as interest on bonds and dividends on preferred stock are the returns
11 that investors in those securities expect. Equity investors expect a return on their
12 capital commensurate with the risks they take and consistent with returns that
13 might be available from other similar investments. Unlike returns from debt and
14 preferred stocks, however, the equity return is not directly observable in advance
15 and, therefore, it must be estimated or inferred from capital market data and
16 trading activity.

17 An example helps to illustrate the cost of equity concept. Assume that an
18 investor buys a share of common stock for \$20 per share. If the stock's expected
19 dividend during the coming year is \$1.00, the expected dividend yield is 5 percent
20 ($\$1.00 / \$20 = 5.0$ percent). If the stock price is also expected to increase to
21 \$21.25 after one year, this \$1.25 expected gain adds an additional 6.25 percent to
22 the expected total rate of return ($\$1.25 / \$20 = 6.25$ percent). Therefore, buying
23 the stock at \$20 per share, the investor expects a total return of 11.25 percent: 5

1 percent dividend yield, plus 6.25 percent price appreciation. In this example, the
2 total expected rate of return at 11.25 percent is the appropriate measure of the cost
3 of equity capital, because it is this rate of return that caused the investor to
4 commit the \$20 of equity capital in the first place. If the stock were riskier, or if
5 expected returns from other investments were higher, investors would have
6 required a higher rate of return from the stock, which would have resulted in a
7 lower initial purchase price in market trading.

8 Each day, market rates of return and prices change to reflect new investor
9 expectations and requirements. For example, when interest rates on bonds and
10 savings accounts rise, utility stock prices usually fall. This is true, at least in part,
11 because higher interest rates on these alternative investments make utility stocks
12 relatively less attractive, which causes utility stock prices to decline in market
13 trading. This competitive market adjustment process is quick and continuous, so
14 that market prices generally reflect investor expectations and the relative
15 attractiveness of one investment versus another. In this context, to estimate the
16 cost of equity one must apply informed judgment about the relative risk of the
17 Company in question and knowledge about the risk and expected rate of return
18 characteristics of other available investments as well.

19 **Q. How does the market account for risk differences among the various**
20 **investments?**

21 A. Risk-return tradeoffs among capital market investments have been the subject of
22 extensive financial research. Literally dozens of textbooks and hundreds of
23 academic articles have addressed the issue. Generally, such research confirms the

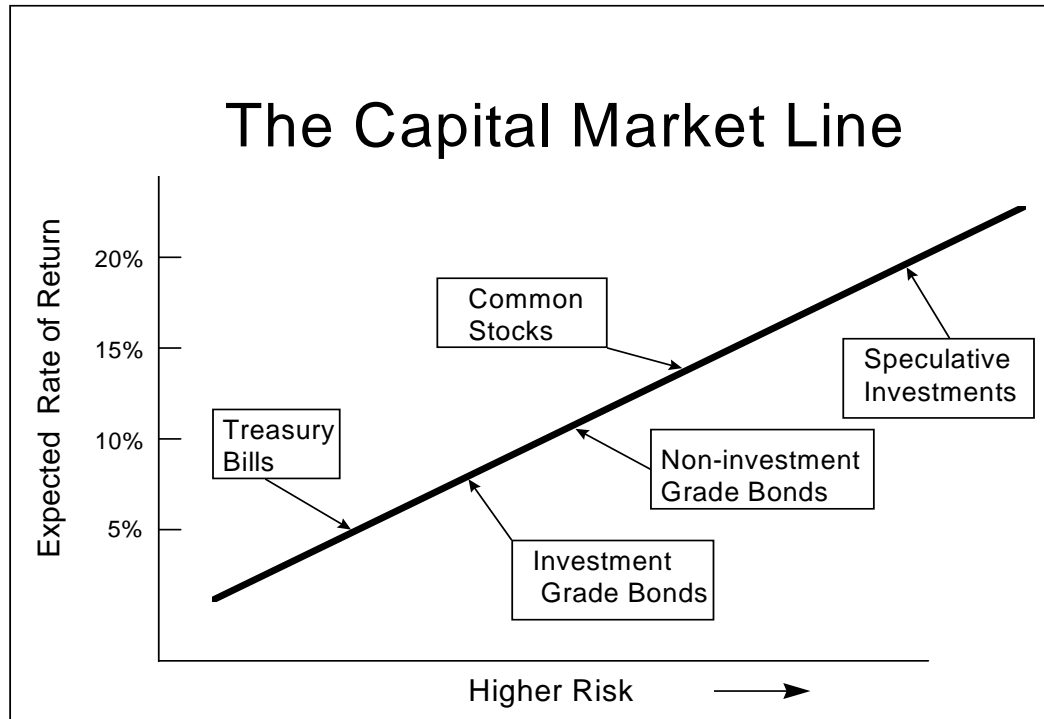
1 common sense conclusion that investors will take additional risks only if they
2 expect to receive a higher rate of return. Empirical tests consistently show that
3 returns from low risk securities, such as U.S. Treasury bills, are the lowest; that
4 returns from longer-term Treasury bonds and corporate bonds are increasingly
5 higher as risks increase; and generally, returns from common stocks and other
6 more risky investments are even higher. These observations provide a sound
7 theoretical foundation for both the DCF and risk premium methods for estimating
8 the cost of equity capital. These methods attempt to capture the well-founded
9 risk-return principle and explicitly measure investors' rate of return requirements.

10 **Q. Can you illustrate the capital market risk-return principle that you just**
11 **described?**

12 A. Yes. The following graph depicts the risk-return relationship that has become
13 widely known as the Capital Market Line ("CML"). The CML offers a graphical
14 representation of the capital market risk-return principle. The graph is not meant
15 to illustrate the actual expected rate of return for any particular investment, but
16 merely to illustrate in a general way the risk-return relationship.

1

Risk-Return Tradeoffs



2 As a continuum, the CML can be viewed as an available opportunity set
3 for investors. Those investors with low risk tolerance or investment objectives
4 that mandate a low risk profile should invest in assets depicted in the lower left-
5 hand portion of the graph. Investments in this area, such as Treasury bills and
6 short-maturity, high quality corporate commercial paper, offer a high degree of
7 investor certainty. In nominal terms (before considering the potential effects of
8 inflation), such assets are virtually risk-free.

9 Investment risks increase as one moves up and to the right along the CML.
10 A higher degree of uncertainty exists about the level of investment value at any
11 point in time and about the level of income payments that may be received.
12 Among these investments, long-term bonds and preferred stocks, which offer

1 priority claims to assets and income payments, are relatively low risk, but they are
2 not risk-free. The market value of long-term bonds, even those issued by the U.S.
3 Treasury, often fluctuates widely when government policies or other factors cause
4 interest rates to change.

5 Farther up the CML continuum, common stocks are exposed to even more
6 risk, depending on the nature of the underlying business and the financial strength
7 of the issuing corporation. Common stock risks include market-wide factors,
8 such as general changes in capital costs, as well as industry and company specific
9 elements that may add further to the volatility of a given company's performance.
10 As I will illustrate in my risk premium analysis, common stocks typically are
11 more volatile (have higher risk) than high quality bond investments and,
12 therefore, they reside above and to the right of bonds on the CML graph. Other
13 more speculative investments, such as stock options and commodity futures
14 contracts, offer even higher risks (and higher potential returns). The CML's
15 depiction of the risk-return tradeoffs available in the capital markets provides a
16 useful perspective for estimating investors' required rates of return.

17 **Q. How is the fair rate of return in the regulatory process related to the**
18 **estimated cost of equity capital?**

19 A. As I have discussed previously, the regulatory process is guided by fair rate of
20 return principles established in the U.S. Supreme Court cases, *Bluefield Water*
21 *Works* and *Hope Natural Gas*:

22 A public utility is entitled to such rates as will permit it to earn a
23 return on the value of the property which it employs for the
24 convenience of the public equal to that generally being made at the
25 same time and in the same general part of the country on

1 investments in other business undertakings which are attended by
2 corresponding risks and uncertainties; but it has no constitutional
3 right to profits such as are realized or anticipated in highly
4 profitable enterprises or speculative ventures. *Bluefield Water*
5 *Works & Imp. Co. v. West Virginia Public Service Commission*,
6 262 U.S. 679, 692-693 (1923).

7 From the investor or company point of view, it is important that
8 there be enough revenue not only for operating expenses, but also
9 for the capital costs of the business. These include service on the
10 debt and dividends on the stock. By that standard the return to the
11 equity owner should be commensurate with returns on investments
12 in other enterprises having corresponding risks. That return,
13 moreover, should be sufficient to assure confidence in the financial
14 integrity of the enterprise, so as to maintain its credit and to attract
15 capital. *Federal Power Comm. v. Hope Natural Gas Co.*, 320 U.S.
16 591, 603 (1944).

17 Based on these principles, the fair rate of return should closely parallel
18 investor opportunity costs as discussed above. If a utility earns its market
19 cost of equity, neither its stockholders nor its customers should be
20 disadvantaged.

21 **Q. What specific methods and capital market data are used to evaluate the cost**
22 **of equity?**

23 A. Given the requirement to find the required rate of return for companies with
24 similar risk, models that employ market-based data for comparable utilities are the
25 most widely used. The DCF model, and sometimes other models, applied to a
26 reference group of investment grade utilities as I have done is the most
27 appropriate for ensuring that the *Hope* and *Bluefield* standards are met. Specific
28 modeling techniques typically fall into three groups: comparable earnings
29 methods, risk premium methods, and DCF methods. Comparable earnings
30 methods have evolved over time. The original comparable earnings methods
31 were based on book accounting returns. This approach developed ROE estimates

1 by reviewing accounting returns for unregulated companies thought to have risks
2 similar to those of the regulated company in question. These methods generally
3 have been rejected because they assume that the unregulated group is earning its
4 actual cost of capital, and that its equity book value is the same as its market
5 value. In most situations these assumptions are not valid and, therefore,
6 accounting-based methods generally do not provide reliable cost of equity
7 estimates.

8 More recent comparable earnings methods are based on historical stock
9 market returns rather than book accounting returns. While this approach has
10 some merit, it too has been criticized because there can be no assurance that
11 historical returns actually reflect current or future market requirements. Also, in
12 practical application, earned market returns tend to fluctuate widely from year to
13 year. For these reasons, a current cost of equity estimate (based on the DCF
14 model or a risk premium analysis) is usually required.

15 The second set of estimation techniques is grouped under the heading of
16 risk premium methods. These methods begin with currently observable market
17 returns, such as yields on government or corporate bonds, and add an increment to
18 account for the additional equity risk. The capital asset pricing model ("CAPM")
19 and arbitrage pricing theory ("APT") model are more sophisticated risk premium
20 approaches. The CAPM and APT methods estimate the cost of equity directly by
21 combining the "risk-free" government bond rate with explicit risk measures to
22 determine the risk premium required by the market. Although these methods are
23 widely used in academic cost of capital research, their additional data

1 requirements and their potentially questionable underlying assumptions have
2 detracted from their use in most regulatory jurisdictions. .

3 The DCF model is the most widely used approach in regulatory
4 proceedings. Like the risk premium method, the DCF model has a sound basis in
5 theory, and many argue that it has the additional advantage of simplicity. I will
6 describe the DCF model in detail below, but in essence its estimate of ROE is
7 simply the sum of the expected dividend yield and the expected long-term
8 dividend (or price) growth rate. While dividend yields are readily available, long-
9 term growth estimates are more difficult to obtain. Because the constant growth
10 DCF model requires very long-term growth estimates (technically to infinity),
11 some argue that its application is subjective and that more explicit multistage
12 growth DCF models are preferred. In the final analysis, ROE estimates are
13 subjective and should be based on sound, informed judgment. To accomplish this
14 task, I apply several versions of the DCF and risk premium models, which result
15 in an ROE range that I believe brackets the fair cost of equity capital.

16 **Q. Please explain the DCF model.**

17 A. The DCF model is predicated on the concept, or in fact the definition, that a
18 stock's price represents the present value of all future cash flows expected from
19 the stock. In the most general form, the model is expressed in the following
20 formula:

$$21 \quad P_0 = D_1/(1+k) + D_2/(1+k)^2 + \dots + D_\infty/(1+k)^\infty \quad (1)$$

22 where P_0 is today's stock price; D_1 , D_2 , etc. are all expected future dividends and
23 k is the discount rate, or the investor's required rate of return on equity. Equation

1 (1) is a routine present value calculation with the difficult data requirement of
2 estimating all future dividends. (As a practical matter, the present value of
3 dividends expected in the very distant future is typically insignificant, and
4 operationally the DCF model can be reasonably estimated by discounting a long,
5 but finite dividend stream, or with the assumption that the stock will be sold for
6 some estimated price in the future.)

7 Under the additional assumption that dividends are expected to grow at a
8 constant rate "g," equation (1) can be solved for k and rearranged into the simple
9 form:

10
$$k = D_1/P_0 + g \quad (2)$$

11 Equation (2) is the familiar constant growth DCF model for cost of equity
12 estimation, where D_1/P_0 is the expected dividend yield and g is the long-term
13 expected dividend growth rate.

14 Under circumstances when growth rates are expected to fluctuate or when
15 future growth rates are highly uncertain, the constant growth model may be
16 questionable, and explicit changing growth estimates may be required. Although
17 the DCF model itself is still valid (equation (1) is mathematically correct), under
18 the assumption of fluctuating growth the simplified form of the model must be
19 modified to capture market expectations accurately.

20 **Q. How is the DCF model applied when the growth rates fluctuate?**

21 A. When growth rates are expected to fluctuate, the more general version of the
22 model represented in equation (1) should be solved explicitly over a finite
23 "transition" period while uncertainty prevails. The constant growth version of the

1 model can then be applied after the transition period, under the assumption that
2 more stable conditions will prevail in the future. There are two alternatives for
3 dealing with the nonconstant growth transition period.

4 Under the "Market Price" version of the DCF model, equation (1) is
5 written in a slightly different form:

6
$$P_0 = D_1/(1+k) + D_2/(1+k)^2 + \dots + P_T/(1+k)^T \quad (3)$$

7 where the variables are the same as in equation (1) except that P_T is the estimated
8 Market Price at the end of the transition period T. Under the assumption that
9 constant growth resumes after the transition period, the price P_T is then expected
10 to be based on constant growth assumptions. As with the general form of the
11 DCF model in equation (1), in the Market Price approach the current stock price
12 (P_0) is the present value of expected cash inflows, but the cash flows are
13 comprised of dividends and an ultimate selling price for the stock. The estimated
14 cost of equity, k , is just the rate of return that investors would expect if they
15 bought the stock at today's price, held it and received dividends through the
16 transition period (until period T), and then sold it for price P_T .

17 Under the "Multistage" growth DCF approach, equation (1) is expanded to
18 incorporate two or more growth rate periods, with the assumption that a
19 permanent constant growth rate can be estimated for some point in the future:

20
$$P_0 = D_0(1+g_1)/(1+k) + \dots + D_0(1+g_2)^n/(1+k)^n +$$

21
$$\dots + D_0(1+g_T)^{(T+1)}/(k-g_T) \quad (4)$$

22 where the variables are the same as in equation (1), but g_1 represents the growth
23 rate for the first period, g_2 for a second period, and g_T for the period from year T
24 (the end of the transition period) to infinity. The first two growth rates are

1 estimates of fluctuating growth over "n" years (typically 5 or 10 years), and g_T is a
2 constant growth rate assumed to prevail forever after year T.

3 Although less convenient for exposition purposes, the nonconstant growth
4 models are based on the same valid capital market assumptions as the constant
5 growth version. The nonconstant growth approach simply requires more explicit
6 data inputs and more work to solve for the discount rate, k. Fortunately, the
7 required data are generally available from investment and economic forecasting
8 services, and computer algorithms can easily produce the required solutions.
9 Both constant and nonconstant growth DCF analyses are presented in the
10 following section.

11 **Q. Please explain the risk premium methodology.**

12 A. Risk premium methods are based on the assumption that equity securities are
13 riskier than debt and, therefore, that equity investors require a higher rate of
14 return. This basic premise is well supported by legal and economic distinctions
15 between debt and equity securities, and it is widely accepted as a fundamental
16 capital market principle. For example, debt holders' claims to the earnings and
17 assets have priority over all claims of equity investors. The contractual interest on
18 mortgage debt generally must be paid in full before any dividends can be paid to
19 shareholders, and secured mortgage claims must be fully satisfied before any
20 assets can be distributed to shareholders in bankruptcy. Also, the guaranteed,
21 fixed-income nature of interest payments on debt makes year-to-year returns from
22 bonds typically more stable than capital gains and dividend payments on stocks.
23 All these factors support the proposition that stockholders are exposed to more

1 risk and that shareholders should reasonably expect a positive equity risk
2 premium.

3 **Q. Are risk premium estimates of the cost of equity consistent with other**
4 **current capital market costs?**

5 A. Yes. The risk premium approach is especially useful because it is founded on
6 current market interest rates, which are directly observable. This feature assures
7 that risk premium estimates of the cost of equity begin with a sound basis, which
8 is tied directly to current capital market costs.

9 **Q. Is there similar consensus about how risk premium data should be**
10 **employed?**

11 A. No. In regulatory practice, there is often considerable debate about how risk
12 premium data should be interpreted and used. Since the analyst's basic task is to
13 gauge investors' required returns on long-term investments, some argue that the
14 estimated equity spread should be based on the longest possible time period.
15 Others argue that market relationships between debt and equity from several
16 decades ago are irrelevant and that recent debt-equity observations should be
17 given more weight in estimating investor requirements. There is no consensus on
18 this issue. Since analysts cannot observe or measure investors' actual
19 expectations, it is not possible to know exactly how such expectations are formed
20 or, therefore, exactly what time period is most appropriate in a risk premium
21 analysis.

22 The important question to answer is the following: "What rate of return
23 should equity investors reasonably expect relative to returns currently available

1 from long-term bonds?" The risk premium studies and analyses I discuss in
2 Section IV address this question. My risk premium recommendation is based on
3 an intermediate position that avoids some of the problems and concerns that have
4 been expressed about both very long and very short periods of analysis with the
5 risk premium model.

6 **Q. Please summarize your discussion of cost of equity estimation techniques.**

7 A. Estimating the cost of equity is a controversial issue in utility ratemaking.
8 Because actual investor requirements are not directly observable, analysts have
9 developed several methods to assist in the process. The comparable earnings
10 method is the oldest but perhaps least reliable. Its use of accounting rates of
11 return, or even historical market returns may or may not reflect current investor
12 requirements. Differences in accounting methods among companies and issues of
13 comparability also detract from this approach.

14 The DCF and market-based risk premium methods are more widely
15 accepted in regulatory practice. I believe that a combination of the DCF model
16 and a review of risk premium data provide the most reliable approach. While the
17 DCF model requires judgment about future growth rates, the dividend yield
18 portion of the model is straightforward, and the model's results are generally
19 consistent with actual capital market behavior. For these reasons, I apply various
20 versions of the DCF model to the reference company group, and I test the
21 reasonableness of the DCF results by comparing to market-based risk premiums.
22 I believe this approach is the most reliable was to assess the rate of return that

1 investors expect from investment alternatives of similar risk as required by the
2 *Hope* and *Bluefield* standards.

3 **V. FUNDAMENTAL FACTORS THAT AFFECT THE COST OF EQUITY**

4 **Q. What is the purpose of this section of your testimony?**

5 A. The purpose of this section is to review recent and future capital market costs and
6 conditions as well as industry- and company-specific factors that should be
7 reflected in the cost of equity estimate.

8 **Q. What has been the recent experience in the U.S. capital markets?**

9 A. Schedule SCH-8, page 1 provides a review of annual interest rates and rates of
10 inflation in the U.S. economy over the past ten years. During that time period,
11 inflation and capital market costs have declined and, generally, have been lower
12 than rates that prevailed in the previous decade. Inflation, as measured by the
13 Consumer Price Index, has remained at historically low levels not seen
14 consistently since the early 1960s. Until early 2004, the uneven pace of economic
15 recovery kept consumer price increases in check and resulted in the lowest
16 interest rates in four decades. Since then, however, economic growth and
17 concerns about renewed inflation have led to fluctuating interest rates. Estimates
18 for the next 12 months are for continued economic growth and further interest rate
19 increases.

20 Schedule SCH-8, page 2, provides a summary of Moody's Average Utility
21 and Baa Utility Bond Yields. For the most recent three months ended May 2006,
22 Moody's Average Utility Rate was 6.23 percent and the Baa Utility Rate was 6.47
23 percent.

1 Schedule SCH-8, page 3, provides S&P's *Economic Trends & Projections*
2 for June 15, 2006. The forecast data show clear expectations for continuing
3 economic growth, with growth in real Gross Domestic Product (GDP) for 2006
4 projected at 3.4 percent. This projected GDP growth rate compares to rates of
5 less than 2 percent in 2001, 2.4 percent for 2002, and 3 percent for 2003.
6 Consistent with sound economic conditions, S&P also forecasts that the
7 unemployment rate will drop to 4.7 percent and that interest rates will rise an
8 additional 40-60 basis points from current levels. The 10-year Treasury Note is
9 projected to increase from its current level of about 5.1 percent to 5.5 during
10 2007. Long-term Treasury Bonds are projected to increase from current levels of
11 about 5.2 percent to 5.6 percent, and Corporate Bonds are projected to increase
12 from current levels of about 6.0 percent to 6.6 percent. These increasing interest
13 rate trends offer important perspective for judging the cost of capital in the
14 present case.

15 **Q. How have utility stocks performed during the past several years?**

16 A. The Dow Jones Utility Average has fluctuated widely. After reaching a level of
17 310 in April 2002, it dropped to below 180 by October 2002. Since 2002, the
18 Average has continued to fluctuate. Its current level of about 400 is 6 percent
19 below its recent record high level of 425, having increased from a level of 280 a
20 little more than a year ago. Utility stock prices generally have fluctuated much
21 more widely in recent years than was previously expected. Widely fluctuating
22 prices for natural gas and other unexpected disruptions of supply caused by
23 various factors, including two major hurricanes along the Gulf Coast and on-

1 going strife in the Middle East have created further unsettling conditions. These
2 factors and continuing concerns for the more competitive market environment for
3 all utility services will likely create further uncertainties and market volatility for
4 utility shares. In this environment, investors' return expectations and
5 requirements for providing capital to the utility industry remain high relative to
6 the longer-term traditional view of the utility industry.

7 **Q. What are the key factors currently affecting electric utility investments?**

8 A. Although many utilities are attempting to return to their core businesses and hope
9 to see more stable results over the next several years, expectations for utility
10 stocks are mixed with stated concerns about higher interest rates, volatile
11 commodity prices, and the relatively high current market valuations for some
12 utility companies. Such concerns and expectations have been offered in various
13 forums. In a feature story on utilities' investment potential, *The Wall Street*
14 *Journal* expressed these concerns:

15 **Sector Has Gleamed Recently, But Worries About Energy**
16 **Prices and Interest Rates Spur Concern**

17 In the past several trading sessions, however, the sector has slipped
18 amid worries that inflation and interest rates are headed up, that the
19 economy will slow and that energy prices have peaked. ...

20 Historically, interest-rate increases have pushed utilities stocks
21 down because such reliable dividend payers long have been used
22 as a bond substitute by income-seeking investors. Rising rates
23 make newly issued bonds with higher yields more attractive than
24 existing income-producing stocks and bonds with lower payouts.
25 (Wall Street Journal, October 10, 2005, page C1.)

26 These market concerns have continued in 2006:

27 **Investment Review**

28 While we remain positive on utility fundamentals and believe the
29 investment cycle is still attractive, the group was impacted by
30 rising interest rates and downward pressure on commodity prices

1 during the first quarter ending March 31, 2006. After rising nearly
2 5% during the first few weeks of January, utilities gave up these
3 gains and ended the first quarter down 1.1%, as measured by the
4 S&P 1500 Utilities Index, compared with a 4.2% gain in the S&P
5 500 Index. (Investment Commentary, Cohen & Steers, March 31,
6 2006.)

7 Rising interest rates also make it more difficult to use traditional rate of return
8 models to estimate the fair, ongoing cost of capital. Analysts' near-term growth
9 estimates for utilities reflect the issues described by *The Wall Street Journal* and
10 analysts' current three-to-five-year growth rate projections are extremely low. As
11 I will discuss in more detail later, this feature raises significant questions about
12 using analysts' currently low growth projections as proxies for long-term growth
13 in the DCF model.

14 **Q. Is Aquila affected by these same market uncertainties and concerns?**

15 A. Yes. To varying extents, all utilities are affected by market uncertainties and the
16 changes affecting the energy industry. As Aquila's MPS/LP operating divisions
17 have entered into a construction cycle, over the next few years the capital
18 requirements for these divisions are projected to be over \$1.2 billion cumulatively
19 from the end of 2006 through the year 2011. This level of expenditure will have
20 the impact of increasing net plant by approximately 93 percent over this period,
21 which is at a level that is significantly above the reference company projected
22 average over the same period. These construction needs are more fully described
23 in the testimony of Aquila witness, Ivan Vancas. Demands to expand the
24 transmission and distribution resources are also growing rapidly. This situation
25 also drives increased capital investment needs. In this setting it is essential for

1 MPS/LP to improve their financial condition and to have a sound utility earnings
2 base to support their capital investment requirements.

3 **Q. How do capital market concerns affect the cost of equity capital?**

4 A. As I discussed previously in Section IV, equity investors respond to changing
5 assessments of risk and financial prospects by changing the price they are willing
6 to pay for a given security. When the risk perceptions increase or financial
7 prospects decline, investors refuse to pay the previously existing market price for
8 a company's securities, and market supply and demand forces then establish a new
9 lower price. The lower market price typically translates into a higher cost of
10 capital through a higher dividend yield requirement as well as the potential for
11 increased capital gains if prospects improve. In addition to market losses for prior
12 shareholders, the higher cost of capital is transmitted directly to the company by
13 the need to issue more shares to raise any given amount of capital for future
14 investment. The additional shares also impose additional future dividend
15 requirements and reduce future earnings per share growth prospects.

16 **VI. COST OF EQUITY CAPITAL FOR MPS/LP**

17 **Q. What is the purpose of this section of your testimony?**

18 A. The purpose of this section is to present my quantitative studies of the cost of
19 equity capital for MPS/LP and to discuss the details and results of my analyses.

20 **Q. How are your studies organized?**

21 A. In the first part of my analysis, I apply alternative versions of the constant growth
22 DCF and multistage DCF model to a reference company group of electric utilities.
23 For inclusion in the group, each company is required to have at least an

1 investment grade bond rating, to have at least 70 percent of its revenues from
2 regulated utility sales, to have consistent financial records not affected by recent
3 mergers or restructuring, and to have a consistent dividend payment record with
4 no recent dividend reductions or eliminations. Application of the minimum 70
5 percent regulated utility revenues filter results in a group *average* percentage of
6 revenues from regulated utility sales of 87 percent, which helps to assure that non-
7 regulated activities are not a significant influence for the group. The results of my
8 DCF analyses are shown in Schedule SCH-9. In total, the DCF models produce
9 an ROE range of 10.0 percent to 11.4 percent for the reference group of
10 comparable companies. As discussed previously, the 10.0 percent result from the
11 traditional constant growth DCF model is not consistent with risk premium
12 checks of reasonableness or other consensus economic forecasts for higher
13 interest rates. Therefore, I do not include that result in my estimated DCF range.
14 The appropriate range from the remaining DCF models is 11.0 percent to 11.4
15 percent.

16 In the second part of my analysis, I develop and review cost of capital
17 estimates based on the risk premium methodology. I present my risk premium
18 study in Schedule 10. That analysis, based on allowed regulatory ROEs relative
19 to contemporaneous utility debt costs, indicates that a cost of equity of 11.05
20 percent is appropriate. Other risk premium approaches indicate ROEs as high as
21 11.98 percent. Given current market and utility industry conditions, the risk
22 premium approach adds useful perspective for judging investor requirements.
23 Based on the DCF and risk premium results, and with consideration for current

1 market, industry, and company-specific factors appropriate for the present case, I
2 estimate the cost of equity for MPS/LP at 11.5 percent.

3 **A. Discounted Cash Flow Analysis**

4 **Q. What stock prices are used in your DCF analyses?**

5 A. My analysis is based on the average of high and low stock prices for each
6 company for each of three recent months (March-May 2006). Although in theory
7 either average or "spot" stock prices can be used in a DCF analysis, a reasonably
8 current price consistent with present market conditions and with the other data
9 employed in the analysis is most appropriate. Since the cost of equity is a current
10 and forward-looking concept, the important issue is that the price should be
11 representative of current market conditions and not unduly influenced by unusual
12 or special circumstances.

13 **Q. Please summarize the results of your reference company DCF analyses.**

14 A. I apply three versions of the DCF model to estimate ROE. The traditional
15 Constant Growth version of the DCF model produces an ROE estimate of only
16 10.0 percent to 10.1 percent. As shown in Schedule SCH-9, page 2 the average
17 dividend yield in this model is about 4.8 percent and the average growth rate is
18 5.25 percent. The average growth rate is derived from traditional sources for
19 estimating growth in the DCF model. Specifically, equal weight is given to (1)
20 the sustainable growth "b times r" method, (2) Zacks' survey of individual
21 company 5-year analysts' earnings estimates, (3) *Value Line's* projected 3-to-5
22 year earnings growth rate, and (4) long-term growth in nominal Gross Domestic
23 Product (GDP). The "b times r" method and the analyst and *Value Line* earnings

1 projections are significantly and negatively influenced by the uncertainties,
2 discussed previously, that are currently affecting the industry. The "b times r,"
3 Zacks, and *Value Line* growth rates average only about 4.8 percent, which is only
4 two-thirds of the 6.6 percent growth rate for long-term GDP. The 10.0 percent to
5 10.1 percent ROE estimate from the traditional constant growth DCF approach is
6 not consistent with consensus economic projections for higher interest rates and is
7 100 basis points or more below current risk premium checks of reasonableness.
8 For these reasons, I do not include the traditional constant growth DCF result in
9 my recommended ROE range.

10 The non-constant growth Two-Stage DCF model indicates an ROE of 11.0
11 percent. For stage one of this model (years 1 through 4), the growth rate is based
12 on *Value Line's* projected dividends. The average growth rate for stage 1 of this
13 model is only 3.49 percent. The growth rate for stage 2 is the nominal growth rate
14 in GDP noted above. In combination, the 4.8 percent average dividend yield and
15 the 11.0 percent ROE estimate from this model imply an overall growth rate of
16 6.2 percent. This implied growth rate is based on the traditional yield plus growth
17 DCF format (11.0 percent ROE = 4.8 percent yield + 6.2 percent growth).

18 My third DCF model is based on the constant growth approach, but with
19 the growth rate estimate at the 6.6 percent long-term GDP growth rate. That
20 model indicates an ROE of range of 11.3 percent to 11.4 percent. As discussed
21 previously, based on expected further increases in market interest rates and other
22 capital market costs, it is my judgment that the fair cost of equity range should be
23 based on the Two-Stage growth DCF model and the Constant Growth model with

1 long-term GDP used as a proxy for long-term investor growth rate expectations.

2 Based on these two versions of the DCF model, the ROE range is 11.0 percent to

3 11.4 percent.

4 **B. Risk Premium Analysis**

5 **Q. How is your risk premium study structured?**

6 A. In my risk premium analysis, I compare authorized electric utility ROEs to
7 contemporaneous long-term interest rates on utility bonds. The equity risk
8 premium then is measured by the difference between the average authorized ROE
9 and the average debt cost for each year. This calculation for the period, 1980-
10 2005, is presented in Schedule SCH-10. The data show that risk premiums are
11 smaller when interest rates are high and larger when interest rates are low. For
12 example, in the early 1980s when utility interest rates exceeded fifteen percent,
13 allowed equity risk premiums were generally less than two percent. In more
14 recent years, with lower interest rates, allowed regulatory risk premiums have
15 generally been in the three- to four-percent range.

16 The inverse relationship between risk premiums and interest rate levels is
17 well documented in numerous, well-respected academic studies. (See, for
18 example, Robert S. Harris and Felicia C. Marston, "Estimating Shareholder Risk
19 Premia Using Analysts' Growth Forecasts," *Financial Management*, Summer
20 1992.)

21 These studies typically use regression analysis or other statistical methods
22 to predict or measure the risk premium relationship under varying interest rate
23 conditions. In Schedule SCH-10, page 2, I present a regression analysis of the

1 allowed annual equity risk premiums relative to interest rate levels. The
2 regression coefficient of -42.58 percent confirms the inverse relationship between
3 risk premiums and interest rates and indicates that risk premiums expand and
4 contract by about fifty-eight percent of the change in interest rates. This means
5 that when interest rates rise by one percentage point, the cost of equity increases
6 by only 0.58 of a percentage point, because the risk premium declines by about
7 0.42 percentage points. Similarly, when interest rates decline by one percentage
8 point, the cost of equity declines by only 0.58 of a percentage point. I use the
9 negative 42.58 percent interest rate change coefficient in conjunction with current
10 interest rates to establish the appropriate current equity risk premium. This
11 calculation is shown in the lower portion of page 1 of Schedule SCH-10. When
12 the resulting risk premium of 4.2 percent is added to the projected single-A utility
13 debt cost of 6.85 percent, the indicated ROE is 11.05 percent ($4.2\% + 6.85\% =$
14 11.05%).

15 **Q. How do the results of your risk premium studies compare to levels found in**
16 **other risk premium studies?**

17 A. My risk premium estimate is lower than those often found in other risk premium
18 studies. From the most widely followed data published by Ibbotson Associates
19 (Ibbotson Associates, *Stocks, Bonds, Bills and Inflation 2006 Yearbook*), for the
20 period 1926-2005, the indicated arithmetic mean risk premium for common
21 stocks versus long-term corporate bonds is 6.1 percent. Under the more
22 conservative assumption of geometric mean compounding, the Ibbotson risk
23 premium is 4.5 percent. Ibbotson argues extensively for the arithmetic mean

1 approach as the appropriate basis for estimating the cost of equity. Even with the
2 more conservative geometric mean risk premium, Ibbotson's data indicate a
3 single-A cost of equity of 11.35 percent (6.85 percent debt cost + 4.5 percent risk
4 premium = 11.35 percent).

5 The Harris and Marston ("H&M") study noted above also provides
6 specific equity risk premium estimates. Using analysts' growth estimates to
7 estimate equity returns, H&M found equity risk premiums of 6.47 percent relative
8 to U.S. Government bonds and 5.13 percent relative to yields on corporate debt.
9 H&M's equity risk premium relative to corporate debt indicates a current single-
10 A cost of equity of almost 12 percent (6.85 percent debt cost + 5.13 percent risk
11 premium = 11.98 percent).

12 **Q. Please summarize the results of your cost of equity analysis.**

13 A. The following table summarizes my results:

<hr/>		
Summary of Cost of Equity Estimates		
<u>DCF Analysis</u>		<u>Indicated Cost</u>
Constant Growth Model (Traditional Growth)		10.0%-10.1%
Constant Growth Model (GDP growth)		11.3%-11.4%
Two-Stage Growth Model		11.0%
Estimated DCF Model Range		<u>11.0% - 11.4%</u>
<hr/>		
Risk Premium Analysis		
Utility Debt + Risk Premium		
Risk Premium Analysis (6.85% + 4.2%)		11.05%
Ibbotson Risk Premium Analysis		
Risk Premium (6.85% + 4.5%)		11.35%
Harris-Marston Risk Premium		
Risk Premium (6.85% + 5.13%)		11.98%
<hr/>		
Reference Group Cost of Equity Capital		<u>11.25%</u>
<hr/>		
MPS/LP Cost of Equity Capital		<u>11.5%</u>
<hr/>		

Q. How should these results be interpreted to determine the fair cost of equity for MPS/LP?

A. To account for Aquila's higher construction and operating risks relative to the reference company group, I have adjusted the reference group ROE upward by a total of 25 basis points, to 11.5 percent. MPL/LP's required construction investments in Missouri over the next six years are expected to equal 93 percent of current net plant. This compares to average expected construction for the reference group companies equal to 59 percent of net plant. Also, MPS/LP's smaller size further increases perceived operating risks. Although uncertainty will continue to exist until fuel and purchased power adjustment clause issues are fully resolved, I have not in this case included a further upward adjustment for this risk. To the extent that FAC issues are resolved constructively, no further risk adjustment to the reference group ROE is appropriate, either up or down,

1 since the reference group companies already have such mechanisms in place. By
2 considering the additional risk characteristics for MPS/LP in conjunction with the
3 reference group estimated ROE, the Commission has a sound basis for setting a
4 fair cost of equity that is consistent consensus economic projections and with the
5 requirements of *Hope* and *Bluefield*.

6 **Q. Does this conclude your direct testimony?**

7 A. Yes.

Aquila Missouri

Capital Spending Relative to Net Plant

(\$millions unless otherwise noted)

No.	Reference Company	2005 Net Plant	Common Shares Outstanding			Capital Spending Per Share			Total Capital Spending	Spending % of 2005
			2006	2007	2008-2011	2006	2007	2008-2011	2006 -2011	Net Plant
1	Alliant Energy Co.	4,860	118.1	119.1	122.1	4.00	5.05	16.40	3,076	63.3%
2	Ameren	13,625	207.4	209.8	216.8	4.80	4.75	18.40	5,981	43.9%
3	American Elec. Pwr.	24,284	394.0	396.0	400.0	9.45	9.10	32.00	20,127	82.9%
4	CH Energy Group	780	15.8	15.8	15.0	5.15	5.10	21.00	477	61.1%
5	Cent. Vermont P.S.	301	10.4	10.5	10.7	1.75	1.70	6.80	109	36.1%
6	Con. Edison	17,112	255.0	257.0	263.0	7.20	7.15	22.80	9,670	56.5%
7	DTE Energy Co.	10,830	178.0	178.0	170.0	7.30	7.30	31.00	7,869	72.7%
8	Duquesne Light	1,542	87.5	87.5	88.0	2.45	1.75	4.00	720	46.7%
9	Empire District	896	27.2	28.2	30.0	4.35	5.35	13.00	659	73.5%
10	Energy East Corp.	5,784	148.0	148.3	149.0	3.00	2.70	10.00	2,334	40.4%
11	Green Mtn. Power	237	5.3	5.4	5.5	4.55	3.75	11.00	105	44.2%
12	Hawaiian Electric	2,543	81.2	81.4	82.0	2.55	2.00	9.00	1,108	43.6%
13	MGE Energy, Inc.	668	20.5	20.5	20.5	3.95	4.00	16.00	491	73.5%
14	NiSource Inc.	9,554	273.0	273.0	275.0	2.35	2.20	9.00	3,717	38.9%
15	Northeast Utilities	6,417	153.6	154.0	155.0	5.60	5.65	22.00	5,140	80.1%
16	NSTAR	3,702	106.8	106.8	106.8	3.80	2.80	11.00	1,880	50.8%
17	Pinnacle West	7,577	99.1	99.1	99.1	8.95	8.65	32.20	4,935	65.1%
18	PPL Corporation	10,916	381.0	382.0	375.0	3.45	3.90	11.00	6,929	63.5%
19	Progress Energy	14,442	254.0	256.0	261.0	6.95	6.75	26.00	10,279	71.2%
20	Puget Energy, Inc.	4,631	116.0	116.5	122.5	7.55	4.35	19.00	3,710	80.1%
21	SCANA Corp.	6,734	117.0	117.0	117.0	4.10	3.50	16.00	2,761	41.0%
22	Southern Co.	29,480	750.0	755.0	780.0	4.00	4.50	14.80	17,942	60.9%
23	Vectren Corp.	2,355	76.2	76.3	76.4	3.75	4.20	13.00	1,599	67.9%
24	Xcel Energy Inc.	14,696	406.0	427.0	435.0	3.90	3.70	10.00	7,513	51.1%
Average										58.7%
Aquila-MPS/LP Operations		1,297							1,203	92.8%

Source: Value Line Investment Survey, Electric Utility (East), Jun 2, 2006; (Central), Mar 31, 2006; (West), May 12, 2006.

Aquila Missouri
Reference Company Adjustment Clauses
June 2006

No.	Reference Company	Operating Company By Jurisdiction	Adjustment Clause?	Comment
1	Alliant Energy Co.	Interstate Power & Light (IA)	Yes	Traditional fuel & purch power adjustment clause
		Wisconsin Power & Light (WI)	Yes	Fuel clause effective outside of monitoring ranges
2	Ameren	CIPSCO, CILCO, Ill. Pwr (IL)	Pending	Recovery allowed 1/2/07, under legal challenges
		Union Electric (MO)	Pending	Enabled in MO July 2005; rules expected 2006
3	American Elec. Pwr.	Columbus South, Ohio Pwr (OH)	No	Rates frozen under rate stabilization plan
		Public Svc. Co. of Oklahoma (OK)	Yes	Traditional fuel & purch power adjustment clause
		AEP Texas Central, North (TX)	n/a	Retail service provided through unaffiliated REPs
		SWEPSCO (TX)	Yes	Traditional fuel & purch power adjustment clause
		Indiana Michigan Pwr Co. (IN)	No	Pending extension of fuel clause rate caps
		Appalachian Pwr Co. (VA)	Yes	Traditional fuel & purch power adjustment clause
		Kentucky Pwr Co. (KY)	Yes	Traditional fuel & purch power adjustment clause
4	CH Energy Group	Central Hudson G&E (NY)	Yes	Traditional fuel & purch power adjustment clause
5	Cent. Vermont P.S.	Cent. Vermont P.S. (VT)	No	No fuel adjustment clause in VT
6	Con. Edison Co.	Con. Ed., Orange & Rockland (NY)	Yes	Traditional fuel & purch power adjustment clause
7	DTE Energy Co.	Detroit Edison (MI)	Yes	Power Supply Cost Recovery mechanism
8	Duquesne Light	Duquesne Light (PA)	No	POLR rates fixed
9	Empire District	Empire District Electric Co. (MO)	Pending	Enabled in MO July 2005; rules expected 2006
10	Energy East Corp.	Central Maine Power (ME)	Yes	Traditional fuel & purch power adjustment clause
		Rochester G&E, NYSEG (NY)	Yes	Traditional fuel & purch power adjustment clause
11	Green Mtn. Power	Green Mt. Power (VT)	No	No fuel adjustment clause in VT
12	Hawaiian Electric	Hawaiian Electric (HI)	Yes	Traditional fuel & purch power adjustment clause
13	MGE Energy, Inc.	Madison G&E (WI)	Yes	Fuel clause effective outside of monitoring ranges
14	NiSource Inc.	NIPSCO (IN)	Yes	Traditional fuel & purch power adjustment clause
15	Northeast Utilities	Connecticut Light & Power (CT)	n/a	T&D utility allowed to recover all supply costs
		Western Mass. Electric Co. (MA)	n/a	T&D utility allowed to recover all supply costs
		Public Service Co. of NH (NH)	Yes	Co. files periodically for new energy services (ES) rate to recover generation and PP costs
16	NSTAR	Boston Edison, Comm Elec, Cambridge Elec (MA)	Yes	Traditional fuel & purch power adjustment clause

Aquila Missouri Reference Company Adjustment Clauses (cont'd)

No.	Reference Company	Operating Company By Jurisdiction	Adjustment Clause?	Comment
17	Pinnacle West	APS (AZ)	Yes	Power Supply Adjustor mechanism
18	PPL Corporation	PPL Electric Utilities (PA)	No	Contracts, risk mgt programs to manage fuel risk
19	Progress Energy	Progress Energy Carolina (NC)	Yes	Traditional fuel & purch power adjustment clause
		Progress Energy Florida (FL)	Yes	Traditional fuel & purch power adjustment clause
20	Puget Energy, Inc.	Puget Sound Energy (WA)	Yes	Power Cost Adjustment mechanism
21	SCANA Corp.	South Carolina E&G (SC)	Yes	Traditional fuel & purch power adjustment clause
22	Southern Co.	Alabama Power (AL)	Yes	Traditional fuel & purch power adjustment clause
		Georgia Power, Sav Pwr (GA)	Yes	Traditional fuel & purch power adjustment clause
		Gulf Power (FL)	Yes	Traditional fuel & purch power adjustment clause
		Mississippi Power (MS)	Yes	Traditional fuel & purch power adjustment clause
23	Vectren Corp.	Southern Indiana G&E (IN)	Yes	Traditional fuel & purch power adjustment clause
24	Xcel Energy Inc.	NSP-Minnesota (MN)	Yes	Traditional fuel & purch power adjustment clause
		NSP-Wisconsin (WI)	Yes	Fuel clause effective outside of monitoring ranges
		PSC Colorado (CO)	Yes	Through Electric Commodity Adjustment
		Southwestern Public Service (TX)	Yes	Traditional fuel & purch power adjustment clause
	Summary of Results	Comparable Cos with Trackers	18	
		Comparable Cos w/o Trackers	6	
		Total Comparable Cos	24	

Source: Company 10-K's

Aquila Missouri
Weighted Average Cost of Debt: MPS
December 2005

<u>Assigned Debt</u>	Effective Rate	224001-122 MPD Elec Dist	224001-121 MPD Elec Trans	224001-123 MPG	MO Electric Assigned Debt	MO Electric Annual Interest	MO Electric Weighted Avg Cost of Debt
30 Yr 8.27%, Due 11/15/21 Effective Rate 8.502%	8.502%	12,771,000	3,494,000	7,889,962	24,154,962	2,053,656	
15 Yr 8.2%, Due 1/15/07 Effective Rate 9.114%	9.114%	9,629,000	2,517,000	2,756,000	14,902,000	1,358,172	
30 Yr 8.0%, Due 3/1/23 Effective Rate 8.129%	8.129%	7,421,000	1,452,000	3,686,000	12,559,000	1,020,924	
Sr 6.70%, Due 10/15/06 Effective Rate 6.745%	6.745%	35,619,752	12,208,967	10,967,712	58,796,431	3,965,832	
Sr 11.875% (downgrade 14.875%), Due 7/1/12 Effective Rate 5.35% (10/01/04)	5.350%	69,954,461	16,976,000	21,133,500	108,063,961	5,781,420	
Wamego 96, Due 3/1/26 Effective Rate 2.441%	2.980%	2,921,000	1,050,000	2,644,000	6,615,000	194,424	
Environ Improve, Due 5/1/28 Effective Rate 2.404%	3.020%	0	0	5,000,000	5,000,000	153,900	
Sanwa Bank Loan, Due 12/9/09 Effective Rate 7.02%	7.020%	0	0	3,192,865	3,192,865	224,136	
Sr 11.875% (downgrade 14.875%), Due 7/1/12 Effective Rate 6.05% (7/15/04)	6.050%	59,655,000	121,000	6,395,000	66,171,000	4,003,344	
Sr 7.625%, Due 11/15/09 Effective Rate 7.742%	7.742%	10,591,084	6,800,000	33,774,000	51,165,084	3,961,200	
Sr 7.95% (downgrade 9.95%), Due 2/1/11 Effective Rate 8.01%	8.010%	21,437,203	6,314,033	39,829,326	67,580,562	5,413,200	
Total		229,999,500	50,933,000	137,268,365	418,200,865	28,130,208	6.726%

Aquila Missouri
Weighted Average Cost of Debt: SJLP
December 2005

<u>Assigned Debt</u>	Electric 224001-122 SJD	Generation 224001-123 SJG	Transmission 224001-121 SJLP	SJLP Electric Assigned Debt	SJLP Electric Annual Interest	SJLP Electric Weighted Avg Cost of Debt
Poll Cntrl Bonds 5.85%, Due 2/1/13 Effective Rate 6.991%	-	5,600,000	-	5,600,000	391,500	
20 Yr MTN 7.13%, Due 11/29/13 Effective Rate 7.541%	1,000,000	-	-	1,000,000	75,408	
20 Yr MTN 7.16%, Due 11/29/13 Effective Rate 7.573%	4,300,000	1,700,000	-	6,000,000	454,380	
30 Yr MTN 7.17%, Due 12/1/23 Effective Rate 7.584%	7,000,000	-	-	7,000,000	530,880	
30 Yr MTN 7.33%, Due 11/30/23 Effective Rate 7.753%	-	3,000,000	-	3,000,000	232,596	
Sr 7.625%, Due 11/15/09 Effective Rate 7.742%	60,600,000	23,600,000	2,700,000	86,900,000	6,727,800	
Sr 7.95% (downgrade 9.95%), Due 2/1/11 Effective Rate 8.01%	1,661,000	18,000,000		19,661,000	1,574,844	
Total	74,561,000	51,900,000	2,700,000	129,161,000	9,987,408	
9.44% FMB, Due 2/1/2021 Effective Rate 9.487%	Debt on SJD books - assumes 100% Electric			18,000,000	1,707,660	
				147,161,000	11,695,068	7.947%

Aquila Missouri
Comparable Company Capital Structure

Company	YE 2005			Value Line 3-5 Year Estimate		
	Common Equity Ratio	Long-Term Debt Ratio	Preferred Stock Ratio	Common Equity Ratio	Long-Term Debt Ratio	Preferred Stock Ratio
1 Alliant Energy Co.	53.0%	41.5%	5.5%	50.0%	46.0%	4.0%
2 Ameren	53.5%	44.5%	2.0%	53.5%	45.0%	1.5%
3 American Elec. Pwr.	44.9%	54.8%	0.3%	39.5%	60.0%	0.5%
4 CH Energy Group	58.0%	39.6%	2.4%	50.0%	48.0%	2.0%
5 Cent. Vermont P.S.	61.8%	34.7%	3.5%	58.5%	39.5%	2.0%
6 Con. Edison	49.0%	49.6%	1.4%	50.5%	48.0%	1.5%
7 DTE Energy Co.	44.9%	55.1%	0.0%	46.5%	53.5%	0.0%
8 Duquesne Light	37.2%	54.4%	8.4%	42.5%	51.0%	6.5%
9 Empire District	49.0%	51.0%	0.0%	47.5%	52.5%	0.0%
10 Energy East Corp.	43.8%	55.9%	0.3%	45.0%	54.5%	0.5%
11 Green Mtn. Power	58.6%	41.4%	0.0%	50.0%	50.0%	0.0%
12 Hawaiian Electric	53.3%	45.2%	1.5%	53.5%	45.5%	1.0%
13 MGE Energy, Inc.	60.7%	39.3%	0.0%	61.0%	39.0%	0.0%
14 NiSource Inc.	48.0%	51.2%	0.8%	52.0%	47.5%	0.5%
15 Northeast Utilities	35.1%	63.2%	1.7%	35.5%	63.0%	1.5%
16 NSTAR	38.6%	60.4%	1.0%	51.5%	47.5%	1.0%
17 Pinnacle West	56.8%	43.2%	0.0%	53.0%	47.0%	0.0%
18 PPL Corporation	42.0%	57.5%	0.5%	49.5%	48.5%	2.0%
19 Progress Energy	43.3%	56.2%	0.5%	51.0%	48.5%	0.5%
20 Puget Energy, Inc.	45.6%	54.4%	0.0%	47.5%	52.5%	0.0%
21 SCANA Corp.	46.6%	51.4%	2.0%	53.5%	45.0%	1.5%
22 Southern Co.	44.3%	53.2%	2.5%	46.0%	52.5%	1.5%
23 Vectren Corp.	49.0%	51.0%	0.0%	50.0%	50.0%	0.0%
24 Xcel Energy Inc.	47.3%	51.7%	1.0%	52.5%	47.0%	0.5%
Average	48.5%	50.0%	1.5%	49.6%	49.2%	1.2%

Source: Value Line Investment Survey, Electric Utility (East), Jun 2, 2006; (Central), Mar 31, 2006; (West), May 12, 2006.

AQUILA MISSOURI
BOND RATINGS CRITERIA
RATIO GUIDELINES

STANDARD & POOR'S
 (Business Profile 6)

Ratio	Bond Rating			
	AA	A	BBB	BB
FFO Interest Coverage*	5.2-6.0x	4.2-5.2x	3.0-4.2x	2.0-3.0x
FFO/Total Debt	35-45%	28-35%	18-28%	12-18%
Total Debt/ Total Capital	32-40%	40-48%	48-58%	58-62%

*Flow of Funds from Operations (FFO) is net income from continuing operations plus non-cash items such as depreciation, amortization, and deferred income taxes.

SOURCE: *Standard & Poor's Rating Criteria*, October 28, 2004.

AQUILA MISSOURI

Rate Base Investment – To Meet Customer Needs

Over the Next 5 Years (\$ Millions)⁽¹⁾

latan2	\$ 290
Environmental	130
150 mW Coal Generation	80
Other – Electric Generation, Transmission	150
Total	\$ 650.0

⁽¹⁾Schedule represents capital expenditures in excess of annual depreciation.

Maturing and Callable Debt – Through 2007

Maturities (\$ Millions)

PIES	\$ 2.6
6.70% Series due October 15, 2006	85.9
8.20% Series due January 15, 2007	36.9
	\$ 125.4

Debt with Call Features:

QUIBS	\$ 287.5
Term Loan	220.0
8.00% Series due March 1, 2023	51.5
	\$ 559.0

Total	\$ 684.4
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Divestiture Statistics

(\$ Millions)

Domestic Utility Assets	\$ 896.7
Merchant Peaking Power Plants	75.0
Everest Communications	85.7

Total Sale Proceeds	\$ 1057.4
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Source: Aquila 2005 Form 10 - Page 31.

Aquila Missouri
Financial Ratio Analysis
(\$millions unless otherwise noted)

Case 1: Company Requested Capital Structure, 11.50% ROE

Revenue Requirement	SJLP Retail Jurisdictional	MPS Retail Jurisdictional
Rate Base	184,536,272	849,916,414
ROE	11.50%	11.50%
Equity Ratio	47.50%	47.50%
Debt Ratio	52.50%	52.50%
Cost of Debt	7.947%	6.726%
Income Tax Rate	38.39%	38.39%
WACC	9.63%	8.99%
Net Operating Income (NOI) Requirement	17,779,470	76,438,508
NOI Available	3,422,409	20,951,266
Additional NOI Needed	14,357,061	55,487,242
Additional Current Tax Required	10,080,125	38,959,556
Additional Gross Revenue Requirement	24,437,186	94,446,798
Funds from Operations (FFO)/Total Debt		
Net Income Requested	10,080,294	46,426,684
Regulatory Disallowances (after-tax)	0	0
Depreciation & Amortization	11,774,542	48,864,056
Deferred Taxes & ITC	(799,370)	951,902
Funds from Operations (FFO)	21,055,466	96,242,642
Long-Term Debt	96,881,543	446,206,117
FFO/Total Debt	21.73%	21.57%
<i>Implied S&P Bond Rating (Business Position: 6)</i>	<i>BBB</i>	<i>BBB</i>
Funds from Operations (FFO) Interest Coverage		
Funds from Operations (FFO)	21,055,466	96,242,642
Interest Expense	7,699,176	30,011,823
FFO Interest Coverage	3.73	4.21
<i>Implied S&P Bond Rating (Business Position: 6)</i>	<i>BBB</i>	<i>A</i>
Total Debt/Total Capital		
Total Debt/Total Capital	52.50%	52.50%
<i>Implied S&P Bond Rating (Business Position: 6)</i>	<i>BBB</i>	<i>BBB</i>

Aquila Missouri
Financial Ratio Analysis
(\$millions unless otherwise noted)

Case 2: Aquila Consolidated Capital Structure, 11.50% ROE

Revenue Requirement	SJLP Retail Jurisdictional	MPS Retail Jurisdictional
Rate Base	184,536,272	849,916,414
ROE	11.50%	11.50%
Equity Ratio	39.80%	39.80%
Debt Ratio	60.20%	60.20%
Cost of Debt	7.947%	6.726%
Income Tax Rate	38.39%	38.39%
WACC	9.36%	8.63%
Net Operating Income (NOI) Requirement	17,274,614	73,314,232
NOI Available	3,422,409	20,951,266
Additional NOI Needed	13,852,205	52,362,966
Additional Current Tax Required	8,631,491	32,628,052
Additional Gross Revenue Requirement	22,483,696	84,991,017
Funds from Operations (FFO)/Total Debt		
Net Income Requested	8,446,225	38,900,674
Regulatory Disallowances (after-tax)	0	0
Depreciation & Amortization	11,774,542	48,864,056
Deferred Taxes & ITC	(799,370)	951,902
Funds from Operations (FFO)	19,421,397	88,716,632
Long-Term Debt	111,090,836	511,649,681
FFO/Total Debt	17.48%	17.34%
<i>Implied S&P Bond Rating (Business Position: 6)</i>	<i>BB</i>	<i>BB</i>
Funds from Operations (FFO) Interest Coverage		
Funds from Operations (FFO)	19,421,397	88,716,632
Interest Expense	8,828,389	34,413,558
FFO Interest Coverage	3.20	3.58
<i>Implied S&P Bond Rating (Business Position: 6)</i>	<i>BBB</i>	<i>BBB</i>
Total Debt/Total Capital		
Total Debt/Total Capital	60.20%	60.20%
<i>Implied S&P Bond Rating (Business Position: 6)</i>	<i>BB</i>	<i>BB</i>

Aquila Missouri
Financial Ratio Analysis
(\$millions unless otherwise noted)

Case 3: Aquila Consolidated Capital Structure, No Rate Increase

	SJLP Retail	MPS Retail
Revenue Requirement	Jurisdictional	Jurisdictional
Rate Base	184,536,272	849,916,414
ROE	11.50%	11.50%
Equity Ratio	39.80%	39.80%
Debt Ratio	60.20%	60.20%
Cost of Debt	7.947%	6.726%
Income Tax Rate	38.39%	38.39%
WACC	9.36%	8.63%
Net Operating Income (NOI) Requirement	17,274,614	73,314,232
NOI Available	3,422,409	20,951,266
Additional NOI Needed	13,852,205	52,362,966
Additional Current Tax Required	8,631,491	32,628,052
Additional Gross Revenue Requirement	22,483,696	84,991,017
Funds from Operations (FFO)/Total Debt		
Net Income Requested	8,446,225	38,900,674
Regulatory Disallowances (after-tax)	(13,852,205)	(52,362,966)
Depreciation & Amortization	11,774,542	48,864,056
Deferred Taxes & ITC	(799,370)	951,902
Funds from Operations (FFO)	5,569,192	36,353,666
Long-Term Debt	111,090,836	511,649,681
FFO/Total Debt	5.01%	7.11%
<i>Implied S&P Bond Rating (Business Position: 6)</i>	<i>B</i>	<i>B</i>
Funds from Operations (FFO) Interest Coverage		
Funds from Operations (FFO)	5,569,192	36,353,666
Interest Expense	8,828,389	34,413,558
FFO Interest Coverage	1.63	2.06
<i>Implied S&P Bond Rating (Business Position: 6)</i>	<i>B</i>	<i>BB</i>
Total Debt/Total Capital		
Total Debt/Total Capital	60.20%	60.20%
<i>Implied S&P Bond Rating (Business Position: 6)</i>	<i>BB</i>	<i>BB</i>

Aquila Missouri
Capital Structure-ROE Tradeoff
Missouri Public Service Company Cost of Debt

Case 1: Company Case As-Filed

Capital Component	Percent	Cost Rate	Weighted Cost	Tax Inclusive Cost
Debt	52.50%	6.73%	3.53%	3.53%
Equity	47.50%	11.50%	5.46%	8.87%
	100.00%		8.99%	<u>12.40%</u>

Case 2: Consolidated Capital Structure; Adjusted ROE to Yield Equivalent Tax-Inclusive Rate of Return

Capital Component	Percent	Cost Rate	Weighted Cost	Tax Inclusive Cost
Debt	60.20%	6.73%	4.05%	4.05%
Equity	39.80%	12.93%	5.15%	8.35%
	100.00%		9.19%	<u>12.40%</u>

Note: Tax rate = 38.39%

Aquila Missouri
Capital Structure-ROE Tradeoff
St. Joseph Light & Power Company Cost of Debt

Case 1: Company Case As-Filed

Capital Component	Percent	Cost Rate	Weighted Cost	Tax Inclusive Cost
Debt	52.50%	7.95%	4.17%	4.17%
Equity	47.50%	11.50%	5.46%	8.87%
	100.00%		9.63%	13.04%

Case 2: Consolidated Capital Structure; Adjusted ROE to Yield Equivalent Tax-Inclusive Rate of Return

Capital Component	Percent	Cost Rate	Weighted Cost	Tax Inclusive Cost
Debt	60.20%	7.95%	4.78%	4.78%
Equity	39.80%	12.78%	5.09%	8.26%
	100.00%		9.87%	13.04%

Note: Tax rate = 38.39%

Aquila Missouri
Historical Capital Market Costs

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Prime Rate	8.3%	8.4%	8.4%	8.0%	9.2%	6.9%	4.7%	4.1%	4.3%	6.2%
Consumer Price Index	2.9%	2.3%	1.6%	2.2%	3.4%	2.8%	1.6%	2.3%	2.7%	3.4%
Long-Term Treasuries	6.7%	6.6%	5.6%	5.9%	5.9%	5.5%	5.4%	5.0%	5.1%	4.7%
Moody's Avg Utility Debt	7.7%	7.6%	7.0%	7.6%	8.1%	7.7%	7.5%	6.6%	6.2%	5.7%
Moody's Baa Utility Debt	8.2%	8.0%	7.3%	7.9%	8.4%	8.0%	8.0%	6.8%	6.4%	5.9%

SOURCES:

Prime Interest Rate - Federal Reserve Bank of St. Louis website
Consumer Price Index - Federal Reserve Bank of St. Louis website
Long-Term Treasuries - Federal Reserve Bank of St. Louis website
Moody's Average Utility Debt - Moody's (Mergent) Bond Record
Moody's A Utility Debt - Moody's (Mergent) Bond Record

Aquila Missouri
Three-Month Average Moody's Utility Bond Yields

<u>MONTH</u>	<u>MOODY'S TRIPLE-B UTILITY BOND YIELD</u>	<u>MOODY'S AVERAGE UTILITY BOND YIELD</u>
Mar-06	6.25%	5.97%
Apr-06	6.58%	6.32%
May-06	6.59%	6.39%
AVERAGE	6.47%	6.23%

Source: Mergent Bond Record

Economic Indicators

Seasonally Adjusted Annual Rates — Dollar Figures in Billions

	Annual % Change				2005				2006				E2007			
	2005	E2006	E2007		2005	4Q	P10	E20	E30	E40	1Q	2Q	3Q			
Gross Domestic Product																
GDP (current dollars)	\$12,487.2	\$13,294.0	\$13,883.0	6.4	6.5	4.4										
Annual rate of increase (%)	6.4	6.5	4.4	-	-	-										
Annual rate of increase—real GDP (%)	3.5	3.4	2.4	-	-	-										
Annual rate of increase—GDP deflator (%)	2.8	3.0	2.0	-	-	-										
* Components of Real GDP																
Personal consumption expenditures	\$7,856.9	\$8,089.0	\$8,282.0	3.5	3.0	2.4										
% change	3.5	3.0	2.4	-	-	-										
Durable goods	1,138.4	1,178.6	1,198.4	4.5	3.5	1.7										
Nondurable goods	2,297.9	2,372.1	2,416.9	4.4	3.2	1.9										
Services	4,436.4	4,556.7	4,682.6	2.9	2.7	2.8										
Nonresidential fixed investment	1,289.0	1,414.5	1,512.2	8.6	9.7	6.9										
% change	8.6	9.7	6.9	-	-	-										
Producers durable equipment	1,050.8	1,158.2	1,225.8	10.9	10.2	5.8										
Residential fixed investment	592.5	591.7	540.9	7.2	(0.1)	(8.6)										
% change	7.2	(0.1)	(8.6)	-	-	-										
Net change in business inventories	20.3	39.5	25.2	-	-	-										
Gov't purchases of goods & services	1,987.1	2,018.8	2,046.8	1.8	1.6	1.4										
Federal	740.5	763.2	767.5	2.3	3.1	0.6										
State & local	1,246.4	1,255.7	1,279.2	1.5	0.8	1.9										
Net exports	(633.1)	(658.0)	(617.3)	-	-	-										
Exports	1,195.3	1,303.0	1,420.4	6.9	9.0	9.0										
Imports	1,828.4	1,980.9	2,037.7	6.3	7.3	3.9										
** Income & Profits																
Personal income	\$10,248.3	\$10,825.0	\$11,435.0	5.5	5.7	5.6										
Disposable personal income	9,038.6	9,469.0	9,952.0	4.3	4.9	5.1										
Savings rate (%)	(0.4)	(1.3)	(0.5)	-	-	-										
Corporate profits before taxes	1,438.3	1,664.0	1,600.1	35.8	15.7	(3.8)										
Corporate profits after taxes	1,060.2	1,221.5	1,179.2	34.5	15.2	(3.5)										
† Earnings per share (S&P 500)	69.92	78.80	82.00	19.4	12.9	3.7										
† Prices & Interest Rates																
Consumer price index	3.4	3.2	1.8	-	-	-										
Treasury bills	3.1	4.7	4.8	-	-	-										
10-yr notes	4.3	5.0	5.5	-	-	-										
30-yr bonds	4.6	5.1	5.6	-	-	-										
New issue rate—corporate bonds	5.2	5.9	6.6	-	-	-										
Other Key Indicators																
Housing starts (1,000 units SAAR)	2,071.8	1,910.0	1,730.0	6.3	(8.0)	(9.1)										
Auto & truck sales (1,000,000 units)	16.9	16.6	16.4	0.0	(1.5)	(1.5)										
Unemployment rate (%)	5.1	4.7	5.0	-	-	-										
\$ U.S. dollar	(1.8)	(2.6)	(6.7)	-	-	-										

Note: Annual changes are from prior year and quarterly changes are from prior quarter. Figures may not add to totals because of rounding. A—Advance data. P—Preliminary. E—Estimated. R—Revised. *1996 Chain-weighted dollars. **Current dollars. †Trailing 4 quarters. ‡Average for period. §Quarterly % changes at quarterly rates. This forecast prepared by Standard & Poor's.

Aquila Missouri
Discounted Cash Flow Analysis
Summary Of DCF Model Results

Company	Traditional Constant Growth DCF Model	Constant Growth DCF Model Long-Term GDP Growth	Low Near-Term Growth Two-Stage Growth DCF Model
1 Alliant Energy Co.	8.8%	10.4%	10.4%
2 Ameren	9.5%	11.7%	10.9%
3 American Elec. Pwr.	8.7%	11.3%	11.2%
4 CH Energy Group	8.8%	11.2%	10.5%
5 Cent. Vermont P.S.	12.1%	11.2%	10.4%
6 Con. Edison	9.4%	11.9%	11.2%
7 DTE Energy Co.	11.0%	11.7%	10.9%
8 Duquesne Light	11.4%	12.6%	11.6%
9 Empire District	10.6%	12.4%	11.4%
10 Energy East Corp.	9.6%	11.7%	11.4%
11 Green Mtn. Power	9.1%	11.0%	11.0%
12 Hawaiian Electric	9.1%	11.3%	10.5%
13 MGE Energy, Inc.	10.4%	11.0%	10.4%
14 NiSource Inc.	8.6%	11.0%	10.6%
15 Northeast Utilities	11.8%	10.5%	10.6%
16 NSTAR	10.2%	11.1%	11.0%
17 Pinnacle West	10.9%	12.0%	11.7%
18 PPL Corporation	12.4%	10.6%	11.1%
19 Progress Energy	9.3%	12.4%	11.7%
20 Puget Energy, Inc.	10.2%	11.4%	11.0%
21 SCANA Corp.	9.7%	11.2%	11.0%
22 Southern Co.	10.3%	11.6%	11.4%
23 Vectren Corp.	9.6%	11.4%	11.0%
24 Xcel Energy Inc.	10.3%	11.6%	11.5%
GROUP AVERAGE	10.1%	11.4%	11.0%
GROUP MEDIAN	10.0%	11.3%	11.0%

Sources: Value Line Investment Survey, Electric Utility (East), Jun 2, 2006; (Central), Mar 31, 2006; (West), May 12, 2006.

NOTE: SEE PAGE 5 OF THIS SCHEDULE FOR FURTHER EXPLANATION OF EACH COLUMN.

Aquila Missouri
Discounted Cash Flow Analysis
Traditional Constant Growth DCF Model

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
Company	Recent Price(P0)	Next Year's Div(D1)	Dividend Yield	Projected Growth Rate Analysis										ROE K=Div Yld+G (Cols 3+13)
				Year 2010 "BR" Growth Rate Calculation						Zacks Value Line GDP Growth			Average Growth (Cols 9-12)	
				DPS	EPS	Retention Rate (B)	NBV	ROE (R)	B*R Growth					
1 Alliant Energy Co.	32.58	1.25	3.84%	1.49	2.30	35.22%	25.70	8.95%	3.15%	4.00%	6.00%	6.60%	4.94%	8.8%
2 Ameren	49.75	2.54	5.11%	2.54	3.45	26.38%	36.35	9.49%	2.50%	6.00%	2.50%	6.60%	4.40%	9.5%
3 American Elec. Pwr.	34.10	1.60	4.69%	1.90	3.00	36.67%	28.25	10.62%	3.89%	3.00%	2.50%	6.60%	4.00%	8.7%
4 CH Energy Group	47.29	2.16	4.57%	2.20	3.25	32.31%	35.25	9.22%	2.98%	NA	3.00%	6.60%	4.19%	8.8%
5 Cent. Vermont P.S.	19.94	0.92	4.61%	0.92	1.75	47.43%	18.95	9.23%	4.38%	NA	11.50%	6.60%	7.49%	12.1%
6 Con. Edison	43.40	2.32	5.35%	2.38	3.20	25.63%	34.30	9.33%	2.39%	4.20%	3.00%	6.60%	4.05%	9.4%
7 DTE Energy Co.	40.67	2.06	5.07%	2.10	4.25	50.59%	41.25	10.30%	5.21%	5.50%	6.50%	6.60%	5.95%	11.0%
8 Duquesne Light	16.65	1.00	6.01%	1.00	1.50	33.33%	10.60	14.15%	4.72%	NA	5.00%	6.60%	5.44%	11.4%
9 Empire District	22.25	1.28	5.75%	1.28	1.50	14.67%	16.25	9.23%	1.35%	NA	6.50%	6.60%	4.82%	10.6%
10 Energy East Corp.	24.11	1.24	5.14%	1.40	2.00	30.00%	21.25	9.41%	2.82%	4.50%	4.00%	6.60%	4.48%	9.6%
11 Green Mtn. Power	28.49	1.24	4.35%	1.54	2.55	39.61%	24.75	10.30%	4.08%	NA	3.50%	6.60%	4.73%	9.1%
12 Hawaiian Electric	26.67	1.24	4.65%	1.24	1.75	29.14%	17.00	10.29%	3.00%	5.20%	3.00%	6.60%	4.45%	9.1%
13 MGE Energy, Inc.	31.47	1.39	4.42%	1.44	2.45	41.22%	19.05	12.86%	5.30%	NA	6.00%	6.60%	5.97%	10.4%
14 NiSource Inc.	20.81	0.92	4.42%	1.00	1.75	42.86%	21.50	8.14%	3.49%	3.30%	3.50%	6.60%	4.22%	8.6%
15 Northeast Utilities	19.69	0.76	3.86%	0.97	2.00	51.50%	19.00	10.53%	5.42%	8.70%	11.00%	6.60%	7.93%	11.8%
16 NSTAR	27.91	1.26	4.51%	1.50	2.50	40.00%	18.75	13.33%	5.33%	5.00%	6.00%	6.60%	5.73%	10.2%
17 Pinnacle West	39.77	2.13	5.36%	2.43	3.55	31.55%	40.20	8.83%	2.79%	6.80%	6.00%	6.60%	5.55%	10.9%
18 PPL Corporation	29.82	1.20	4.02%	1.65	3.25	49.23%	17.75	18.31%	9.01%	8.30%	9.50%	6.60%	8.35%	12.4%
19 Progress Energy	43.18	2.50	5.79%	2.62	3.40	22.94%	36.65	9.28%	2.13%	3.80%	1.50%	6.60%	3.51%	9.3%
20 Puget Energy, Inc.	20.92	1.00	4.78%	1.10	1.75	37.14%	21.00	8.33%	3.10%	7.00%	5.00%	6.60%	5.42%	10.2%
21 SCANA Corp.	39.21	1.80	4.59%	2.10	3.50	40.00%	30.00	11.67%	4.67%	4.70%	4.50%	6.60%	5.12%	9.7%
22 Southern Co.	32.29	1.62	5.02%	1.88	2.75	31.64%	18.60	14.78%	4.68%	4.80%	5.00%	6.60%	5.27%	10.3%
23 Vectren Corp.	26.36	1.27	4.82%	1.39	2.05	32.20%	18.35	11.17%	3.60%	5.00%	4.00%	6.60%	4.80%	9.6%
24 Xcel Energy Inc.	18.46	0.93	5.04%	1.10	1.75	37.14%	15.75	11.11%	4.13%	4.20%	6.00%	6.60%	5.23%	10.3%
GROUP AVERAGE	30.66	1.48	4.82%						3.92%	5.22%	5.21%	6.60%	5.25%	10.1%
GROUP MEDIAN			4.74%											10.0%

Sources: Value Line Investment Survey, Electric Utility (East), Jun 2, 2006; (Central), Mar 31, 2006; (West), May 12, 2006.

NOTE: SEE PAGE 5 OF THIS SCHEDULE FOR FURTHER EXPLANATION OF EACH COLUMN.

Aquila Missouri
Discounted Cash Flow Analysis
Constant Growth DCF Model
Long-Term GDP Growth

	(15)	(16)	(17)	(18)	(19)
	Next			ROE	
Company	Recent Price(P0)	Year's Div(D1)	Dividend Yield	GDP K=Div Yld+G Growth	(Cols 17+18)
1 Alliant Energy Co.	32.58	1.25	3.84%	6.60%	10.4%
2 Ameren	49.75	2.54	5.11%	6.60%	11.7%
3 American Elec. Pwr.	34.10	1.60	4.69%	6.60%	11.3%
4 CH Energy Group	47.29	2.16	4.57%	6.60%	11.2%
5 Cent. Vermont P.S.	19.94	0.92	4.61%	6.60%	11.2%
6 Con. Edison	43.40	2.32	5.35%	6.60%	11.9%
7 DTE Energy Co.	40.67	2.06	5.07%	6.60%	11.7%
8 Duquesne Light	16.65	1.00	6.01%	6.60%	12.6%
9 Empire District	22.25	1.28	5.75%	6.60%	12.4%
10 Energy East Corp.	24.11	1.24	5.14%	6.60%	11.7%
11 Green Mtn. Power	28.49	1.24	4.35%	6.60%	11.0%
12 Hawaiian Electric	26.67	1.24	4.65%	6.60%	11.3%
13 MGE Energy, Inc.	31.47	1.39	4.42%	6.60%	11.0%
14 NiSource Inc.	20.81	0.92	4.42%	6.60%	11.0%
15 Northeast Utilities	19.69	0.76	3.86%	6.60%	10.5%
16 NSTAR	27.91	1.26	4.51%	6.60%	11.1%
17 Pinnacle West	39.77	2.13	5.36%	6.60%	12.0%
18 PPL Corporation	29.82	1.20	4.02%	6.60%	10.6%
19 Progress Energy	43.18	2.50	5.79%	6.60%	12.4%
20 Puget Energy, Inc.	20.92	1.00	4.78%	6.60%	11.4%
21 SCANA Corp.	39.21	1.80	4.59%	6.60%	11.2%
22 Southern Co.	32.29	1.62	5.02%	6.60%	11.6%
23 Vectren Corp.	26.36	1.27	4.82%	6.60%	11.4%
24 Xcel Energy Inc.	18.46	0.93	5.04%	6.60%	11.6%
GROUP AVERAGE	30.66	1.48	4.82%	6.60%	11.4%
GROUP MEDIAN			4.74%		11.3%

Sources: Value Line Investment Survey, Electric Utility (East), Jun 2, 2006; (Central), Mar 31, 2006; (West), May 12, 2006.

NOTE: SEE PAGE 5 OF THIS SCHEDULE FOR FURTHER EXPLANATION OF EACH COLUMN.

Aquila Missouri
Discounted Cash Flow Analysis
Low Near-Term Growth
Two-Stage Growth DCF Model

	(20)	(21)	(22)	(23)	(24)	(25)	(26)	(27)	(28)	(29)	(30)
Company	Next	2010	Annual	CASH FLOWS							ROE=Internal
	Year's	Div	Change	Recent	Year 1	Year 2	Year 3	Year 4	Year 5	Year 5-150	Rate of Return
	Div	Div	to 2010	Price	Div	Div	Div	Div	Div	Div Growth	(Yrs 0-150)
1 Alliant Energy Co.	1.25	1.49	0.08	32.58	1.25	1.33	1.41	1.49	1.59	6.60%	10.4%
2 Ameren	2.54	2.54	0.00	49.75	2.54	2.54	2.54	2.54	2.71	6.60%	10.9%
3 American Elec. Pwr.	1.60	1.90	0.10	34.10	1.60	1.70	1.80	1.90	2.03	6.60%	11.2%
4 CH Energy Group	2.16	2.20	0.01	47.29	2.16	2.17	2.19	2.20	2.35	6.60%	10.5%
5 Cent. Vermont P.S.	0.92	0.92	0.00	19.94	0.92	0.92	0.92	0.92	0.98	6.60%	10.4%
6 Con. Edison	2.32	2.38	0.02	43.40	2.32	2.34	2.36	2.38	2.54	6.60%	11.2%
7 DTE Energy Co.	2.06	2.10	0.01	40.67	2.06	2.07	2.09	2.10	2.24	6.60%	10.9%
8 Duquesne Light	1.00	1.00	0.00	16.65	1.00	1.00	1.00	1.00	1.07	6.60%	11.6%
9 Empire District	1.28	1.28	0.00	22.25	1.28	1.28	1.28	1.28	1.36	6.60%	11.4%
10 Energy East Corp.	1.24	1.40	0.05	24.11	1.24	1.29	1.35	1.40	1.49	6.60%	11.4%
11 Green Mtn. Power	1.24	1.54	0.10	28.49	1.24	1.34	1.44	1.54	1.64	6.60%	11.0%
12 Hawaiian Electric	1.24	1.24	0.00	26.67	1.24	1.24	1.24	1.24	1.32	6.60%	10.5%
13 MGE Energy, Inc.	1.39	1.44	0.02	31.47	1.39	1.41	1.42	1.44	1.54	6.60%	10.4%
14 NiSource Inc.	0.92	1.00	0.03	20.81	0.92	0.95	0.97	1.00	1.07	6.60%	10.6%
15 Northeast Utilities	0.76	0.97	0.07	19.69	0.76	0.83	0.90	0.97	1.03	6.60%	10.6%
16 NSTAR	1.26	1.50	0.08	27.91	1.26	1.34	1.42	1.50	1.60	6.60%	11.0%
17 Pinnacle West	2.13	2.43	0.10	39.77	2.13	2.23	2.33	2.43	2.59	6.60%	11.7%
18 PPL Corporation	1.20	1.65	0.15	29.82	1.20	1.35	1.50	1.65	1.76	6.60%	11.1%
19 Progress Energy	2.50	2.62	0.04	43.18	2.50	2.54	2.58	2.62	2.79	6.60%	11.7%
20 Puget Energy, Inc.	1.00	1.10	0.03	20.92	1.00	1.03	1.07	1.10	1.17	6.60%	11.0%
21 SCANA Corp.	1.80	2.10	0.10	39.21	1.80	1.90	2.00	2.10	2.24	6.60%	11.0%
22 Southern Co.	1.62	1.88	0.09	32.29	1.62	1.71	1.79	1.88	2.00	6.60%	11.4%
23 Vectren Corp.	1.27	1.39	0.04	26.36	1.27	1.31	1.35	1.39	1.48	6.60%	11.0%
24 Xcel Energy Inc.	0.93	1.10	0.06	18.46	0.93	0.99	1.04	1.10	1.17	6.60%	11.5%
GROUP AVERAGE											11.0%
GROUP MEDIAN											11.0%

Sources: Value Line Investment Survey, Electric Utility (East), Jun 2, 2006; (Central), Mar 31, 2006; (West), May 12, 2006.

NOTE: SEE PAGE 5 OF THIS SCHEDULE FOR FURTHER EXPLANATION OF EACH COLUMN.

Aquila Missouri
Discounted Cash Flow Analysis
DCF Analysis Column Descriptions

Column 1: Three-month Average Price per Share (Mar 2006-May 2006)	Column 16: See Column 2
Column 2: Estimated 2007 Dividends per Share from Value Line	Column 17: Column 16 Divided by Column 15
Column 3: Column 2 Divided by Column 1	Column 18: See Column 12
Column 4: Estimated 2010 Dividends per Share from Value Line	Column 19: Column 17 Plus Column 18
Column 5: Estimated 2010 Earnings per Share from Value Line	Column 20: See Column 2
Column 6: One Minus (Column 4 Divided by Column 5)	Column 21: See Column 4
Column 7: Estimated 2010 Net Book Value per Share from Value Line	Column 22: (Column 21 Minus Column 20) Divided by Three
Column 8: Column 5 Divided by Column 7	Column 23: See Column 1
Column 9: Column 6 Multiplied by Column 8	Column 24: See Column 20
Column 10: "Next 5 Years" Company Growth Estimate as Reported by Zacks.com	Column 25: Column 24 Plus Column 22
Column 11: "Est'd 03-05 to 09-11" Earnings Growth Reported by Value Line.	Column 26: Column 25 Plus Column 22
Column 12: Average of GDP Growth During the Last 10 year, 20 year, 30 year, 40 year, 50 year, and 57 year growth periods.	Column 27: Column 26 Plus Column 22
Column 13: Average of Columns 9-12	Column 28: Column 27 Increased by the Growth Rate Shown in Column 29
Column 14: Column 3 Plus Column 13	Column 29: See Column 12
Column 15: See Column 1	Column 30: The Internal Rate of Return of the Cash Flows in Columns 23-28 along with the Dividends for the Years 6-150 Implied by the Growth Rates shown in Column 29

Aquila Missouri

Risk Premium Analysis

	MOODY'S AVERAGE PUBLIC UTILITY BOND YIELD (1)	AUTHORIZED ELECTRIC RETURNS (2)	INDICATED RISK PREMIUM
1980	13.15%	14.23%	1.08%
1981	15.62%	15.22%	-0.40%
1982	15.33%	15.78%	0.45%
1983	13.31%	15.36%	2.05%
1984	14.03%	15.32%	1.29%
1985	12.29%	15.20%	2.91%
1986	9.46%	13.93%	4.47%
1987	9.98%	12.99%	3.01%
1988	10.45%	12.79%	2.34%
1989	9.66%	12.97%	3.31%
1990	9.76%	12.70%	2.94%
1991	9.21%	12.55%	3.34%
1992	8.57%	12.09%	3.52%
1993	7.56%	11.41%	3.85%
1994	8.30%	11.34%	3.04%
1995	7.91%	11.55%	3.64%
1996	7.74%	11.39%	3.65%
1997	7.63%	11.40%	3.77%
1998	7.00%	11.66%	4.66%
1999	7.55%	10.77%	3.22%
2000	8.14%	11.43%	3.29%
2001	7.72%	11.09%	3.37%
2002	7.53%	11.16%	3.63%
2003	6.61%	10.97%	4.36%
2004	6.20%	10.75%	4.55%
2005	5.67%	10.54%	4.87%
AVERAGE	9.48%	12.56%	3.09%

INDICATED COST OF EQUITY

PROJECTED TRIPLE-B UTILITY BOND YIELD*	6.85%
MOODY'S AVG ANNUAL YIELD DURING STUDY	9.48%
INTEREST RATE DIFFERENCE	-2.63%

INTEREST RATE CHANGE COEFFICIENT	-42.58%
ADJUSTMENT TO AVG RISK PREMIUM	1.12%

BASIC RISK PREMIUM	3.09%
INTEREST RATE ADJUSTMENT	1.12%
EQUITY RISK PREMIUM	4.20%

PROJECTED TRIPLE-B UTILITY BOND YIELD*	6.85%
INDICATED EQUITY RETURN	11.05%

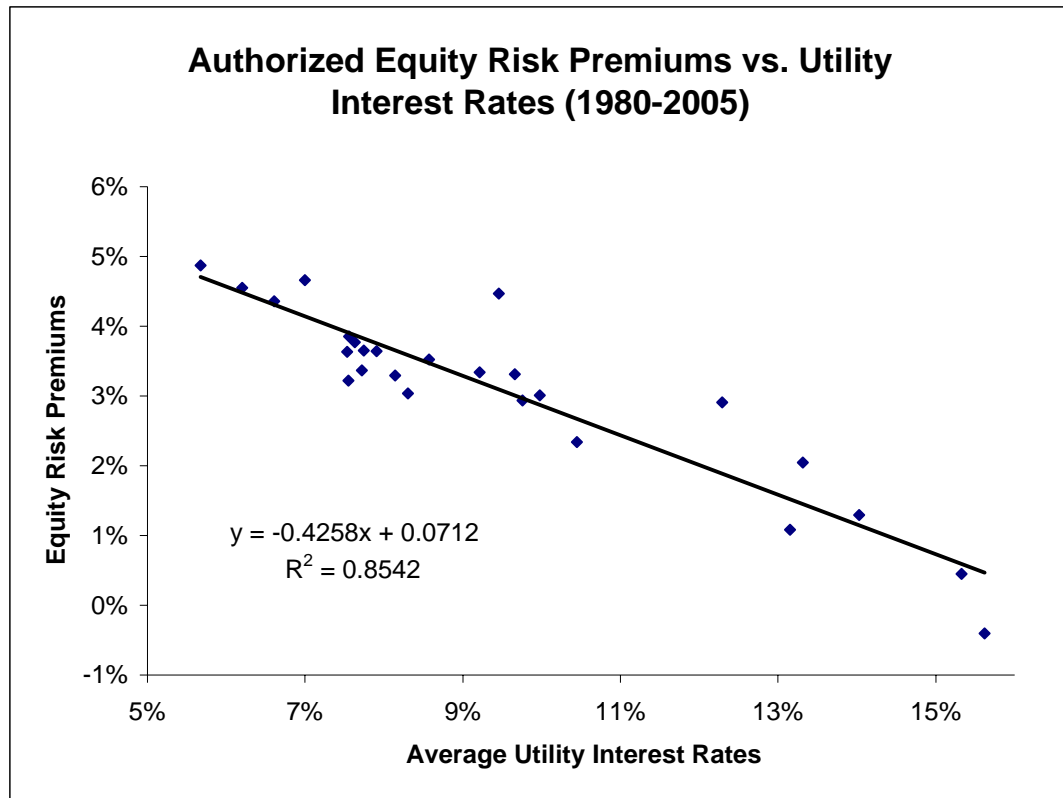
Sources:

(1) Moody's Investors Service

(2) Regulatory Focus, Regulatory Research Associates, Inc.

*Projected triple-B utility bond yield is 125 basis points over projected long-term Treasury rate from page 3 of Schedule SCH-8.

Aquila Missouri
Risk Premium Analysis



Aquila Missouri

Summary of DCF and Risk Premium ROE Estimates

<u>DCF Analysis</u>	<u>Indicated Cost</u>
Constant Growth (Traditional Growth)	10.0%-10.1%
Constant Growth (GDP Growth)	11.3%-11.4%
Multistage Growth Model	11.0%
Reasonable DCF Range	<u>11.0%-11.4%</u>
 <u>Risk Premium Analysis</u>	 <u>Indicated Cost</u>
Utility Debt + Risk Premium	
Risk Premium (6.85% + 4.20%)	11.05%
Ibbotson Risk Premium Analysis	
Risk Premium (6.85% + 4.5%)	11.35%
Harris-Marston Risk Premium	
Risk Premium (6.85% + 5.13%)	11.98%
<hr/>	
Reference Group Cost of Equity Capital	11.25%
MPS/LP Cost of Equity Capital	<u>11.5%</u>
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**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the matter of Aquila, Inc. d/b/a Aquila
Networks-MPS and Aquila Networks-L&P,
for authority to file tariffs increasing electric
rates for the service provided to customers in
the Aquila Networks-MPS and Aquila
Networks-L&P area

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Case No. ER-_____

County of Travis)

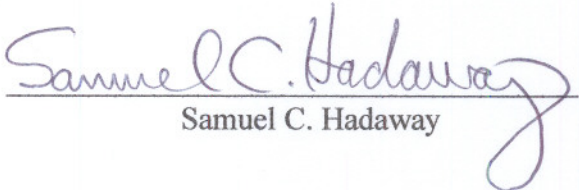
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State of Texas)

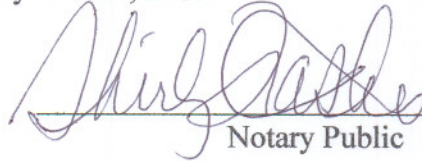
AFFIDAVIT OF SAMUEL C. HADAWAY

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



Samuel C. Hadaway

Subscribed and sworn to before me this 26th day of June, 2006.



Notary Public

My Commission expires:

