EXHIBIT

Exhibit No.: ____________
Issue(s): Acquisition Adjustment/ Regulatory Plan
Witness/Type of Exhibit: Burdette/Rebuttal
Sponsoring Party: Public Counsel
Case No.: EM-2000-292

REBUTTAL TESTIMONY

OF

MARK BURDETTE

Submitted on Behalf of
the Office of the Public Counsel

UTILICORP UNITED INC.
AND
ST. JOSEPH LIGHT & POWER COMPANY MERGER

Case No. EM-2000-292

Exhibit No. 200
Date 7/12/00 Case No. EM-2000-292
Reporter KRM

May 2, 2000

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In The Matter Of The Joint Application Of UtiliCorp United Inc. and St. Joseph Light & Power Company for Authority to Merge St. Joseph Light & Power Company with and into UtiliCorp United Inc., and, in Connection Therewith, Certain Other Related Transactions.	)	Case No. EM-2000-292

AFFIDAVIT OF MARK BURDETTE

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Mark Burdette, of lawful age and being first duly sworn, deposes and states:

1. My name is Mark Burdette. I am a Financial Analyst for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony consisting of pages 1 through 39.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

Mark Burdette

Mark Burdette

Subscribed and sworn to me this 2nd day of May, 2000.

Bonnie S. Howard

Bonnie S. Howard
Notary Public

My commission expires May 3, 2001.

DIRECT TESTIMONY

OF

MARK BURDETTE

UTILICORP UNITED INC.

CASE NO. EM-2000-292

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REBUTTAL TESTIMONY

OF

MARK BURDETTE

UTILICORP UNITED INC. / ST. JOSEPH LIGHT & POWER

CASE NO. EM-2000-292

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Mark Burdette, P.O. Box 7800, Jefferson City, Missouri 65102-7800.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by the Office of the Public Counsel of the State of Missouri (OPC or Public Counsel) as a Public Utility Financial Analyst.

A. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

Q. I earned a Bachelor of Science in Electrical Engineering from the University of Iowa in May 1988. I earned a Master's in Business Administration with emphases in Finance and Investments from the University of Iowa Graduate School of Management in December 1994.

Q. PLEASE DESCRIBE YOUR CONTINUING EDUCATION.

A. I have attended various regulatory seminars presented by the Financial Research Institute, University of Missouri-Columbia and the National Association of State Utility Consumer Advocates. Also, I attended The Basics of Regulation: Practical Skills for a Changing Environment presented by the Center for Public Utilities, New Mexico State University.

Q. DO YOU HAVE ANY PROFESSIONAL AFFILIATIONS?

A. Yes. I am a member of the Society of Utility and Regulatory Financial Analysts (SURFA).

Q. DO YOU HOLD ANY PROFESSIONAL DESIGNATIONS?

A. Yes. I have been awarded the professional designation Certified Rate of Return Analyst (CRRA) by the Society of Utility and Regulatory Financial Analysts. This designation is awarded based upon work experience and successful completion of a written examination.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION (MPSC OR THE COMMISSION)?

A. Yes.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. I will present testimony in regard to the proposed merger between UtiliCorp United Inc. (UCU, UtiliCorp) and St. Joseph Light & Power (SJLP, St. Joe), jointly referred to as the Companies. I will address specific issues including the claimed acquisition premium and the regulatory plan.

Q. ARE THE COMPANIES IN THIS CASE INDEPENDENT AND PUBLICLY TRADED?

A. Yes, they are. Both Companies are publicly traded on the New York Stock Exchange. UtiliCorp stock trades under the ticker symbol UCU; St. Joe trades under the ticker symbol SAJ.

CAPITAL STRUCTURE

Q. WHAT PROPOSALS HAVE THE COMPANIES MADE REGARDING CAPITAL STRUCTURE AFTER COMPLETION OF THE MERGER?

A. The Companies have made two proposals concerning capital structure and recovery of an acquisition premium.

First, the Companies' regulatory plan calls for adding 50% of the unamortized balance of any acquisition premium to rate base beginning in the sixth year of a ten year regulatory plan, after a five year rate moratorium has expired. Adding *any* portion of the premium to rate base will allow UCU to earn a return on that amount. UCU proposes the return on the premium be calculated using a capital structure of 60% debt and 40% equity (McKinney, page 7, lines 1-9).

Second, the Companies' propose that for the same period of the regulatory plan (years 6-10), the return on the remaining portion of St. Joe's rate base, i.e. the actual used and useful utility assets as opposed to an alleged acquisition premium, be based on a capital structure consisting of 47% debt and 53% equity. According to UCU witness McKinney, "This capital structure approximates the capital structure recommended by Staff in SJLP's last rate case." (McKinney, page 7, lines 12-14).

Additionally, UCU is asking that the rates paid by the current St. Joe customers – and based on a capital structure and cost of capital from 12/31/98 – stay in effect for a period of ten years.

Q. DO YOU HAVE COMMENTS REGARDING THE COMPANIES' PROPOSALS?

A. Yes, I do. The Companies' propose SJLP's rates during the ten-year regulatory plan be based on the capital structure from St. Joe's last rate case (ER-99-247). The test year for that rate case was the year ending December 31, 1998. Rates based on this old test year would be in effect for a period of ten additional years beyond the completion of *this* case. Therefore, the Companies' proposal is to use a capital structure from a test year that could easily be twelve years old (by the tenth year of the regulatory plan) to set rates for St. Joe's customers – regardless of the actual capital structure in place or how it might change and regardless of changes in the industry or the economy. Rates based on such an old analysis rather than the actual cost of service cannot be deemed just and reasonable and would be detrimental to the public interest.

Q. WHAT ARE THE PROBLEMS WITH THE PROPOSAL TO USE THE CAPITAL STRUCTURE FROM SJLP'S LAST RATE CASE?

A. Capital structure should be representative of the manner in which the utility has financed its assets. This is true because regulatory financial analysts use the capital structure to make recommendations regarding the utility's cost of capital and, ultimately, the returns the utility will have the opportunity to earn. Also, customers should pay just and reasonable rates based on the utility's actual cost of service.

The costs and relative proportions of each component in the capital structure should be similar to the actual way in which the utility has financed its assets so that the utility has the opportunity to earn its cost of capital. A gross mismatch between the capital structure used to set rates and the actual way in which the utility assets are financed could lead to the utility either earning windfall profits or failing to earn its cost of capital. It could also lead to Missouri ratepayers paying costs beyond the actual cost of service for the utility.

Q. COMPANY WITNESS MCKINNEY STATES THAT IF THIS CAPITAL STRUCTURE IS NOT APPROVED BY THE COMMISSION, UCU WOULD HAVE TO RESTRUCTURE THE REGULATORY PLAN IN ORDER TO MAINTAIN THE FEASIBILITY OF THIS MERGER. COULD YOU COMMENT?

A. Yes. If the proposed regulatory plan hinges on gaining approval of a very old capital structure for setting rates, then UCU should follow through with its claim and restructure the regulatory plan. The proposed treatment of capital structure not only defies financial common sense, it is wholly inconsistent with the regulatory principal of just and reasonable rates.

Q. IS AN ALTERNATIVE CAPITAL STRUCTURE RATHER THAN ACTUAL EVER APPROPRIATE TO USE IN A REGULATORY PROCEEDING?

A. Yes, in some cases. If a utility has a capital structure far out of line with what is reasonable for the industry, then the use of a hypothetical capital structure based on a **current** analysis of other utilities in the industry at that time might be appropriate. In fact, both Staff and Public Counsel recommended the use of a hypothetical capital structure for St. Joe in Case No. EM-99-292 because St. Joe's actual capital structure contained excessive common equity. The recommended hypothetical capital structure in that case contained a level of common equity on the high end of the range calculated for regulated electric utilities. A reasonable recommendation for a lower level of common equity could also have been made and would have led to even lower rates.

Q. IS IT APPROPRIATE TO USE A PARENT COMPANY'S ACTUAL CAPITAL STRUCTURE RATHER THAN A CAPITAL STRUCTURE 'MAINTAINED' BY THE PARENT FOR A PARTICULAR SUBSIDIARY OR BUSINESS UNIT?

A. Yes, in some cases. A capital structure maintained by a parent for a subsidiary is meaningless if that subsidiary has no debt or equity of its own. In that case it is appropriate to use the parent's capital structure since it is that capital structure that actually supports the regulatory assets – regardless of internal bookkeeping or allocations.

Q. WHY IS THAT IMPORTANT IN THIS PROCEEDING?

A. It is important because after the completion of this merger SJLP will be absorbed into UCU. There will be no separate capital structure for St. Joe other than whatever UCU decides to fabricate internally. The operating business unit of UCU that was previously St. Joseph

Light & Power will not have debt issued in its name nor will it have publicly traded common equity. It will be wholly and exclusively supported by UCU's overall capital structure.

Q. WHAT ARE THE IMPLICATIONS OF THIS FACT?

A. First, any capital structure "set" for the St. Joe operating unit of UCU would be arbitrary and potentially unrepresentative of the way St. Joe's utility assets are financed. The capital structure proposed by UCU of 47% debt and 53% equity – based on a test year ending 12/31/98 – could be 'representative' of nothing except a very old capital structure of a company that no longer exists.

Q. ARE YOU SAYING THAT YOU WOULD NEVER USE A HYPOTHETICAL CAPITAL STRUCTURE FOR THE ST. JOE OPERATING UNIT OF UCU?

A. No. The potential use of a hypothetical capital structure for any operating unit of any Missouri utility would be founded on a current analysis of the industry compared with the actual parent company capital structure. That analysis may or may not show that a hypothetical capital structure was just and reasonable for setting rates. The point, however, is that the determination would be made on *current conditions* – current market conditions, current industry conditions and the current condition of the company. I would not go back ten years to determine a capital structure – conditions simply are no longer representative of reality. However, using a ten year old (or more) capital structure to set rates is exactly what the Companies propose in this proceeding.

Q. WHAT JUSTIFICATION DO THE COMPANIES OFFER IN SUPPORT OF USING SUCH AN OLD CAPITAL STRUCTURE?

A. Company witness McKinney states "Absent the merger, this capital structure would not have changed appreciably." (McKinney-direct, page 28, line 9).

Q. DOES WITNESS MCKINNEY OFFER ANY SUPPORT FOR THIS ASSERTION?

A. No.

Q. IS THIS ASSERTION SUPPORTED HISTORICALLY?

A. No. Empirical evidence shows that the level of UtiliCorp United's own capital structure components have changed dramatically over the past ten years. According to Value Line Investment Survey, UCU's common equity ratio has ranged from a high of 49.5% in 1998 to a low of 39% in 1995. This is an absolute swing of more than 10 percentage points in three years, or a relative increase of 26.92% from 1995 to 1998. St. Joseph Light & Power's common equity ratio has also changed over the past ten years, from a high of 59.6% in 1992 to a low of 52.7% in 1995. That represents an almost 7 percentage point absolute change in only three years, or a relative change of 11.58% from 1992 to 1995.

The level of common equity for SJLP on 31 December 1999 was over 58%.

Q. DO COMPANIES CHANGE THEIR CAPITAL STRUCTURES IN RESPONSE TO ECONIMIC AND MARKET CONDITIONS?

A. Certainly. Companies alter the relative levels of capital structure components and the makeup of individual components. For example, in times of low interest rates a company might take on more debt than usual, or it might refinance older, higher-interest debt. These sorts of changes are captured during rate cases so that current rates can be based on as current a capital structure as is possible. UCU's proposal in this case removes any and all opportunity for capital structure changes to be appropriately reflected in rates. And empirical evidence shows that these changes have occurred for both UCU and SJLP. To remove the opportunity for rates to reflect future changes in capital structure, for a ten year period, is a violation of just and reasonable rates.

Q. DOES PRE-SETTING THE CAPITAL STRUCTURE FOR TEN YEARS CREATE THE POSSIBILITY FOR EXTRA PROFITS FOR UCU?

A. Yes, it does. St. Joe's (or more accurately the St. Joe operating unit of UCU) rates would be set based on a capital structure consisting of 47% debt and 53% equity and the cost of capital associated with that capital structure. To the extent that the actual financing of the assets contained less than 53% equity, yet rates were based on an equity level of 53%, UCU would collect a return greater than its cost of capital (assuming equity costs are greater than debt costs). This windfall would be in addition to any extra revenue the Company was entitled to keep because of a rate moratorium.

Q. DOES THE POSSIBILITY EXIST FOR THIS SORT OF CHANGE IN EQUITY?

A. Absolutely. UCU will be free to finance the SJLP assets in any manner it decides – and out of the reach of the MPSC. Currently, UCU maintains its own level of common equity at less than 40%. Company witness McKinney states (McKinney-direct, page 31, line 21 – page 32, line 2):

> Q. What impact will this merger have with respect to the jurisdiction of the Commission?
>
> A. Minimal. It is my understanding that due to the merger, the Commission will lose jurisdiction over the equity financing of SJLP.

The MPSC will lose jurisdiction over the equity financing of the SJLP operating unit; said financing will be completely in the hands of UCU's management.

The Companies propose a regulatory plan that would lock in the capital structure *for ratemaking purposes only* for ten years, while at the same time the merger would remove the MPSC's jurisdiction over how SJLP's assets are actually financed. Any reduction in the level of equity from that which was present when current rates were set would potentially result in a windfall profit to UCU in the form of capital costs included in and collected through rates, but no longer paid by UCU in the market. UCU is literally asking the MPSC to set a regulatory capital structure going forward for ten years while at the same time UCU gains total control over the actual capital structure.

From a cost of service perspective, this proposal is no different than UCU asking the MPSC to set ANY particular cost based on a ten-year-old test year, and then relinquishing any jurisdiction over that cost.

Q. WOULDN'T THE MPSC LOSE JURISDICTION OVER THE WAY UCU CHOOSES TO FINANCE THE ST. JOE UNIT REGARDLESS OF WHETHER A CAPITAL STRUCTURE IS SET OR NOT?

A. Yes. Once the SJLP assets are absorbed into UCU and St. Joseph Light & Power ceases to exist as a separate company, the MPSC would lose jurisdiction over how those particular assets are financed internally by UCU (the MPSC would retain jurisdiction over the regulated assets of UCU in Missouri on the whole).

Losing jurisdiction over how those assets are financed is not the point. The points are:

(1) UCU is asking for the MPSC to set a capital structure for a period of ten years for the purposes of setting rates;

(2) the MPSC is losing jurisdiction over that capital structure.

It is detrimental to the public interest for the Commission to lock in rates based on a capital structure that will not be updated for potentially ten years or more regardless of the actual financing used, while at the same time the MPSC loses jurisdiction over the capital structure.

RISK

Q. ARE THERE OTHER CONCERNS RELATED TO CAPITAL STRUCTURE AND THE COMPONENTS OF CAPITAL STRUCTURE?

A. Yes. UtiliCorp maintains a capital structure that contains more debt and less equity than St. Joe's capital structure. This creates significant differences in financial risk between UtiliCorp (greater risk) and St. Joe. (relatively less risk). Also, UtiliCorp's long-term debt carries a credit rating of BBB which is far below St. Joe's rating of A-. This also represents significant differences in risk, again, with UtiliCorp being the more risky company.

Q. HAS THE FINANCIAL COMMUNITY RECOGNIZED THESE DIFFERENCES IN RISK AND UTILICORP'S GREATER OVERALL RISK?

A. Yes. On 20 October 1999, Standard & Poor's placed St. Joseph Light & Power Co. on "CreditWatch with negative implications." Standard & Poor's (S&P) stated:

> The ratings for St. Joseph Light & Power Co. are on CreditWatch with negative implications, reflecting the proposed acquisition of the company by UtiliCorp United Inc. for about $191 million in equity.
>
> **The CreditWatch with negative implications listing reflects the weaker credit profile of the much larger UtiliCorp. Should the merger be completed as outlined, the ratings for St. Joseph are expected to equal those of UtiliCorp.** Upon the expected completion of the merger in early 2000, St. Joseph will become a UtiliCorp subsidiary. [Emphasis added]

St. Joe's credit rating was put on CreditWatch with negative implications for no other reason than the *proposal* of the merger. And S&P makes it clear that should the merger be completed, debt previously considered worthy of an A- rating are expected to fall to a rating of BBB. This degree of change is certainly significant and should serve for the MPSC as an early indication of the market's view of the risks associated with this merger proposal.

For no other reason than a change of ownership, the long-term debt financing the public utility assets of St. Joe will be considered more risky. The assets haven't changed.

The ability of those assets to be used to provide useful utility service has not changed. Only the ownership of the assets will change, yet that is sufficient reason for S&P to prepare the market for a decline in credit rating.

The increase in risk that will occur upon change of ownership is a detriment to the public interest.

Q. DOES STANDARD & POOR'S REPORT ON THE CREDIT RATINGS OF UCU?

A. Yes. The most recent S&P report on UtiliCorp United is dated January 2000. Included in that report are the following statements:

> The company's acquisition strategy and focus on unregulated opportunities, the unpredictability of future acquisitions, and the capital requirements associated with these acquisitions impair credit quality. Furthermore, the credit profile of unregulated operations are weaker than the utility's core business. [Page 1]
>
> As the nonregulated businesses continue to grow more quickly than the utility operations, UtiliCorp's financial profile will have to strengthen to compensate for the increased business risk. [Page 1]
>
> **Financial policy: Aggressive.** The company has grown through acquisitions, which have generally been successful but have put pressure on the balance sheet. Although management's proactive approach to managing the transition to competition from regulation is commendable, its acquisitions strategy (including plans to increase nonregulated operations which now account for about one-third of earnings), the unpredictability of future acquisitions, and the capital requirements associated with these acquisitions impair credit quality. [Page 7]
>
> **Capital Structure.** Management's aggressive attitude regarding debt leverage and off-balance-sheet obligations appears in the balance sheet ratios, where total debt to capital approaches 60% and it projected to decrease only moderately in the future. Some ebbing in the attitude towards leverage has been manifested at times, but Standard & Poor's believes that management's historic affinity for the use of leverage is still present and will limit credit quality in the future. [Page 7]

Standard & Poor's already recognizes UtiliCorp to be a relatively risky company, as reflected in credit ratings of BBB for UCU's Senior debt. A BBB rating is the *minimum* to be considered investment grade. Additionally, S&P makes note of several aspects of UCU's operations and business practices that will put negative pressure on future ratings.

Q. ARE THERE OTHER CONCERNS ASSOCIATED WITH THE CHANGE IN RISK AND CREDIT RATING?

A. Yes. While the actual change in credit rating per se is not the issue (Public Counsel does not believe the MPSC should regulate to a particular rating), the ramifications of the change in risk are important to consider.

The greater risk associated with UCU's long-term debt (rated BBB) will lead directly to an increased cost of debt generally over the cost of debt currently paid by SJLP. This change will be reflected in rates eventually, even if a rate moratorium is in place. This increased cost of debt would be a detriment to the public interest.

Q. IS UCU'S CURRENT COST OF DEBT GREATER THAN SJLP'S?

A. Yes. Value Line Investment Survey shows that UCU paid $190 million in interest on $2234.2 million of long term debt, for a rate of 8.5% as of 9/30/99. Value Line shows that SJLP paid $6.0 million in interest on long-term debt of $72.6 million, for a rate of approximately 8.26% as of 9/30/99.

ACQUISTION PREMIUM

Q. DOES THE PROPOSED MERGER OF UCU AND SJLP INCLUDE AN ALLEGED ACQUISITION PREMIUM?

A. Yes. The companies claim this transaction creates an approximate $92 million premium, plus various other expenses. Please see OPC witness Robertson's testimony for details.

Q. COMPANY WITNESS MCKINNEY PROVIDES EXAMPLES FROM OTHER STATES IN WHICH AN ACQUISITION PREMIUM WAS ALLOWED BY REGULATORS TO BE RECOVERED IN SOME WAY. ARE THERE ALSO EXAMPLES FROM OTHER STATES IN WHICH THE COMPANY WAS DENIED RECOVERY OF AN ACQUISITION PREMIUM?

A. Certainly. The Minnesota Public Utilities Commission wrote the following in the Order from Docket No. E, G-001/PA-96-184, Interstate Power Company, March 24, 1997:

> The Commission will approve the merger upon the condition that Interstate not seek recovery of any acquisition price over book value. This will preclude rate recovery of any acquisition premium, whether considered as good will or as an acquisition adjustment.

Also, The North Carolina Utilities Commission wrote the following in the Order from Docket No. G-5, Sub 400, Docket No. G-43, SCANA Corporation and Public Service Company of North Carolina (PSNC), December 7, 1999:

> (26) All costs of the merger and all direct and indirect corporate costs increases (including those that may be assigned to SCANA, a service company affiliate), if any, attributable to the merger, will be excluded from PSNC's utility accounts, and shall be treated for accounting and ratemaking purposes so that they do not affect PSNC's natural gas rates and charges. For purposes of this condition, the term "corporate cost increases" is defined as costs in excess of the level that PSNC would have incurred using prudent business judgment had the merger not occurred.
>
> (27) Any acquisition adjustment that results from the business combination of SCANA and PSNC will be excluded from PSNC's utility accounts and treated for accounting and ratemaking purposes so that it does not affect PSNC's natural gas rates and charges.

Q. DOES THE CLAIMED ACQUISITION PREMIUM REPRESENT AN INVESTMENT WHICH INCREASES THE LEVEL OF ASSETS THAT ARE USED AND USEFUL IN PROVIDING UTILITY SERVICE?

A. No. The assets acquired by UCU will be the same assets previously owned by SJLP. There is no new investment in new utility assets. The total book value of all UCU utility assets after the proposed merger equals the sum of the book values of the current UCU utility assets plus book value of SJLP's utility assets. The ability to provide utility service and the value of the assets employed to provide that service, as measured by original-cost rate base, will not change after the transaction.

Q. WHAT REGULATORY TREATMENT OF THE ACQUISITION PREMIUM DO THE COMPANIES PROPOSE IN THIS CASE?

A. The Companies' regulatory plan calls for an amortization of the premium (plus other expenses) during a five year rate moratorium followed by adding 50% of the unamortized balance (including non-premium expenses) to rate base beginning in the sixth year of a ten year regulatory plan, after the five year rate moratorium has expired. Amortization of the premium would continue. The level of unamortized balance added to rate base in year six would not be reduced going forward until UCU's next rate case, even as yearly amortizations reduce the amount outstanding.

Q. GENERALLY, HOW WOULD THE INCLUSION OF AN ACQUISITION PREMIUM IN RATE BASE EFFECT RATEPAYERS?

A. First, including an acquisition premium in rate base increases the overall level of authorized earnings (authorized rate of return multiplied by rate base) for the public utility, leading to increased rates – this is a return ON the premium. Second, the amortization of an acquisition premium would increase the utility's level of expenses and, therefore, cost of service, also resulting in increased rates for ratepayers – this is a return OF the premium.

The increased rate base (providing the return ON the premium) and the increased cost of service (return OF the premium) each lead to increased rates for ratepayers. However, these higher rates are not the result of an increase in the utility's ability to provide service as measured by rate base assets.

Q. WOULD THESE RATE INCREASES RESULT DUE TO AN INCREASE IN THE USEFULNESS OF THE ASSETS?

A. No. The assets are the same regardless of ownership. The ability of public utility assets to be used and useful in providing utility service to ratepayers is not enhanced by paying more than book value.

Q. WHY DOES AN ALLEGED ACQUISITION PREMIUM EXIST IN THIS CASE?

A. The companies claim an acquisition premium exists in this case because the price UCU is paying for each share of SJLP stock is greater than the book value of that stock. That difference is the claimed premium.

Q. BASED ON THIS METHOD OF CALCULATING AN ACQUISITION PREMIUM, DOESN'T EVERY INVESTOR WHO BUYS A SHARE OF SJLP STOCK PAY AN ACQUISITION PREMIUM?

A. Absolutely. If I, as an investor, go out into the market today and pay the current price for a share of SJLP stock, ANY amount I pay over book value could be considered an "acquisition premium" if such a premium is defined as the difference between market price and book value. However, as a rational investor, I made the choice to pay that price based on what I believe the future earnings of the company will be – regardless of book value. And, of course, as an owner of common stock, I am in fact a residual owner of SJLP.

Q. CAN AN INDIVIDUAL INVESTOR THEN APPROACH SJLP'S RATEPAYERS AND DEMAND TO BE REIMBURSED FOR THAT AMOUNT OVER BOOK VALUE?

A. No. An investor makes her decision of purchase price based on an analysis of what she believes that stock will provide as a return; that return being either the dividend or price appreciation that stem from cash flows produced by the assets underlying the stock. Book value is irrelevant when calculating the value of the stock and an investor cannot demand any sort of partial return of purchase price based on the difference of market price and book value.

Q. BUT ISN'T THAT VERY DEMAND – THE RETURN OF PART OF THE PURCHASE PRICE – EXACTLY WHAT UCU WANTS IN THIS CASE?

A. Yes, it is. UCU wants Missouri's ratepayers to refund to them part of the supposedly fair price UCU paid for SJLP stock. However, if UCU's determination of a fair price for SJLP's stock was based on sound financial analysis, then UCU expects the future cash flows from the SJLP assets to provide them an acceptable return of and on their investment. There is no need for ratepayers to provide **additional** returns for UCU's shareholders.

Q. CAN A COMPANY OPERATING IN A COMPETITIVE ENVIRONMENT ALWAYS PASS ALONG THE COSTS OF INVESTMENTS TO THEIR ULTIMATE CUSTOMERS?

A. No. A competitive company can pass along and recover investment expenses only to the extent that the market will allow. If the company can not raise prices or in some other way enhance income, then the *shareholders* will pay the bill. That is as it should be; the shareholders own the company, they are the ones who should be paying for investments and taking on the risk of recovery.

Q. IN TERMS OF EXPECTED RETURNS AND HOW THAT LEADS TO A FAIR PRICE, HOW IS UCU'S PURCHASE OF ALL OF THE OUTSTANDING SHARES OF SJLP DIFFERENT THAN AN INDIVIDUAL INVESTOR'S DECISION TO PURCHASE SHARES?

A. It is no different. If UCU is willing to pay an amount over book value for a share of SJLP stock, then obviously UCU believes that the assets supporting that share of stock will produce cash flows that justify that purchase price. The purchase price UCU is willing to pay is, or it SHOULD be, based on sound financial analysis that shows that the assets will provide cash flows that will provide a return to UCU not only of the principal, but earnings on that principal. An analysis to calculate a fair price should NOT include an assumption about recovery of a portion of the purchase price from a third party, such as ratepayers. To do so would be imprudent.

Certainly UCU could include such utterly optimistic assumptions in the analysis, with plans to cancel the deal if the assumptions do not come to pass. However, the mere inclusion of those assumptions, and the threat to cancel the deal should the MPSC not grant "favorable" regulatory treatment, is no reason for the MPSC to grant UCU's request. The MPSC is under no obligation to assure deals work out if the deal isn't appropriate from the perspective of just and reasonable rates.

Q. HOW DOES AN ACQUISITION PREMIUM ENTER THE PICTURE IF UCU OFFERED, AS THE COMPANY CLAIMS, A FAIR PRICE FOR SJLP STOCK?

A. After calculating a purchase price, UCU compared that purchase price to the book value of each share of stock. The difference, the purchase price less book value, is the claimed premium the company wants to collect through a rate moratorium and rate base treatment.

Q. SO THE CALCULATED ACQUISITION PREMIUM, WHICH DEPENDS ON BOOK VALUE, COULD CHANGE EVEN WHILE THE FAIR PRICE FOR THE STOCK REMAINS THE SAME?

A. Yes, if the change in book value wasn't also reflected in rate base in order to effect cash flows. But even then, any potential change in cash flows for the utility would not happen until a rate case when rate base would be adjusted.

The acquisition premium is nothing more than the result of a subtraction of book value from purchase price.

Q. BUT IF UCU PERFORMED A SOUND FINANCIAL ANALYSIS TO CALCULATE SHARE PRICE, WON'T THE COMPANY HAVE THE OPPORTUNITY TO RECOVER THE CLAIMED ACQUISITION PREMIUM OVER THE LIFE OF THE STOCK AS IT COLLECTS THE CASH FLOWS, JUST LIKE THE INDIVIDUAL INVESTOR?

A. Absolutely. The price paid, $23 per share, should fairly represent the present value of the *net* cash flows associated with the assets underlying that share of stock., assuming the assumptions made by UCU. That means it considers estimations of all expenses and cash inflows associated with the transaction. It does not consider book value; it is **not** made up of a "real value of the stock" plus some arbitrary upward bump to create a premium – or at least it shouldn't be. If that purchase price is fair, it is because it considers the present value of ALL the cash flows UCU expects to receive – *NET* of expenses.

Q. SO THEN IS RECOVERY OF AN ACQUISITION PREMIUM FROM RATEPAYERS IS DOUBLE RECOVERY?

A. That is exactly what it is. Additionally, the company gets to receive this bonus from ratepayers more quickly than it would normally and appropriately recover its investment.

Q. COULD YOU EXPLAIN FURTHER?

A. Certainly. When calculating the value of a share of SJLP stock, UCU should have looked at the **net** future cash flows they estimate will be produced by the assets supporting that stock, calculated a value for the assets, then calculated a per share value for the common equity. That the assets are recorded at book value doesn't matter in the least when calculating the value of the stock except how book value relates to the cash flows those assets produce. The appropriate purchase price of that stock depends on those cash flows. That is how UCU *should* have developed a purchase price. In this case, UCU is claiming that they calculated a purchase price of $23 per share for SJLP stock, and offered that amount. UCU offered $23 per share because they believe the cash flows they will receive justifies that price – the ENTIRE purchase price, not just a portion of it.

To then ask ratepayers to ALSO pay part of the purchase price means that UCU will double-recover that portion. *UCU will already receive the return of their purchase price and a return ON the purchase price over the life of the stock in the form of cash flows from the assets.* But the company wants ratepayers to pay part of it as well. ANY part of the purchase price paid by ratepayers will be a windfall to UCU because UCU will get their return over the life of the stock.

Q. HOW DOES BOOK VALUE ENTER INTO THIS ANALYSIS?

A. Book value entered into the analysis when UCU was calculating the level of future cash flows because the cash flows streaming from SJLP are based on book value regulation.

Q. PLEASE EXPLAIN.

A. Regardless of whether a merger target is regulated or unregulated, a valuation of the company depends on the estimation of future cash flows and other real benefits associated with the assets of that company. An unregulated company would have its particular set of business and financial risks that have to be considered when estimating future cash flows. But in the end, what you care about for valuation is the net cash flows.

Similarly, SJLP has a particular set of business and financial risks that must be considered when estimating the cash flows the company could produce. In THAT analysis, book value would be considered because rate base is based on book value. To estimate the future cash flows, book value of rate base would be important. However – once the cash flows are estimated, once UCU has determined what it reasonably expects to receive from SJLP's assets, book value is no longer part of the equation.

Q. WHAT DOES THIS MEAN IN TERMS OF AN ALLEGED ACQUISITION PREMIUM?

A. It means that the calculation of the premium is a meaningless calculation comparing a valuation of a share of stock (based on the estimation of future cash flows) to whatever the book value of that stock happens to be.

Q. HOW ACCURATE ARE UCU'S ESTIMATES OF FUTURE CASH FLOWS?

A. That is very difficult to determine. The accuracy of the estimates depends not only on the assumptions made by UCU's analysts, but also, obviously, on how closely future events match the estimates. Overall, the estimates are just that – estimates – and the further into the future the estimate, the increased opportunity for assumptions to be wrong and actual cash flows vary from the estimate.

Additionally, the future could bring unforeseen events such as a decision to sell certain assets which could greatly effect cash flows. Also, UCU had to make certain assumptions about regulatory issues which might not develop as the Company anticipated.

Q. COULD A MINOR CHANGE IN UCU'S ESTIMATES ALTER THE PRICE DETERMINED FOR SJLP'S STOCK?

A. Yes. A minor change in an estimate, everything else being equal, could result in a different "fair" price determination. What that means is that the acquisition premium we are discussing could be a very different value with only a minor change in an estimate. That is a good indication that the difference between a "fair" price and book value is somewhat arbitrary, as is any level of premium claimed UCU.

Q. WHAT DOES THE DIFFERENCE IN PURCHASE PRICE AND BOOK VALUE SAY ABOUT THE RETURNS UCU EXPECTS TO RECEIVE FROM SJLP'S UTILITY ASSETS?

A. The fact that UCU is willing to pay a price over book for SJLP's assets means that UCU expects those assets to earn a return above the cost of capital supporting those assets.

Q. COULD YOU EXPLAIN THAT STATEMENT?

A. Yes. Book value regulation allows a utility the opportunity to earn a return on the book value of the utility assets. Because a share of stock represents ownership of a portion of the utility assets, the price of that stock will be based on the expected returns from those assets. A simplified example will help clarify. If utility assets were authorized to earn a 10% rate of return on book value, and the investor demanded a 10% return, then the investor would pay only up to book value for the stock. ANY purchase price over book value would mean that the rate of return on the investor's money would be below 10%. For example, if $1 of book value of assets was expected to return 10%, then the investor would expect those assets to return $0.10. If the investor expects the assets to return $0.10, and the investor requires a 10% return, then the investor won't pay more than $1 for the stock or else a $0.10 return produces a *rate* of return below 10%. If he pays MORE than book value, say $1.25 rather than $1, then that $0.10 return would equate to a rate of return less than 10%. Specifically, if an investor is willing to pay $1.25 for a $0.10 return, then the required rate of return must be only $0.10 / $1.25 = 8.0%. That means that the investor's required return is BELOW 10%, specifically it is 8.0%, otherwise he would never pay more than $1 (book value) for the stock.

Q. HOW DOES THIS EXAMPLE APPLY TO THE CURRENT PROCEEDING?

A. In the current case, UCU would have the MPSC believe that a rational company would pay well over book value for assets on which the company does **not** expect to earn its required rate of return on it's entire investment. That would be irrational behavior. To reference back to the previous example: the investor won't pay more than $1 for a stock paying a $0.10 return if the investor REALLY requires a rate of return of 10%. To do so would be irrational and it would defy logic. The only way the investor would pay MORE than book value is if that investor expects the return on book value, i.e. the $0.10, to provide his TOTAL return for his total investment. Therefore, the investor's required return is below 10%. This is true because the investor has no other recourse. An investor can't go out into the market and pay too much for a share of a company's stock and then go to the customers of that company and demand a return of a portion of his investment. It doesn't work that way.

The principal is the same for UCU. It would be irrational behavior for UCU to require a 10% return but pay more than $1 for a stock paying $0.10. The fact that UCU is prepared to pay MORE than book value means that UCU's required return is below the cost of capital supporting those assets, i.e. below the authorized return.

Q. WHAT DOES THAT MEAN IN THE CONTEXT OF THIS CASE?

A. It means that there is no reason for Missouri ratepayers to pay a "premium" to UCU because of investments UCU has decided to make. An investor buys a share of stock based on solid financial analysis. If the investor fails to do that, he can't seek retribution from the company's customers.

UCU decided to make an investment in SJLP based on, hopefully, a solid financial analysis based on sound estimates of cash flows and NOT considering recovery of any cost over book value from ratepayers. If UCU failed to do so, it does not fall to Missouri's ratepayers to provide recompense.

Q. YOU SAID THAT WHEN UCU ANALYZED THIS TRANSACTION, THE COMPANY SHOULD HAVE CONSIDERED SJLP'S BUSINESS RISK. SHOULD THAT ANALYSIS OF BUSINESS RISK INCLUDE A CONSIDERATION OF REGULATORY ENVIRONMENT AND LIKELY REGULATORY SCENARIOS?

A. Certainly. Any evaluation of a utility that did NOT include consideration of regulatory-based business risk would be a flawed evaluation.

Therefore, UCU's decision to offer $23 per share for SJLP's common equity, if based on a solid financial analysis, had to assume NO recovery of an alleged acquisition premium AND sharing savings with ratepayers because that is not only a realistic future scenario, it is the one most supported by history. For UCU to ignore this when analyzing this transaction would be ludicrous. Yet UCU still made the offer.

Q. ARE YOU SAYING UCU SHOULD HAVE ASSUMED WHAT WOULD BE FOR THEM UNFAVORABLE REGULATORY TREATMENT?

A. No, UCU did not have to assume any particular outcome, not even one that was rational, supported by precedent or logical. I believe they should have done that, but they didn't have to. But if UCU chose to factor in favorable regulatory treatment as a base assumption, it does not then fall to the MPSC to grant them that treatment just because that is what they assumed.

Q. WHAT DOES IT MEAN THAT UCU MADE AN OFFER OF $23 PER SHARE FOR SJLP STOCK WHEN RECOVERY OF ANY ALLEGED PREMIUM IS NOT ASSURED?

A. If the analysis was based on reasonable assumptions, it means that UCU believes it will earn its required return with no recovery of a portion of its investment from a third party (i.e. Missouri's ratepayers.)

Q. WHY IS IT APPROPRIATE TO EXCLUDE AN ACQUISITION PREMIUM FROM RATE BASE AND COST OF SERVICE?

A. Under cost-based regulation, a utility's rates are set to allow recovery of its operating expenses, depreciation, and taxes on a dollar for dollar basis, and the opportunity but not the guarantee to earn a fair rate of return on the depreciated or net book value of plant or other assets utilized to provide service to its customers (the rate base).

Simply transferring ownership of used and useful utility assets does not increase the ability of those assets to provide public service. Because ratepayers are captives of the monopoly utility providing service, the ratepayer has no viable alternative to obtain utility service. The regulatory bargain between ratepayer and public utility would be violated if the ratepayer was subject to increased cost of service simply because the new utility owner *chose* to acquire the utility assets at a price greater than net original cost.

Q. DO THE GENERAL COMMENTS YOU MADE REGARDING RECOVERY OF AN ACQUISITION PREMIUM APPLY TO THE PREMIUM IN THIS CASE?

A. Yes. Allowing UCU to recover the acquisition premium in this case would increase rates paid by Missouri ratepayers, even though the utility assets providing service have not changed.

Q. DO YOU HAVE ANY ADDITIONAL COMMENTS REGARDING ACQUISITION PREMIUM?

A. Yes. It is important for the MPSC to remember exactly who is getting paid in this transaction. The alleged acquisition premium is NOT some unavoidable expense to a third party that might be appropriately shared between ratepayers and shareholders. It is precisely the current shareholders of SJLP who will receive the money. And after that receipt, those same shareholders will be UCU shareholders. This transaction represents nothing more than an redistribution of wealth from one set of UCU shareholders (those of record before the merger) to another set of UCU shareholders (the 'new' shareholders who had previously owned SJLP stock). But instead of UCU shareholders properly paying that money, the Company wants Missouri's ratepayers to pay it. This transfer of shareholder wealth is supported by an article appearing in the April 1, 2000 Public Utilities Fortnightly, which states:

> The acquisitions largely will result in transfer of wealth from the acquirer to target shareholders. {"Ten Energy Mergers and How They Stacked Up", page 51}

In a nutshell, UCU shareholders asked SJLP shareholders to join them in ownership and offered to pay them a premium to do so. Now, UCU wants Missouri ratepayers to foot the bill.

OTHER ISSUES

Q. DO THE COMPANIES COMMENT ON SHAREHOLDER APPROVAL OF THE MERGER AS IT RELATES TO RECOVERY OF ANY ALLEGED PREMIUM?

A. Yes. Robert K. Green states:

> In other words, without some mechanism to recover the acquisition premium, the shareholders of the acquiring company have no incentive to close the transaction. [Green – direct, page 11, lines 11-13]

Q. WHETHER TRUE OR NOT, IS THIS ASSERTION RELEVANT TO THIS CASE?

A. No. The MPSC is not charged with granting regulatory approval for the sake of appeasing a set of shareholders or to provide incentive to shareholders. If UCU has not informed or misinformed its shareholders as to the realistic possibility of premium recovery, that is an issue for the shareholders to take up with management.

Q. COMPANY WITNESS MCKINNEY SAYS THAT ACCOUNTING INFORMATION FOR UCU AND SJLP WILL BE KEPT SEPARATE. DO YOU HAVE COMMENTS REGARDING THIS ASSERTION?

A. Yes. It could be possible that certain accounting information and records could be kept separate for the different operating divisions within UCU should the merger take place. However, as a single entity, UCU has a single form of common stock representing all the operations of the Company. Similarly, the same long term debt will support all domestic operations of the Company. The cost of capital as well as the various components of cost of capital, such as cost of long term debt, cannot be segregated and costed separately to UCU's different operating divisions. UtiliCorp United Inc. - as a whole - will issue debt and raise equity in the market; the separate operating divisions will not. Therefore, not all of the expenses of operations – such as cost of capital - can be kept separate.

In fact, UCU does not even maintain a separate capital structure for their Missouri-jurisdictional operations – they are included under the corporate umbrella. Also under this same corporate umbrella are all of UCU's other operating divisions and units. Only select foreign investments have specific debt issuances tied to them.

Q. WITNESS MCKINNEY CLAIMS THAT THE RATE MORATORIUM PROPOSED BY UCU IN THIS CASE IS SIMILAR TO THE MORATORIUM APPROVED FOR WESTERN RESOURCES AND KANSAS CITY POWER AND LIGHT (KCPL). DO YOU AGREE WITH THIS CLAIM?

A. No, not once the details are considered. First, UtiliCorp in this case asked for a rate moratorium for a period of five (5) years. The rate moratorium in the Western Resources / KCPL case restricted the filing of new rate cases or complaints for a period of 30 months after the close of the merger, and restricted the effective date for new rate cases or complaints for a period of 36 months. Essentially, UCU's requested moratorium is twice as long as the moratorium terms in the Western/KCPL Stipulation.

Secondly, UtiliCorp has asked for rate base treatment of a portion of the acquisition premium at the end of the moratorium. No such treatment is allowed in the Western/KCPL Stipulation. This difference is significant and cannot be dismissed with language asserting how the two moratorium plans are "similar."

Q. YOU PREVIOUSLY MENTIONED AN ARTICLE ON UTILITY MERGERS APPEARING IN PUBLIC UTILITIES FORTNIGHTLY. DOES THIS ARTICLE CONTAIN OTHER INFORMATION RELEVANT TO THIS CASE?

A. Yes. The article in the April 1, 2000 issue of Public Utilities Fortnightly entitled "Ten Energy Mergers and How They Stacked Up" (page 36) looks at mergers in the industry. The subtitle of the article is "Why about half of them destroyed wealth for shareholders of the acquiring company." Following are quotes from the article:

> **We expect to see continued overpayment by acquirers, and inability to deliver promised performance.** (page 37) [Emphasis added]
>
> Acquiring firms will continue to pursue accounting earnings, reduce the value of their shares in most mergers, **and fail to deliver the operating performance implied in the premiums they pay over market value.** Merger negotiation and integration will distract utility management from the serious business of improving their operating and capital efficiency, and changing the "guaranteed rate of return" mentality of their employees. (page 37) [Emphasis added]
>
> Deal financing is an important part of ensuring the success of any deal. The use of stock vs. cash has had very different results for acquirers. **Acquiring companies financing deals with stock have seen significantly worse results than those that have used cash** (or cash equivalents). Some stock mergers have even been accused of using funny money. (page 49) [Emphasis added]
>
> **The five-year stock return of acquirers was slightly worse than that of peer companies that did not merge, suggesting that buyers overpaid in their zeal to complete a deal.** (page 49) [Emphasis added]
>
> In studying the performance of several mergers, we expect that there will be continued **overpayment by acquirers, and inability to deliver performance promised implicitly in premiums paid. The acquisitions largely result in transfer of wealth from the acquirer to target shareholders.** (page 51) [Emphasis added]

Q. HOW DOES THIS ARTICLE RELATE TO THE CURRENT PROCEEDING?

A. The current proceeding is an energy merger being financed partially with stock; the companies involved claim synergies and savings; and there is a sizable acquisition premium in question. This article in a well-respected utility publication raises serious questions about the realistic financial outcome of this deal as compared to the claims made by UCU.

Q. COULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?

A. Yes. Several aspects of UCU's proposed regulatory plan are obviously detrimental to the public interest. Among these are locking in a capital structure for ten years for the purpose of setting rates, and recovery of an alleged acquisition premium from ratepayers. Also, because UCU is a more risky company than SJLP, the St. Joe assets are going to become financially more risky. This fact will show up as increased rates eventually for St. Joe's ratepayers, even though the assets have not actually changed.

Additionally, the MPSC should be wary of overly optimistic claims for savings and synergies stemming from utility mergers, especially when recovery of alleged savings are supposed to come from ratepayers. History shows that often purchase prices are excessive and the optimistic claims for savings don't come to pass. Simply because UCU has estimated savings and claims a "fair" purchase price does not mean those savings are attainable or that ratepayers will benefit. Current SJLP shareholders are possibly the only party to benefit from this merger.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

APPENDIX A
DEVELOPMENT & PURPOSES OF REGULATION

Q. WHY ARE PUBLIC UTILITIES REGULATED?

A. The nature of public utility services generally requires a monopolistic mode of operation. Only a limited number of companies (and quite often only one) are normally allowed to provide a particular utility service in a specific geographic area. Public utilities are often referred to as "natural" monopolies; a state created by such powerful economies of scale or scope that only one firm can or should provide a given service. Even when a utility is not a pure monopoly, it still has substantial market power over at least some of its customers.

In order to secure the benefits arising from monopolistic-type operations, utilities are generally awarded an exclusive franchise (or certificate of public convenience) by the appropriate governmental body. Since an exclusive franchise generally protects a firm from the effects of competition, it is critical that governmental control over the rates and services provided by public utilities is exercised. Consequently, a primary objective of utility regulation is to produce market results that closely approximate the conditions that would be obtained if utility rates were determined competitively. Based on this competitive standard, utility regulation must: 1) secure safe and adequate service; 2) establish rates sufficient to provide a utility with the opportunity to cover all reasonable costs, including a fair rate of return on the capital employed; and 3) restrict monopoly-type profits.

APPENDIX B
CALCULATION OF THE WEIGHTED AVERAGE COST OF CAPITAL

Q. PLEASE EXPLAIN HOW THE WEIGHTED AVERAGE COST OF CAPITAL IS USED IN TRADITIONAL RATEMAKING AND HOW IT IS DERIVED.

A. The basic standard of rate regulation is the revenue-requirement standard, often referred to as the rate base-rate of return standard. Simply stated, a regulated firm must be permitted to set rates that will cover operating costs and provide an opportunity to earn a reasonable rate of return on assets devoted to the business. A utility's total revenue requirement can be expressed as the following formula:

$$R = O + (V - D + A)r$$

where R = the total revenue required,

O = cost of operations,

V = the gross value of the property,

D = the accrued depreciation, and

A = other rate base items,

r = the allowed rate of return/weighted average cost of capital.

This formula indicates that the process of determining the total revenue requirement for a public utility involves three major steps. First, allowable operating costs must be ascertained. Second, the net depreciated value of the tangible and intangible property, or net investment in property, of the enterprise must be determined. This net value, or investment (V - D), along with other allowable items is referred to as the rate base. Finally, a "fair rate of return" or weighted average cost of capital (WACC) must be determined. This rate, expressed as a percentage, is multiplied by the rate base. The weighted average cost of capital (WACC) is applied to the rate base (V-D+A) since it is generally recognized the rate base is financed with the capital structure and these two items are normally similar in size. The allowed rate of return, or WACC, is typically defined as follows:

$$r = i(D/C) + l(P/C) + k(E/C)$$

where i = embedded cost of debt capital,

D = amount of debt capital,

l = embedded cost of preferred stock,

P = amount of preferred stock,

k = cost of equity capital,

E = amount of equity capital, and

C = amount of total capital.

This formula indicates that the process of determining WACC involves separate determinations for each type of capital utilized by a utility. Under the weighted cost approach, a utility company's total invested capital is expressed as 100 percent and is divided into percentages that represent the capital secured by the issuance of long-term debt, preferred stock, common stock, and sometimes short-term debt. This division of total capital by reference to its major sources permits the analyst to compute separately the cost of both debt and equity capital. The cost rate of each component is weighted by the appropriate percentage that it bears to the overall capitalization. The sum of the weighted cost rates is equal to the overall or weighted average cost of capital and is used as the basis for the fair rate of return that is ultimately applied to rate base.

APPENDIX C
ECONOMIC PRINCIPLES OF REGULATION

Q. BRIEFLY DESCRIBE THE ECONOMIC RATIONALE FOR RATE BASE-RATE OF RETURN REGULATION.

A. Rate base-rate of return regulation is based, in part, on basic economic and financial theory that applies to both regulated and unregulated firms.

> Although it is well recognized that no form of economic regulation can ever be a perfect substitution for competition in determining market prices for goods and services, there is nearly unanimous acceptance of the principle that regulation should act as a substitute for competition in utility markets. (Parcell, The Cost of Capital Manual p.1-4).

It is the interaction of competitive markets forces that holds the prices an unregulated firm can charge for its products or services in line with the actual costs of production. In fact, competition between companies is generally viewed as the mechanism that allows consumers to not only purchase goods and services at prices consistent with the costs of production but also allows consumers to receive the highest quality product. Since regulated utilities are franchised monopolies generally immune to competitive market forces, a primary objective of utility regulation is to produce results that closely approximate the conditions that would exist if utility rates were determined in a competitive atmosphere.

Under basic financial theory, it is generally assumed the goal for all firms is the maximization of shareholder wealth. Additionally, capital budgeting theory indicates that, in order to achieve this goal, an unregulated firm should invest in any project which, given a certain level of risk, is expected to earn a rate of return at or above its weighted average cost of capital.

Competition, in conjunction with the wealth maximization goal, induces firms to increase investment as long as the expected rate of return on an investment is greater that the cost of capital. Competitive equilibrium is achieved when the rate of return on the last investment project undertaken just equals the cost of capital. When competitive equilibrium is achieved, the price ultimately received for goods or services reflects the full costs of production. Therefore, not only does competition automatically drive unregulated firms to minimize their capital costs (investment opportunities are expanded and competitive position is enhanced when capital costs can be lowered), it also ensures that the marginal return on investment just equals the cost of capital.

Given that regulation is intended to emulate competition and that, under competition, the marginal return on investment should equal the cost of capital, it is crucial for regulators to set the authorized rate of return equal to the **actual** cost. If this is accomplished, the marginal return on prudent and necessary investment just equals cost and the forces of competition are effectively emulated.

APPENDIX D
LEGAL REQUIREMENT FOR A FAIR RATE OF RETURN

Q. IS THERE A JUDICIAL REQUIREMENT RELATED TO THE DETERMINATION OF THE APPROPRIATE RATE OF RETURN FOR A REGULATED UTILITY?

A. Yes. The criteria established by the U.S. Supreme Court closely parallels economic thinking on the determination of an appropriate rate of return under the cost of service approach to regulation. The judicial background to the regulatory process is largely contained in two seminal decisions handed down in 1923 and 1944. These decisions are,

> Bluefield Water Works and Improvement
> Company v. Public Service Commission,
> 262 U.S. 679 (1923), and
>
> FPC v. Hope Natural Gas Co., 320 U.S., 591 (1944)

In the Bluefield Case, the Court states,

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.

Together, Hope and Bluefield have established the following standards,

1). A utility is entitled to a return similar to that available to other enterprises with similar risks;

2). A utility is entitled to a return level reasonably sufficient to assure financial soundness and support existing credit, as well as raise new capital; and

3). A fair return can change along with economic conditions and capital markets. Furthermore, in Hope, the Court makes clear that regulation does not guarantee utility profits and, in Permian Basin Area Rate Cases, 390 US 747 (1968), that, while investor interests (profitability) are certainly pertinent to setting adequate utility rates, those interests do not exhaust the relevant considerations.

APPENDIX E
REGULATION IN MISSOURI

Q. WHAT IS THE ORIGIN AND RATIONALE FOR THE REGULATION OF PUBLIC UTILITIES IN THE STATE OF MISSOURI?

A. All investor owned public utilities operating in the state of Missouri are subject to the Public Service Commission Act, as amended. The Public Service Commission Act was initially passed by the Forty-Seventh General Assembly on April 15, 1913. (Laws of 1913 pp. 557-651, inclusive).

In State ex rel Kansas City v. Kansas City Gas Co. 163 S.W. 854 (Mo.1914), the case of first impression pertaining to the Public Service Commission Act, the Missouri Supreme Court described the rationale for the regulation of public utilities in Missouri as follows:

> That act (Public Service Commission Act) is an elaborate law bottomed on the police power. It evidences a public policy hammered out on the anvil of public discussion. It apparently recognizes certain generally accepted economic principles and conditions, to wit: That a public utility (like gas, water, car service, etc.) is in its nature a monopoly; that competition is inadequate to protect the public, and, if it exists, is likely to become an economic waste; that regulation takes the place of and stands for competition; that such regulation to command respect from patron or utility owner, must be in the name of the overlord, the state, and, to be effective, must possess the power of intelligent visitation and the plenary supervision of every business feature to be finally (however invisible) reflected in rates and quality of service. (Kansas City Gas Co. at 857-58).

> The General Assembly has determined that the provisions of the Public Service Commission Act "shall be liberally construed with a view to the public welfare, efficient facilities and substantial justice between patrons and public utilities" (See: 386.610 RSMo 1994). Pursuant to the above legislative directive, when developing the cost of equity capital for a public utility operating in Missouri, it is appropriate to do so with a view toward the public welfare; giving the utility an amount that will allow for efficient use of its facilities and the proper balance of interests between the ratepayers and the utility.

APPENDIX F

EFFICIENT NATURE OF THE CAPITAL MARKETS

Q. IS THE DISCOUNTED CASH FLOW MODEL INHERENTLY CAPABLE OF ADJUSTING FOR THE LEVEL OF REAL OR PERCEIVED RISKINESS TO A GIVEN SECURITY?

A. Yes. It is impossible for any one analyst to systematically interpret the impact that each and every risk variable facing an individual firm has on the cost of equity capital to that firm. Fortunately, this type of risk-by-risk analysis is not necessary when determining the appropriate variables to be plugged into the DCF formula.

As stated earlier, the DCF model can correctly identify the cost of equity capital to a firm by adding the current dividend yield (D/P) to the correct determination of investor-expected growth (g). Thus, the difficult task of determining the cost of equity capital is made easier, in part, by the relative ease of locating dividend and stock price information and the efficient nature of the capital markets.

Q. PLEASE EXPLAIN THAT STATEMENT.

A. The DCF model is based on the assumption that investors (1) calculate intrinsic values for stocks on the basis of their interpretation of available information concerning future cash flows and risk, (2) compare the calculated intrinsic value for each stock with its current market price, and (3) make buy or sell decisions based on whether a stock's intrinsic value is greater or less than its market price.

Only if its market price is equal to or lower than its intrinsic value as calculated by the marginal investor will a stock be demanded by that investor. If a stock sells at a price significantly above or below its calculated intrinsic value, buy or sell orders will quickly push the stock towards market equilibrium. The DCF model takes on the following form when used by investors to calculate the intrinsic value of a given security, P^ = D/k-g

where P^= the intrinsic value of the security,

D = the current dividend,

g = the expected growth rate, and

k = the required return on the security

Since the required rate of return for any given investor is based on both the perceived riskiness of the security and return opportunities available in other segments of the market, it can be easily demonstrated that when perceived riskiness is increased, the investors' required return is also increased and the market value of the investment falls as it is valued less by the marginal investor. Returning to the form of the DCF model used to determine the cost of equity capital to the firm,

k = D/P + g

we see that the required return rises as an increase in the perceived risk associated with a given security drives the price down. Within this context, the DCF formula incorporates all known information, including information regarding risks, into the cost of equity capital calculation. This is known as the "efficient market" hypothesis.

Q. IS THE "EFFICIENT MARKET" HYPOTHESIS SUPPORTED IN THE FINANCIAL LITERATURE?

A. Yes. Modern investment theory maintains that the U.S. capital markets are efficient and, at any point in time, the prices of publicly traded stocks and bonds reflect all available information about those securities. Additionally, as new information is discovered, security prices adjust virtually instantaneously. This implies that, at any given time, security prices reflect "real" or intrinsic values. This point is further clarified in Investments, by Bodie, Kane, and Marcus. According to Bodie, et.al.,

> A large body of empirical evidence supports a theory called the **efficient markets hypothesis** (EMH), which among other things says that active management of both types should not be expected to work for very long. The basic reasoning behind the EMH is that in a competitive financial environment successful trading strategies tend to "self-destruct." Bargains may exist for brief periods, but with so many talented highly paid analysts scouring the markets for them, by the time you or I "discover" them, they are no longer bargains. (pg. 3-4)

According to Brealy and Myers;

> In an efficient market you can trust prices. They impound all available information about the value of each security. (Principles of Corporate Finance, Fourth Edition, page 300)