Exhibit No.:
Issues: Rate of Return, Capital Structure, Return on Equity, Cost of Debt
Witness: John C. Dunn
Sponsoring Party: Missouri Public Service
Case No.: ER-2001-672

Before the Public Service Commission
of the State of Missouri

Rebuttal Testimony

of

John C. Dunn

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
REBUTTAL TESTIMONY OF JOHN C. DUNN
ON BEHALF OF
MISSOURI PUBLIC SERVICE
A DIVISION OF UTILICORP UNITED INC.
CASE NO. ER-2001-672

INTRODUCTION

Q. Please state your name and business address.

A. My name is John C. Dunn. My business address is 7400 West 110th Street, Suite 750, Overland Park, Kansas 66210.

Q. Are you the same John C. Dunn who filed direct testimony before the Missouri Public Service Commission ("Commission") in this proceeding on behalf of Missouri Public Service ("MPS")?

A. Yes sir I am.

Q. What is the purpose of your testimony at this point in the proceeding?

A. To respond to the direct testimony of Commission Staff ("Staff") witness, David Murray, and Office of Public Counsel ("Public Counsel") witness, Mark Burdette, both who submitted testimony dealing with the issue of rate of return, including specifically the issue of cost of debt, capital structure and return on equity.

Q. How will you proceed?

A. There are five specific areas which I believe warrant rebuttal. Each is common to both of the testimonies. These areas are:

- the failure to reflect a significant change in industry-wide dividend policy in the calculations.
- the incorrect selection of a comparable group;
- the failure to make a risk adjustment from the comparative group to MPS;
- the cost of debt;
- the capital structure selected.

I believe that the improper calculations and failure to consider these items appropriately in each of these testimonies has resulted in a significant understatement of the cost of common equity recommendation by each of the witnesses to the Commission.

SUMMARY

Q. What change in dividend policy did the two witnesses fail to recognize in their analysis?

A. Both witnesses failed to recognize the fact that utilities have changed their dividend policy from increasing dividends each and every year to a much more conservative policy of rarely increasing dividends or only modestly increasing such dividends occasionally. Failure to recognize this change has led to an understatement in the growth component of the discounted cash flow ("DCF") analysis of both witnesses. A correction and recognition of this fact alone would significantly increase the recommendation of both witnesses.

Q. What is the problem with the Staff and Public Counsel selection of a comparable risk group?

A. Both used criteria for selection which had little or nothing to do with risk. As a result, the "comparable" companies are not comparable.

Q. What risk adjustment did both witnesses fail to make in their analysis?

A. MPS is not a publicly traded company. It is a division of UtiliCorp United Inc. ("UtiliCorp"). As a consequence, it is appropriate to analyze a group of companies to determine a recommended cost of equity for MPS. However, it is widely recognized that it is impossible to develop a precisely identical comparable group of companies. As a result, it is necessary to develop a return requirement for a proxy group (as the comparable companies are now usually described), and then calculate a risk adjustment from the return indicated for the proxy group to the subject company, in this case MPS.

Q. What about the cost of debt?

A. Both witnesses used the UtiliCorp consolidated cost of debt. In both cases, the cost of debt used contains substantial amount of international debt which, by the terms of that debt, is dedicated to and confined to use in a single country, other than the United States.

Q. What capital structure did each witness use in their analysis?

A. Each witness used the consolidated capital structure of UtiliCorp. This is incorrect as a matter of principle and, in my opinion, a regulatory policy which is fraught with potential problems. It is also a regulatory recommendation which clearly leads to incorrect results. The appropriate capital structure is the division capital structure assigned by UtiliCorp to MPS.

Q. What do you believe will be the effect if these changes are corrected in both witnesses' testimonies?

A. I believe the reflection of these changes in both witnesses' testimonies will have a significant impact both increasing the cost of equity and increasing the overall cost of capital. I believe the cost of debt in both witnesses' testimonies has been understated (the Staff witness calculated the cost of debt and the Public Counsel witness adopted the Staff cost of debt calculation) and the proper recognition of the change in dividend policy will result in a significant increase in the cost of equity.

The capital structure does not significantly impact the overall rate of return since the consolidated capital structure is very similar to the target capital structure for MPS. However, the use of a consolidated capital structure as a regulatory policy is inappropriate and a potentially dangerous regulatory decision. If the consolidated capital structure is used, it leads to bad regulatory policies since it is incorrect and it results in decisions which are unfounded and potentially very, very detrimental to customers.

UTILITY DIVIDEND POLICY

Q. Has there been a change in utility dividend policy generally?

A. Yes. For many years, from the 1970's into early 1990's, utility dividends were regularly increased from year to year under a dividend policy which was based on the notion that utilities were high dividend paying companies and thus a suitable investment for extremely conservative investors dependent on income.

Q. How has that policy changed?

A. In recent years, utilities have begun to slow, in fact almost stop regular dividend increases in order to conserve cash for capital requirements and, more importantly in recognition of the fact that high dividend pay-outs are tax inefficient and thus not the best way to help an investor realize an acceptable return from a utility investment.

Q. How difficult is it to firmly establish that utilities have changed their dividend policy?

A. It is not difficult at all. For example, UtiliCorp and its predecessor increased dividends annually from before the 1970's until 1997. Since 1997, although earnings have increased significantly, the dividend has not been increased, and it has been held at $1.20 per share for 1998 until now, and Value Line projects no future change in dividends through 2006, although Value Line projects significant increases in earnings. This is not an uncommon pattern in the utility industry.

Q. How does this impact on the cost of capital?

A. It depends on the methodology used to estimate the cost of equity. Both the Staff witness and the Public Counsel witness used the discounted cash flow model (the "DCF") as their primary tool in determining the cost of common equity. The DCF model generally states that the return associated with an investment is the expected or prospective yield on the investment, plus the growth in the dividend over the years ahead. This means that the formula is generally stated as expected dividend, plus growth in dividend.

Now that growth in dividend has been slowed almost to zero, it is clear that a zero component in the formula, all other things equal will produce a low indicated cost of equity. But a zero growth in dividend does not mean a zero growth in return or other elements that contribute to shareholder compensation. The formula simply must be modified to reflect a new primary growth <u>driver</u>. Furthermore, it means that a calculation such as the retention rate calculation for dividend growth based on historic facts is no longer appropriate in any event and that is not even arguable.

Q. What is the growth driver under this new paradigm?

A. The growth driver is earnings per share. Earnings will be growing and, other things equal, they will grow faster because less is paid out in dividends. The earnings growth is expected all other things equal to translate into growth in stock price in the same way that dividend increases under the old paradigm were expected to translate into growth in stock price. This simply assumes a reasonably consistent market moving into the future as has always been assumed in the DCF calculation.

Q. Is there evidence that the dividend per share policies of utilities have changed?

A. Yes. The Public Counsel witness has selected a group of five companies as comparable companies from which to establish a recommended return on equity for MPS. Those companies and their growth rates are shown on Public Counsel Schedule MB-8. The first section of MB-8, p. 1, shows historic growth in earnings, book value and dividends for each of the companies. Clearly, the dividend per share growth is different -- it is much lower -- from the growth in either earnings per share or book value per share. On a compound basis, dividend growth is less than one-half of the book value growth and about one-third of the earnings growth. On a projected basis, dividend growth is expected to be less than 1%, while book value growth is expected to be 4.5% and earnings growth is expected to be 6.5%. UtiliCorp, which has been included in the analysis of the Public Counsel witness, is expected to have 12.5% future earnings growth and zero dividend growth.

Since it is assumed in the DCF model that earnings and dividends grow in tandem, it is clear that a proper application of the DCF must take into consideration this significant change. It is a factual deviation from the assumptions of the DCF model which is so significant that failure to recognize the change renders work with the DCF worthless.

Q. What can you conclude from this pattern of growth rates?

A. Clearly, there is a divergence or a change in practice. Dividend growth is slowing or stopping and earnings growth is increasing more rapidly than the past. The assumption of the discounted cash flow model is that dividend growth is in lock step with earnings growth because the pay-out ratio is always the same. This is no longer true. It may have been true in the past, but not now. A proper and correct analysis must recognize the facts have changed.

Q. Does the Staff comparative group show the same pattern in reduction of dividend increases?

A. Yes. The Staff comparative companies and their growth rates are shown on Schedules 14-1 and 14-2 of the Staff witness. Schedule 14-1 shows the growth for the period 1990 to 2000. For each of the Staff comparative companies, the average dividend per share growth is 2.06 over the long period, and the earnings per share growth is 2.62. However, for the five-year period, there is a different relationship with the dividend per share growth dropping to 1.59, while the earnings growth has remained over 2% at 2.39%.

Furthermore, the earnings growth amount in the Staff calculation is substantially impacted (made much lower) by two negative observations. Also, three of the companies in the Staff group of seven have zero dividend growth for the past five years. This is a clear indication that a dividend policy is being implemented which involves a slower rate of dividend growth.

It is clear that earnings are increasing or growing faster than dividends and that the pattern is longer standing. It is so obvious that it cannot be ignored in a serious analysis.

Q. You said that the Staff earnings growth rates were significantly impacted by negative growth amounts for 1995 to 2000. What is the effect of removing those negative growth amounts?

A. The Staff calculated average earnings per share growth, including the negative observations, is 2.39%. If the negative amounts are not included in the calculation, the earnings per share growth rate is 7.2%. This is a substantial contrast to the dividend growth rate of less than 2%.

Q. Should the Staff witness have excluded the negative growth rates from his calculations?

A. Yes. By including a negative historic growth rate in the calculation, the Staff is assuming that the negative growth will continue into the future. If in fact negative growth is expected, potential investors would imply ignore the stock. They would not reduce their requirements for return but they would find better alternatives for investment. Including a negative observation in the growth calculation simply causes the results of the calculations to be biased inappropriately to the downside. It is a calculation which in no way reflects which behavior.

Q. Has the Public Counsel witness included negative growth rates in their calculation?

A. No.

Q. What conclusion can you draw from this difference in growth rates?

A. Under the DCF assumptions, growth in earnings and dividends are assumed to be locked together, both increasing and decreasing at the same rate. This is not true today. The dividend growth rate has not slowed because of a slowing in earnings growth. It is slowing because of a deliberate policy which is different from past policy. The DCF model assumes the dividend growth rate would be the same as the earnings growth rate. Clearly, it is not. The dividend growth rate is much lower than the earnings growth rate. As a consequence, it is only reasonable and appropriate to conclude that a dividend growth policy of the underlying companies has changed and must be accommodated in a reasonable analysis.

Q. The Staff also includes UtiliCorp data in its analysis. What has been UtiliCorp's dividend policy?

A. UtiliCorp has paid the same dividend since 1998 and, for the two years prior to that, paid the same amount. In other words, it has increased the dividend only one time in the past five years and that was three years ago. Also, the Staff witness, on his Schedule 17, provides its estimate of UtiliCorp's future dividend and it expects no increase in dividends from the current amount. UtiliCorp has, however, paid dividends every year since 1939 and has increased those dividends almost every year at least from the 1970's until 1998. Clearly, this is a change in policy which must be taken into consideration in a DCF calculation.

Q. Do you have any other observations with respect to the dividend yield component of the Staff calculation?

A. Yes. Both the Staff and the Public Counsel witness made an analysis of the UtiliCorp data in reaching their conclusions on return on equity. Presumably that analysis and that set of calculations with respect to UtiliCorp played a role in establishing the cost of common equity they recommended.

As shown on the Staff witnesses Schedule 17, the UtiliCorp price used in the calculation was $32.67. Since that calculation was made, the UtiliCorp stock price has dropped substantially into the $20 to $25 range. As a consequence, the dividend yield if calculated using the current data would be significantly greater than the dividend yield calculation included in the Staff computations. This would lead to a higher return on equity indication from the DCF analysis of the UtiliCorp data. As a result, if the UtiliCorp data really played any role in reaching the conclusions recommended by the Staff and Public Counsel, the recommendation needs to be increased to reflect this change in stock price.

Q. What would be the actual impact of substituting the more current data for UtiliCorp stock prices into the calculation?

A. The dividend yield calculated on the basis of $1.20 per share and $32.67 as a stock price is 3.7%. If $25 per share and the same $1.20 dividend is used, the dividend yield is 4.8% or an increase of 1.1 percentage points. This is a substantial amount and this difference should be reflected in the DCF recommendation.

Q. Is there any other public data which indicates that dividend policies have changed?

A. Yes. The Internet has numerous articles about dividend policy and changes in that policy over the past several years. An article from MSN Money Central dated June 1, 2001 indicates that analysts at one time argued in favor of dividends but now believe that dividends are no longer a useful indicator of value. Dividends " have fallen out of favor because the pay-outs are taxed twice . . . and investors looked to appreciation and share prices for a larger and larger part of their investment gains."

Q. Are there any other articles which indicate how widely the information on the change in dividend policy has spread?

A. Yes. Time.com, on February 2, 1998, published a brief piece on disappearing dividends. It states, among other things:

> "In this so-called new era for investing, perfectly healthy electric utility companies, the widows and orphan stocks long known for their generous dividend policies, have been slashing their pay-out rates without a trace of remorse. . . . There are powerful pro-investor arguments for dumping the dividend. One is that many investors reinvest dividends anyway and incur transaction costs to do so, but the main argument is that dividends are taxed as ordinary income."

Q. Have you accumulated any information with respect to utility pay-outs which supports this conclusion?

A. Yes. I went to Market Guide Provestor Plus for UtiliCorp. Market Guide selects a group of companies it believes comparable to the company under consideration. The company selected here was UtiliCorp and the comparable companies were primarily electric utilities. From the comparable utilities, Market Guide calculates industry average standards to compare the subject company to. These industry average standards show that the industry average dividend growth rate for the past five years is negative and that UtiliCorp's is less than 1%.

Q. How does this difference impact the calculation procedure?

A. The difference in dividend policy if not properly recognized leads to a substantial understatement of the estimated cost of equity. Specifically, the dividend growth rate, a significant component of the DCF calculation, is much lower today because of a conscious policy of utility companies. This conscious policy leads to higher growth in earnings and higher overall returns for shareholders. However, unless it is properly recognized in the calculation, the change in policy results in an artificially low recommenced return on equity by incorporating a variable in the calculation which is not relevant.

Q. Do you have any comments about the Staff data?

A. Yes. The Staff data includes a calculation procedure which distorts the growth rates as a group.

Q. Please explain.

A. There are too many averaging of averages included in the Staff calculation. The Staff's Schedule 14-1 and Schedule 14-2 are averaged together on Schedule 14-3. That data is taken to Schedule 15 and averaged together with five other growth amounts. The averaging, particularly of the Value Line data, including the negatives and the low dividend per share growth results in a distortion of the final average amount.

Q. Does this show up in the data on Schedule 15?

A. Yes. The averaged data which is brought forward from Value Line averages 1.72%. All of the other non-averaged data about 6% or more. As a consequence, it is clear that the averaging and including negatives reduced the result by over four percentage points.

THE SELECTION OF THE COMPARABLE RISK GROUP

Q. Are there any problems associated with the Staff and Public Counsel comparable risk group?

A. Yes, there are two problems. The first is that the methodology employed by both the Staff witness and the witness for the Public Counsel do not actually focus on risk in spite of the fact that they claim to. Secondly, once the return was calculated for the proxy companies, that return was simply applied to MPS without consideration of any risk analysis or risk adjustment as is required in this type of analysis. This is especially true in light of the selection process.

Q. What is the proper way to complete an analysis of this type?

A. The proper way is to select a proxy group of companies, paying attention to the extent possible, to comparability between the proxy companies and the subject company. By paying attention, I mean selecting companies of the same type and similar size which have similar risk characteristics knowing full well they are not identical. Secondly, once an analysis is completed and a proxy group is selected, that analysis produces a result which should be considered a benchmark. The risk differences between the proxy group and the subject company should then be measured. This measurement is done by using a standard deviation. This is a typical approach which is considered standard financial practice. Based on this calculation, a risk adjustment is made to the benchmark return to connect the cost calculated for the proxy group to one that is appropriate for the subject company.

Q. Why do you say that the companies were not selected on the basis of risk differences or risk characteristics?

A. The Staff witness selected his companies or proxy group on the basis of seven criteria. The criteria are as follows:

- Stock publicly traded;
- Information printed in Value Line;
- No Missouri operations;
- Ten years of data available;
- 70% of revenues from electric;
- Total capitalization less than Five Billion;
- No nuclear operations.

Source Staff Schedule 12.

The Public Counsel witness identified its selection criteria on page 34 of Appendix G. The selection criteria used in selecting the Public Counsel "comparable" group is as follows:

- Publicly traded company;
- No Missouri operations;
- Covered by Value Line;
- At least 70% of revenues from electric;
- Total revenues less than Four Billion;
- Standard & Poor's bond rating between BBB+ and AA-.

Q. Which portions of these selection criteria are not risk related?

A. Clearly, the fact that the information is printed in Value Line is not a risk characteristic of the company or its operations. The fact that a company has data in Value Line or does not have data in Value line should not affect the company's ability to produce earnings, nor the variability of those earnings.

Q. In this context, what is risk?

A. Risk is the measure of the predictability of earnings. Earnings are usually projected to vary in the future. The greater the variation expected, the greater the risk. Because we have no way to truly predict the future, we measure the variability of earnings in the past, assuming that to some degree past patterns will be repeated. Past variability is the equivalent of risk because the more variable earnings, the less predictable they are. The less predictable the earnings, the greater the risk.

Q. Is the fact that a company's data is not printed in Value Line a measure of risk?

A. No. It simply can't be a measure of risk.

Q. Do both witnesses used that as a criteria in their selection process?

A. Yes.

Q. What other criteria do not impact risk?

A. Clearly, whether or not a company is publicly traded has no impact on the company's risk profile. It may have an impact on the company's stock price, but it does not have an impact on the company's ability to generate predictable earnings.

Q. Are there any others that have absolutely no relationship to risk?

A. The fact that the companies were selected on the basis of whether or not they had Missouri operations in my opinion has no impact on risk.

Q. Are there any other factors which impact risk?

A. In the case of the Staff analysis, the fact that ten years of data are available for his analysis does not affect the risk of the company's operations. It is simply a matter of convenience to the analyst and not a method for selecting comparable companies.

Q. Have you examined the companies produced by this selection process?

A. Yes. The Staff witness produced a group of seven companies. The group is as follows:

- DPL, Inc.
- DQE, Inc.
- Hawaiian Electric
- IDACORP
- INSTAR
- Potomac Electric Power
- Puget Energy, Inc.

Source Staff Schedule 14-1.

The process employed by the Public Counsel witness produced a group of five companies which include the following:

- DPL, Inc.
- Hawaiian Electric Industries

- IDACORP, Inc.
- INSTAR
- Potomac Electric Power

Q. On their face, are these companies comparable to MPS?

A. Based on my review of the Value Line reports for each of these companies, I believe there is a serious question about comparability. I base that conclusion on the following:

DPL, Inc. is the parent company of Dayton Power & Light Company. It is a holding company. DPL, Inc. has recently embarked on a major non-utility diversification effort. It is also operating in a deregulated environment and has sold its gas distribution business. It is also the owner of a 1.2 Billion Dollar investment portfolio.

DQE, Inc., according to Value Line, is a multi-utility delivery and services company, with ventures and partnerships in the U.S. and Canada. Value Line does not recommend this company and states its equity is trading near a ten-year low with the possibility of a dividend reduction to enhance cash flow.

Hawaiian Electric is in fact the parent company of Hawaiian Electric Company but also the parent company of American Savings Bank. As an electric utility, it serves a number of islands which have a completely different operating and cost characteristics than a company such as MPS. Furthermore, because of the climate, it may be a much less risky company than MPS.

IDACORP is the holding company for Idaho Power, which Value Line describes as a hydro electric utility that partly owns three coal plants and markets natural gas. As a hydro electric utility (41% of output), it has a much lower risk profile than a predominantly coal fired company. Furthermore, it is a substantial purchaser of power at 21% of its supply. Purchase is a less risky position than generating if the purchase contracts are carefully developed.

INSTAR is a holding company for Boston Edison Company. This company is significantly larger than MPS, serving 1,044,000 electric customers and 244,000 gas customers. It sold all of its producing plants in 1998. As a purchaser, it has a completely different risk profile than MPS, which is a generating electric utility of more modest size.

Potomac Electric Power Company supplies 719,000 customers in Washington, D.C. It also purchases a significant percentage of its requirements and is in the process of a substantial merger.

Puget Energy is a holding company for Puget Sound Energy, which sells electric and gas to 1.2 million customers, again significantly larger than MPS. It was involved in a merger with Washington Energy in

February of '97 and purchase power amounts to 75% of its supply. The company is in a financial emergency and is not recommended by Value Line.

In sum, there is not much correspondence between these companies and MPS.

Q. Does this mean that in your view the Staff and Public Counsel effort in this analysis is wasted?

A. I think a better group of comparable companies could have been selected. However, if a proper risk adjustment from this group to MPS is calculated, the analysis can be corrected.

THE PROPER RISK ADJUSTMENT

Q. What is the appropriate methodology to address the differences between the comparable companies or proxy group and the subject company or, in this case, MPS?

A. The proper approach is to perform a quantitative risk comparison between the group and MPS. That is done by comparing the variability of income of MPS with the variability of income of the comparable group. That is the only way to make a risk comparison in this context and the use of beta as used by the Public Counsel witness is inappropriate in a risk comparison for a single company as compared to another single company or small proxy group.

Q. Have you made such calculations?

A. Yes sir I have.

Q. What are the results of those calculations?

A. The results of the analysis are as follows:

Missouri Public Service
Risk Analysis

	MPS	Public Counsel Group	Staff Group
Standard Deviation	.92	.33	.27
Coefficient of Variation	9.15%	4.27%	3.51%

Q. What does this risk analysis show?

A. Specifically, the higher the standard deviation in this comparison, the greater the risk. Also, the higher the coefficient of variation, the greater the risk. The standard deviation is stated in units being measured, in this case percentage points, and the coefficient of variation is a percentage amount. Both of these calculations show that MPS has greater risk than either the Public Counsel or Staff group.

Q. Please be more specific.

A. The calculations show that the standard deviation for MPS rate of return for the past five years is greater than the standard deviation of the Public Counsel group or the Staff group. When the coefficient of variation is calculated, MPS has a greater coefficient of variation than the Public Counsel group or the Staff group. This means that MPS has greater risk in total than either the Public Counsel group or the Staff group.

Q. What does this indicate as a requirement?

A. Since MPS has greater risk than these two groups, it is appropriate, in fact necessary, to adjust the generic return indicated by an analysis of the proxy groups upward to reflect the greater risk of MPS.

COST OF DEBT

Q. What is the issue with respect to cost of debt?

A. The cost of debt has been established by the Staff witness on his Schedule 10-1. The cost of debt calculated on that Schedule is 7.35%. This compares to the cost of debt proposed by MPS in this proceeding of 7.906%.

Q. What cost of debt has been proposed by the witness for the Public Counsel?

A. The Public Counsel witness has adopted the calculation of the cost of debt made by the Staff witness.

Q. Is there a problem associated with the calculation of the Staff cost of debt?

A. Yes. UtiliCorp has a process for allocating long term debt to the individual divisions based on a permanent assignment of long term debt to the individual divisions based upon the need of the division. This process results in an assignment of debt to individual divisions based on customer requirements and leads to a cost of debt which reflects the actual costs at the time the customers required that debt be acquired.

Q. Is anything wrong with the cost of debt proposed by the Staff and calculated on Staff Schedule 10-1?

A. Yes. It is the consolidated cost of debt or the cost of all of UtiliCorp's debt, both foreign and domestic. The primary problem is that the Staff calculation includes a substantial amount of debt properly assigned to other divisions and a substantial amount of international debt which is much lower in cost because it is short term or floating rate. Exposing the MPS customers to this debt means that if international long term interest rates increase, Missouri customers will be required to have higher rates simply to pay for higher costs of long term debt associated with operations in New Zealand or Australia or Canada or Great Britain.

Furthermore, the Australian and New Zealand long term debt is loaned to the company under the terms of an indenture for each of the issues which requires that that debt be used solely within the borders of the country and for a specific purpose. This particular lending requirement is different than that used in the United States.

I have attached as JCD-11 selected pages from a lending agreement in Australia which shows the constraint on UtiliCorp and clearly demonstrates the fact that international debt cannot be used outside of the company of origin.

THE CAPITAL STRUCTURE ISSUE

Q. Please state the issue as it relates to capital structure.

A. MPS is a division of UtiliCorp. UtiliCorp is an international electric gas utility with operations in North America, Europe, New Zealand, Australia and Jamaica. In North America, UtiliCorp has electric and natural gas divisions which supply at retail electric and gas service to customers in both the United States and in Canada. MPS is a division of UtiliCorp and it provides electric service to a certificated area in Missouri.

Early in its operations, UtiliCorp recognized that it would have different business activities, both inside and outside of the utility business. Because each of those divisions required a different mix of capital to properly support its activities, UtiliCorp established a capital allocation process under which appropriate amounts of debt and equity were allocated to each of its divisions so that the divisions would be appropriately financed and consequently would be able to provide service to their customers at reasonable prices. The allocation of capital in this manner is consistent with contemporary finance theory and the practices of most financially sophisticated companies. The UtiliCorp process has been reviewed by regulatory agencies, by its auditors, and by financial analysts. It has been concluded that the process is reasonable and that if UtiliCorp were to employ a lesser process, such as the use of the consolidated capital structure, it would indicate a poorly managed company unable to properly capitalize its activities and unaware of appropriate risk levels and financial requirements for its various activities. This would be unacceptable to financial analysts and most likely would impair the ability of the company to raise equity.

In this case, MPS has proposed that its allocated capital structure be employed in determining the cost of capital. That allocated capital structure consists of 48% common equity and 52% long term debt.

Q. What has the Staff and Public Counsel proposed?

A. In contrast, the Staff witness and the Public Counsel witness have both decided to use the consolidated capital structure to calculate the cost of capital for MPS.

Q. Why did they select the consolidated capital structure?

A. The only reason which I can find in the direct testimony of the Public Counsel witness is the fact that to invest in MPS it is necessary to invest in UtiliCorp as a whole and then UtiliCorp must allocate the capital to MPS. He concludes that as a consequence of this fact, i.e. that MPS is not publicly traded, it is appropriate to use UtiliCorp's capital structure. (See page 5, lines 9-12.)

The Staff witness used the consolidated capital structure for exactly the same reason as stated on page 21, lines 10-14 of his direct testimony.

Q. Is this an issue involving substantial amounts of revenue requirement?

A. The consolidated capital structure is very similar to the assigned capital structure. The issue is a matter of principle and correctness and the dangers associated with employing a regulatory policy, i.e. the consolidated capital structure policy, which is incorrect.

Q. What is the matter of principle involved in the decision with respect to the capital structure?

A. It is appropriate to use correct financial and regulatory principles in reaching regulatory decisions regardless of the impact of those decisions on the cost of service. The cost of service impact of this particular decision is not great at this time but it is clearly incorrect and in other time periods a consolidated capital structure approach may yield wildly inappropriate results.

Q. What is the over-riding principle involved in choosing the correct capital structure?

A. The correct capital structure involves matching the activities of the company with the financial structure to balance the total risk of the company in a manner consistent with industry practices.

Q. Please explain.

A. The total risk of a company or what is usually called shareholder risk is the sum of financial risk and business risk. Business risk is the risk which arises from the operation of the company's assets, the sale of its product, and the inherent uncertainty of doing any business regulated or otherwise. Financial risk, on the other hand, concerns the use of leverage in the capital structure. As leverage or debt is added to the capital structure, financial risk is increased. This financial risk is added to business risk to develop total risk for the company. The total risk of this company should equal or tend toward the total risk of its peers. Therefore, it should have a capital structure similar to the capital structure of its peer group.

Q. Is the target capital structure or division capital structure set for MPS by the process of capital allocation employed by UtiliCorp typical for its electric utility peer group?

A. Yes sir it is. The capital structure for MPS has been developed by analyzing a peer group of electric utilities and establishing the appropriate capital structure for an operating electric utility in the mid-west.

Q. Is the consolidated capital structure necessarily equal to the capital structure required for the appropriate operation of MPS?

A. No. As explained in my direct testimony, the consolidated capital structure is simply the addition of all of the capital structures of all of the company's activities. It is only a coincidence that a consolidated capital structure would be precisely equal to the division capital structure or a subsidiary capital structure for a complex operating company such as UtiliCorp.

Q. Much has been made in the Staff and Public Counsel testimony of the riskiness of UtiliCorp's other activities. What are UtiliCorp's other activities?

A. The vast majority of UtiliCorp's other activities are utility activities in the United States, Canada, and other countries. UtiliCorp also has utility-related activities, such as marketing and utility construction. UtiliCorp does not have wildly different corporate activities, nor does it have a complicated capital structure.

Q. Are there negative impacts associated with the application of bad regulatory policy?

A. Yes. When a regulatory decision is predicated on an incorrect input, it is entirely possible that bad results will be produced. In the case of the consolidated capital structure, a portion of the cost of service, the rate of return, will vary as a function of the company's capital structure on a consolidated basis rather than as a function of the specific risks associated with the operating utility. This means that if UtiliCorp were to change its mix of business and consequently change its consolidated capital structure, the revenue requirement for the utilities if a consolidated capital structure were used in ratemaking would change even though the utilities may not have changed one iota. This means that other activities of the company would be determining the cost of capital and overall revenue requirement for the utility operations. This is clearly inappropriate for a company such as UtiliCorp with geographically diverse utility activities, each of which has an appropriate cost of capital and cost of service.

Q. Are there any other dangers associated with using the consolidated capital structure?

A. I believe there is one very grave danger which strongly suggest that the consolidated capital structure not be used. The danger is associated with viewing the company as a whole rather than viewing the company in its discrete parts. MPS is a discrete part of UtiliCorp. It has an individual risk profile. UtiliCorp, on the other hand, has a risk profile which is different from the risk profile of MPS. The Commission, in my opinion, would not want the activities of the company blended together in such a way as to develop subsidies between all of UtiliCorp and its regulated parts, nor would it want the company viewed in such a way as to disguise the risks of all of UtiliCorp and its individual parts.

Q. Earlier, you indicated that financial analysts would view a company as unsophisticated and perhaps not entitled to appropriate amounts of capital if it did not have a capital allocation system. Please explain what you mean.

A. UtiliCorp is a complicated company. Unless the pieces of UtiliCorp are isolated and viewed in isolation, both in terms of capital requirements and capital mix, it is impossible to understand the individual requirements and, when they are added together, the total corporate requirements. Without a good system of capital allocation, it would only be by chance that a company such as UtiliCorp had an appropriate capital structure and it would only be by chance that the company in total earn an amount or had target earnings expectations in an amount equal to a level appropriate for the sum of al of the company's risks. As a result of these facts, financial analysts require companies to maintain capital mixes and capital tracking procedures which are appropriate to the times and the state of financial knowledge. Analysts would not recommend the company for purchase based on the fact that it did not know and apply contemporary financial tools to the operations of its business.

Q. You said that both the Staff witness and the Public Counsel witness claimed that it was appropriate to use the consolidated capital structure because the funds to MPS are obtained from UtiliCorp who in turn obtains those funds on a consolidated basis. How do you respond?

A. Is this not an appropriate analysis?

Q. Why not?

A. The selection of a capital structure impacts the cost of capital. The cost of capital is in no way related to the source of capital. The cost of capital is functionally related to and absolutely determined by the risks experienced by that capital in its actual deployment. If I owned $1.00 of UtiliCorp equity, that equity would have a cost associated with the risks related to the UtiliCorp operation. If that $1.00 of equity was in my pension fund managed by a bank, precisely the same would be true and the fact that the fund was operated by a bank and that the direct immediate source of capital to UtiliCorp was a bank rather than an individual or a pension fund or a mutual fund would have no impact whatsoever on the cost of capital because that capital cost is solely a function of the risk of UtiliCorp.

These matters are absolutely well established and not even controversial. Risk determines return requirement, not ownership. To say otherwise is to absolutely reject all of contemporary financial analysis.

Q. Is there a direct connection between UtiliCorp's cost of capital and the cost of capital of MPS?

A. Yes. The cost of capital of MPS determined in isolation based on the relevant facts associated with MPS is a weighted component of UtiliCorp's overall cost of capital. UtiliCorp's overall cost of capital is the sum of the weighted average cost of capital of each of its activities, including MPS.

A COMMENT ON SUBSEQUENT EVENTS

Q. Have there been substantial changes in capital costs and overall economic activity since September 11, 2001?

A. Yes. Everybody in this country is aware of the tragic events of September 11th. Those events had far-reaching impacts, including forcing an economy which was on the brink of recession into a substantial recession. This recession has precipitated a significant reaction by the Federal Reserve Bank reducing interest rates. However, it has been and is widely expected that the recession which is now officially in place will be replaced by renewed economic growth and activity in the second quarter of next year (2002). The massive reaction of the Federal Reserve to the slow down and economic activity has many analysts concerned that there will be an inflationary reaction to the Federal Reserve's recent policy of reducing interest rates. If there is an inflationary reaction, it is highly likely that the cost of equity will increase from almost the day the rates in this proceeding are authorized and for the duration of those rates. The Commission should take this into consideration when reaching its decision on return in this case.

Mallesons Stephen Jaques
SOLICITORS

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Facility Agreement

Dated 5 December 2000

UtiliCorp Asia Pacific Pty Ltd
and
Westpac Banking Corporation

Mallesons Stephen Jaques
Solicitors
Rialto
525 Collins Street
Melbourne Vic 3000
Telephone (61 3) 9643 4000
Fax (61 3) 9643 5999
Ref: AJH
MELBOURNE/ 0327709.01

Facility Agreement
Details

Interpretation – Definitions are at the end of this agreement before the schedules.

Parties	Company and Financier, each as described below.	
Company	Name	UtiliCorp Asia Pacific Pty Ltd
	ABN	17 086 824 142
	Incorporated in	Victoria
	Address	Level 13 101 Collins Street Melbourne Vic 3000
	Fax	(03) 9222 9144
	Telephone	(03) 9222 9186
	Attention	Matt Giesecke
Financier	Name	Westpac Banking Corporation
	ABN	33 007 457 141
	Address	Level 10 360 Collins Street Melbourne Vic 3000
	Fax	(03) 9670 4875
	Telephone	(03) 9608 3394
	Attention	Robert Spee, Director, Utilities and Resources
Facility	Facility Limit	A$75,000,000 as reduced by the total of all cancellations, prepayments and repayments under this agreement.
	Availability period	The period commencing on the date of this agreement and ending on 8 December 2000.
	Maturity Date	31 January 2001.
	Margin	1.10% per annum
	Interest Rate	Bank Bill Rate plus the Margin.

	Interest Period (clause 3)	1 or 2 months (or such other period to which the Financier agrees), subject to clause 3.2 ("Notification of Interest Period").
	Purpose	To fund the purchase of securities and common shares from Subsidiaries of the Guarantor.
	Drawdown	Minimum of A$5,000,000 and a whole multiple of A$1,000,000.
	Prepayment (clause 4)	Prepayments of at least A$1,000,000 or a whole multiple of A$1,000,000 are permitted without break costs (see clause 15.3 ("Items included in loss, liability and Costs")) on the last day of the Interest Period of the relevant Drawing if notice is given by 11am on or before the 10th Business Day before the last day of the Interest Period.
Fees (also see clause 8)	Commitment fee	an amount equal to 40% of the Margin which would be applicable on each day from the date of this agreement until the date the Undrawn Facility Limit is cancelled under clause 7.1 ("Automatic Cancellation"), calculated on the daily balance of the Undrawn Facility Limit and using a 365 day year.
Transaction Documents		include: • this agreement • any Drawdown Notice • any Selection Notice • the Guarantee
Business Day place(s)		Melbourne and Sydney
Governing law		Victoria
Date of agreement		See Signing page

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Missouri Public Service 672	)	Case No. ER-2001-
of Kansas City, Missouri, for authority	)	
to file tariffs increasing electric rates	)	
for service provided to customers in the	)	
Missouri Public Service area	)	

County of Johnson)
) ss
State of Kansas)

AFFIDAVIT OF JOHN C. DUNN

John C. Dunn, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of John C. Dunn;" 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.

John C. Dunn

Subscribed and sworn to before me this 7th day of January, 2002.

Peggy A. Ernst

Notary Public

My Commission expires:

April 21, 2004

NOTARY PUBLIC STATE OF KANSAS PEGGY A. ERNST My Appt. Exp. 4-21-04